

Domestic Monetary Policy.

Part 7

ECONOMIC POLICY

Part 1: May 1979

Part 7: December 1980

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
<del>8.12.80</del>							
<del>9.12.80</del>							
<del>17.12.80</del>							
<del>22.12.80</del>							
<del>31.12.80</del>							
<del>27.1.81</del>							
<del>4.2.81</del>							
<del>11.2.81</del>							
<del>19.2.81</del>							
<del>23.2.81</del>							
<del>6.3.81</del>							
<del>5.3.81</del>							
12.3.81							
<del>ends</del>							

PREM 19/4/80

PART 7 ends:-

12. 3. 87

PART 8 begins:-

18. 3. 87



H M Treasury  
Parliament Street London SW1P 3AG

Switchboard 01-233 3000  
Direct Dialling 01-233 .....

P E Middleton  
Under Secretary

~~These charts~~ p. 2

These charts  
show clearly  
that the

balance of payments

M<sub>0</sub> and M<sub>1</sub> -

have grown  
more slowly

than M<sub>3</sub>.

Dear Tim,

I attach some more

charts. The PM might like  
to read the note which goes  
with the ones you have got.

12

Yours  
PEM

1 4.

## INDEX TO CHARTS

### A. VELOCITY

- A1 Log of base velocity
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- D4 £M3, PSL1, PSL2; rates of change

E. TRACKING PERFORMANCE OF DEMAND FOR MONEY EQUATIONS

E1 M1

E2 £M3

E3 PSL1

E4 PSL2

F. EFFECTIVE EXCHANGE RATE AND MONEY

F1 Mo

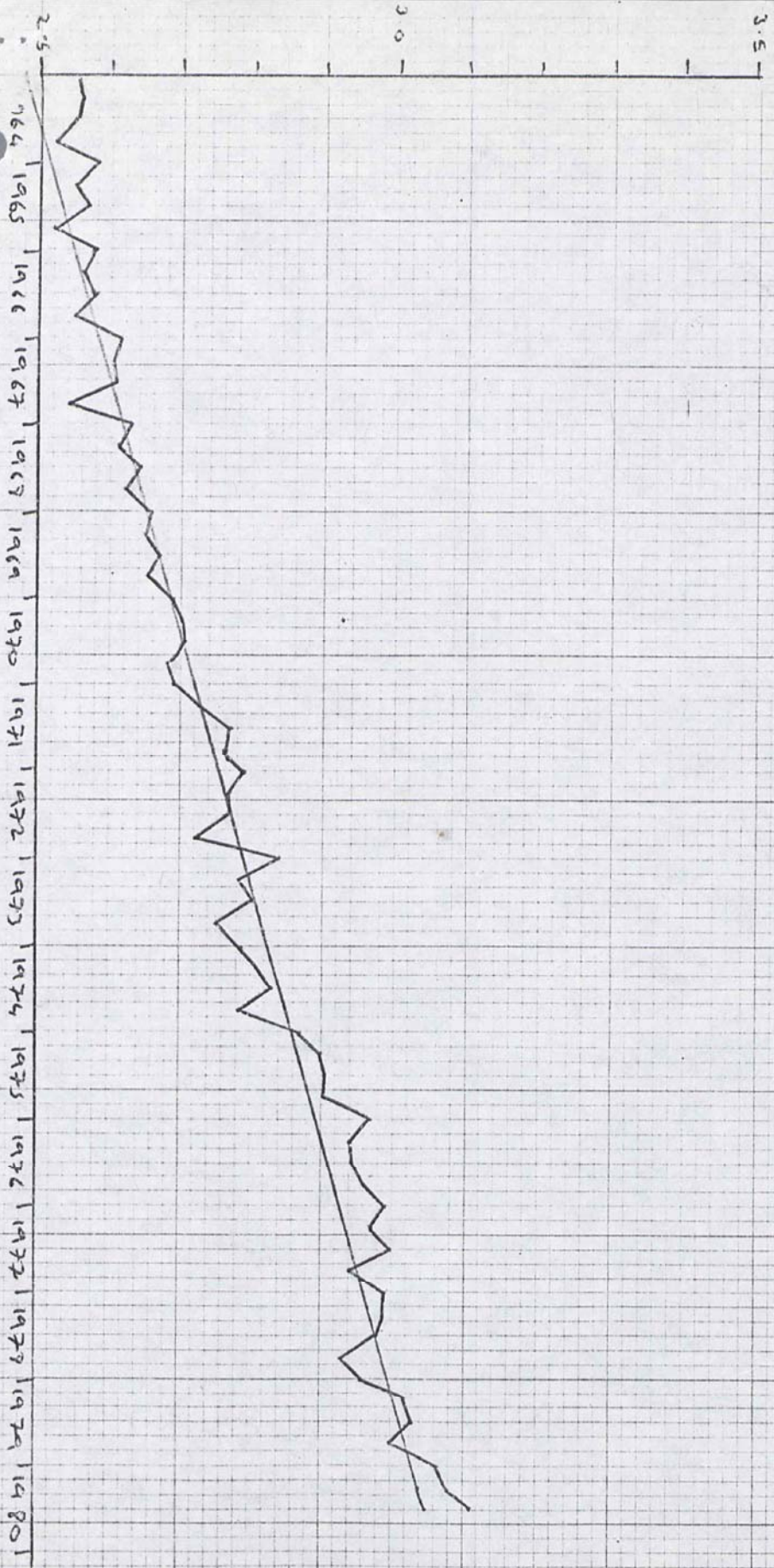
F2 M1

F3 £M3

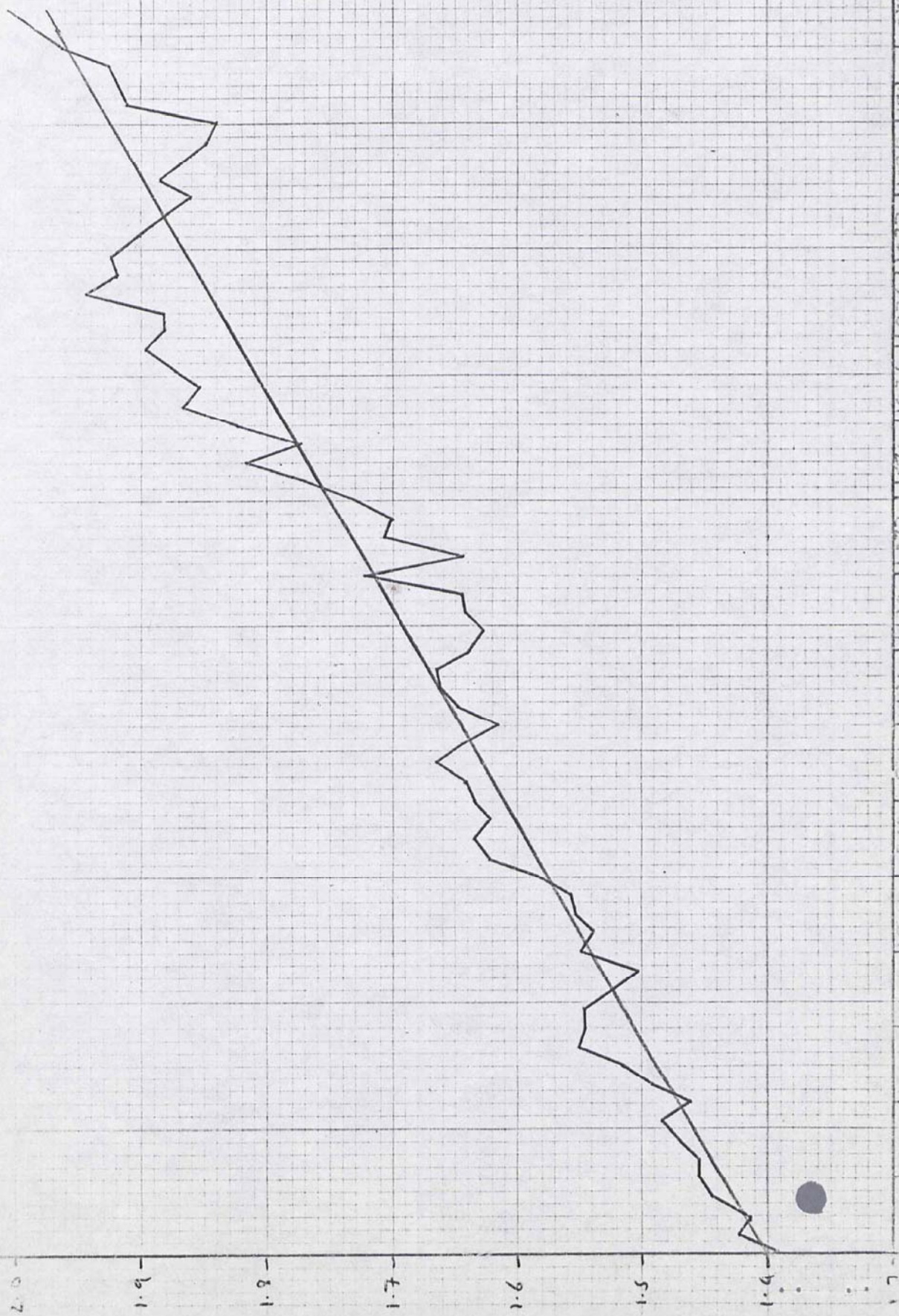
F4 £/¢ AND Mo

A1 BASE VELOCITY

409

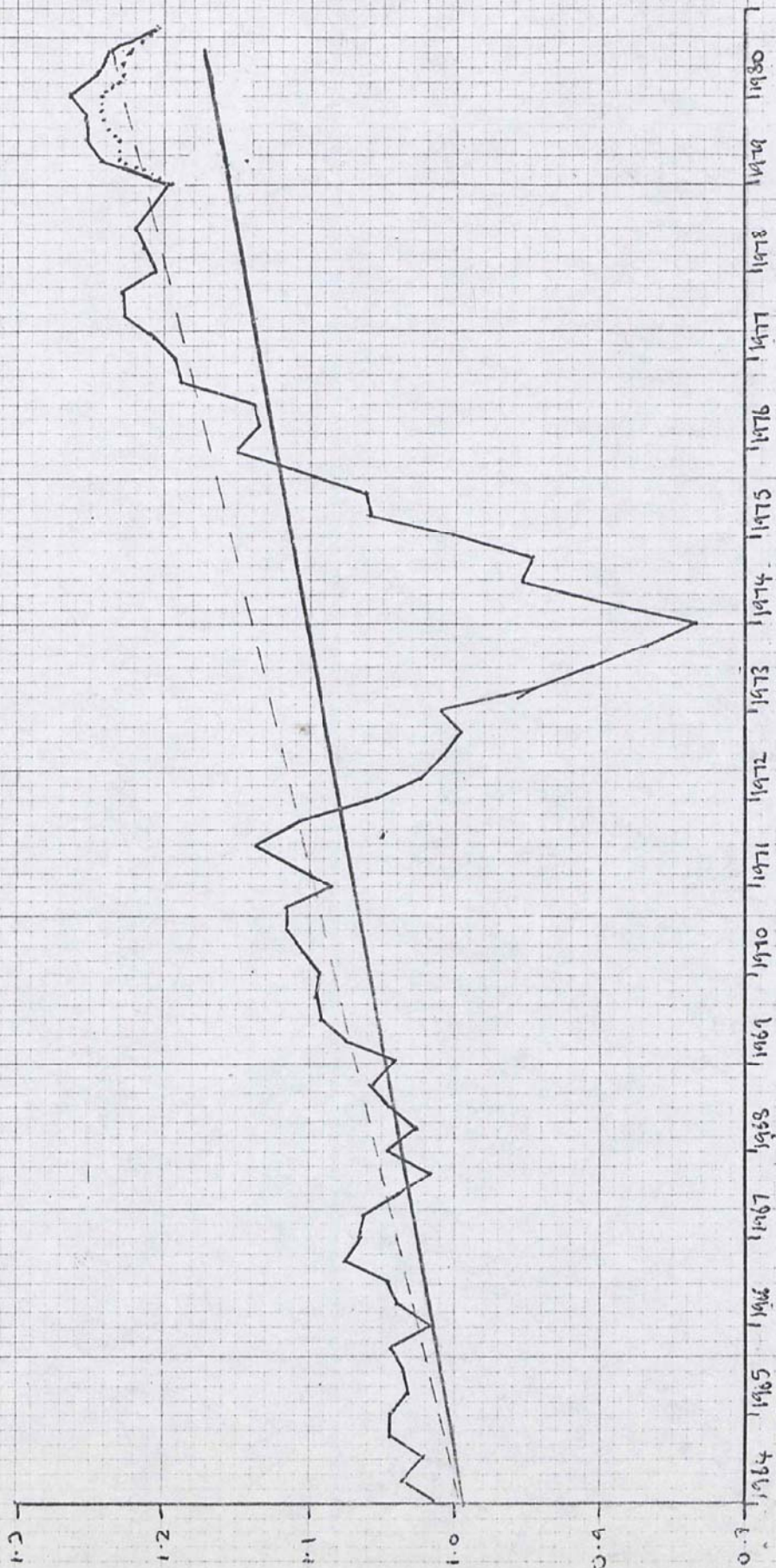


A2 M1 VELOCITY



A3 & M3 VELOCITY

.....corset adjusted

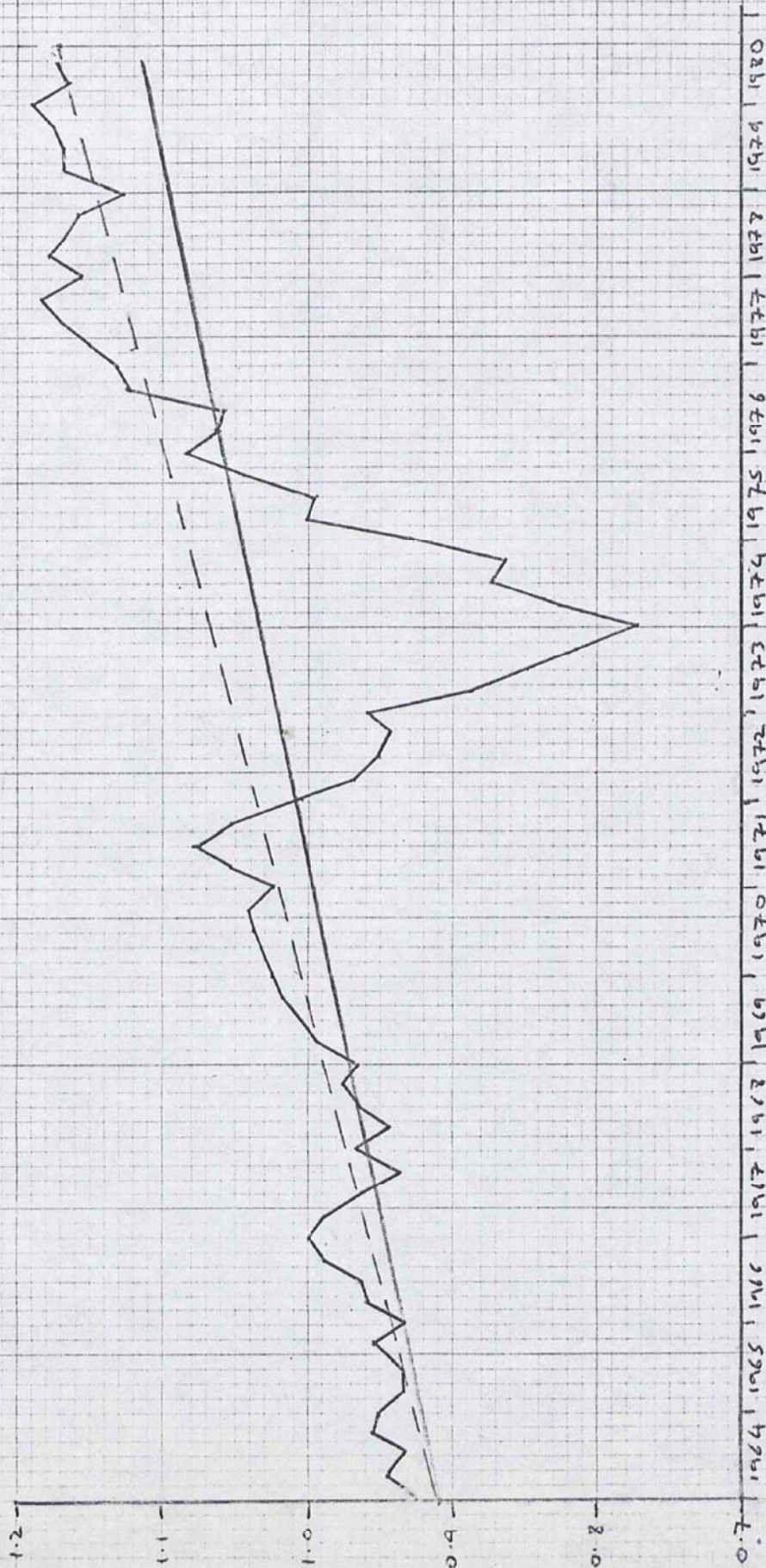


159

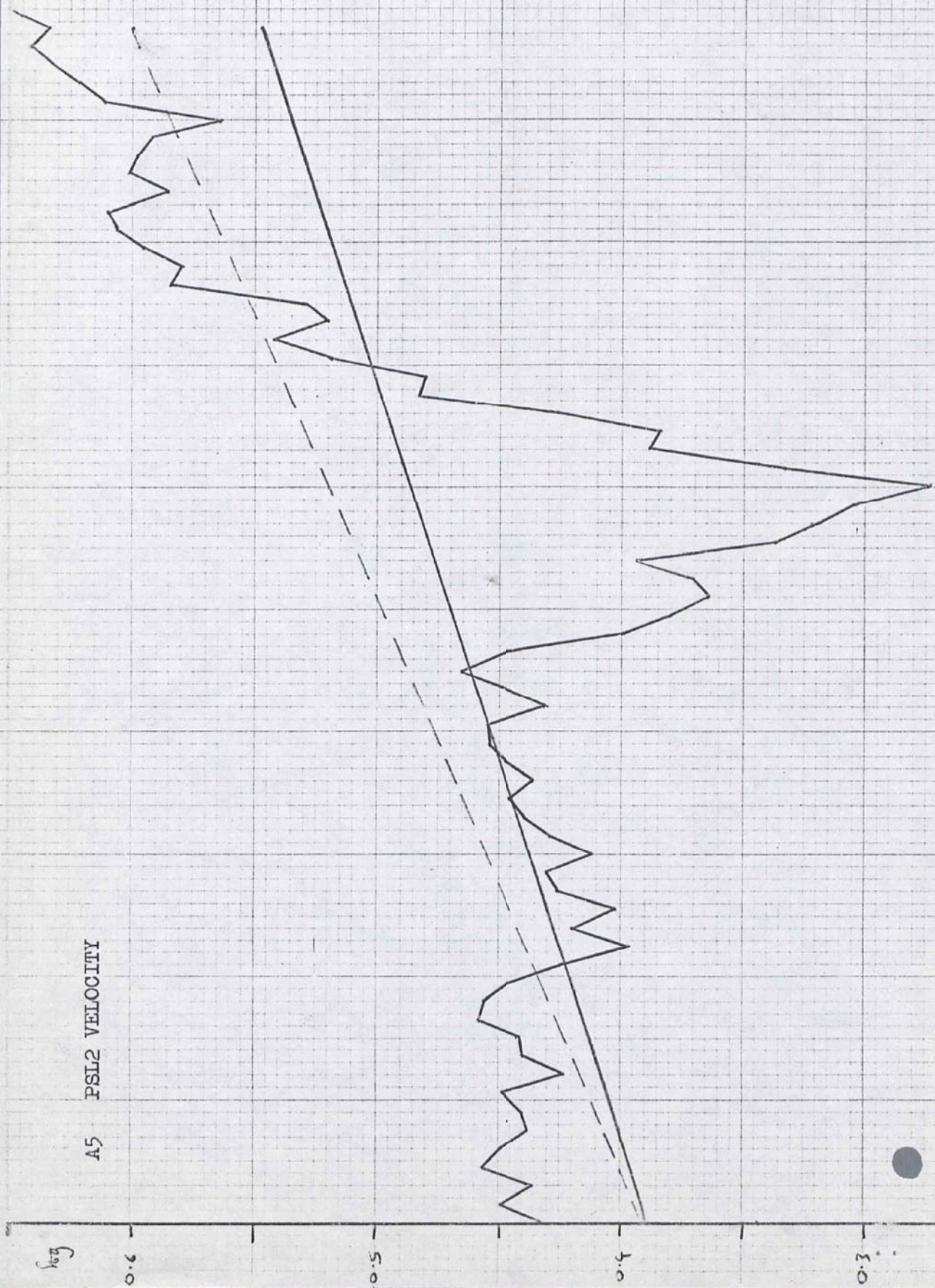


A4 PSL-1 VELOCITY

leg

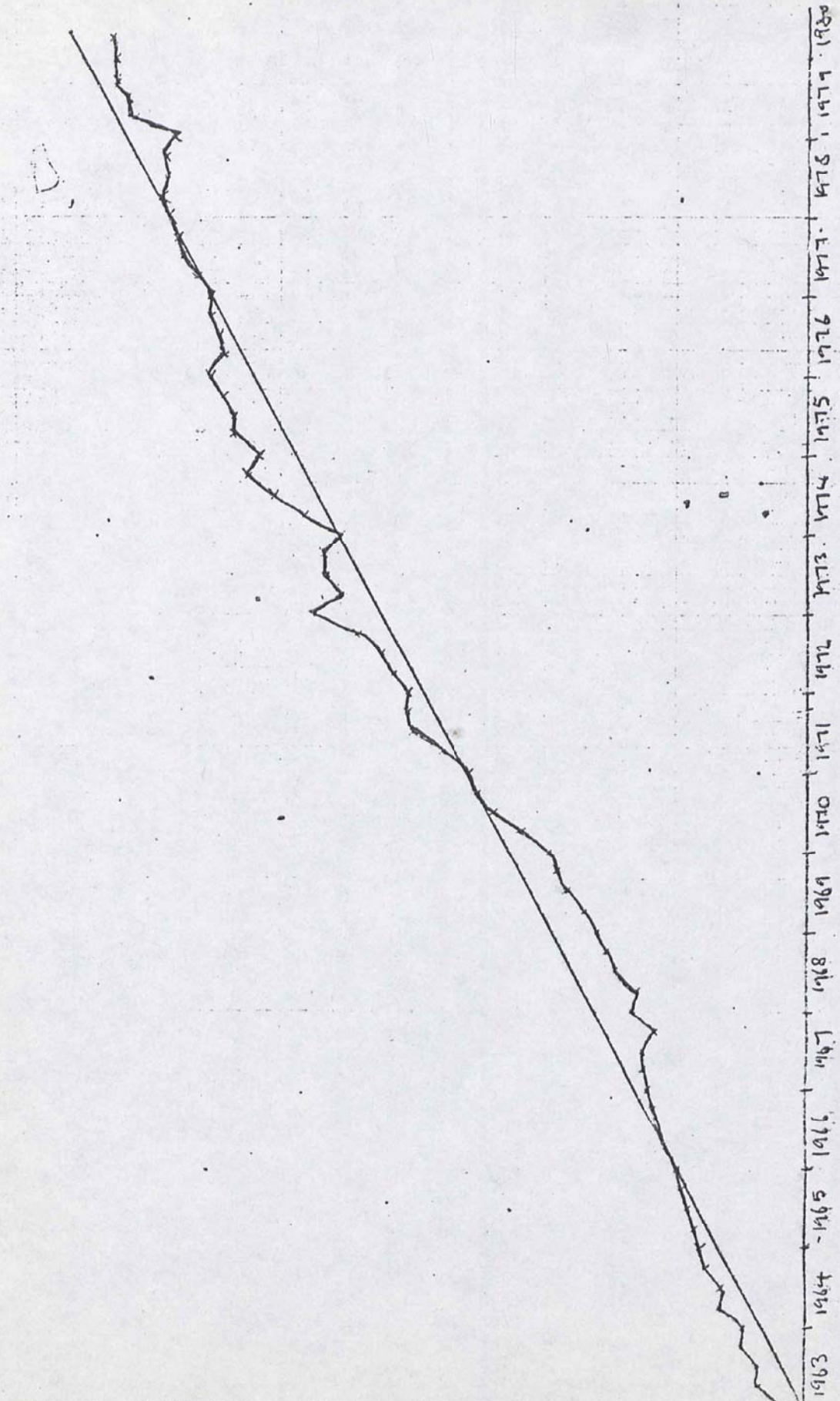


A5 PSL2 VELOCITY



A6 PSFI VELOCITY

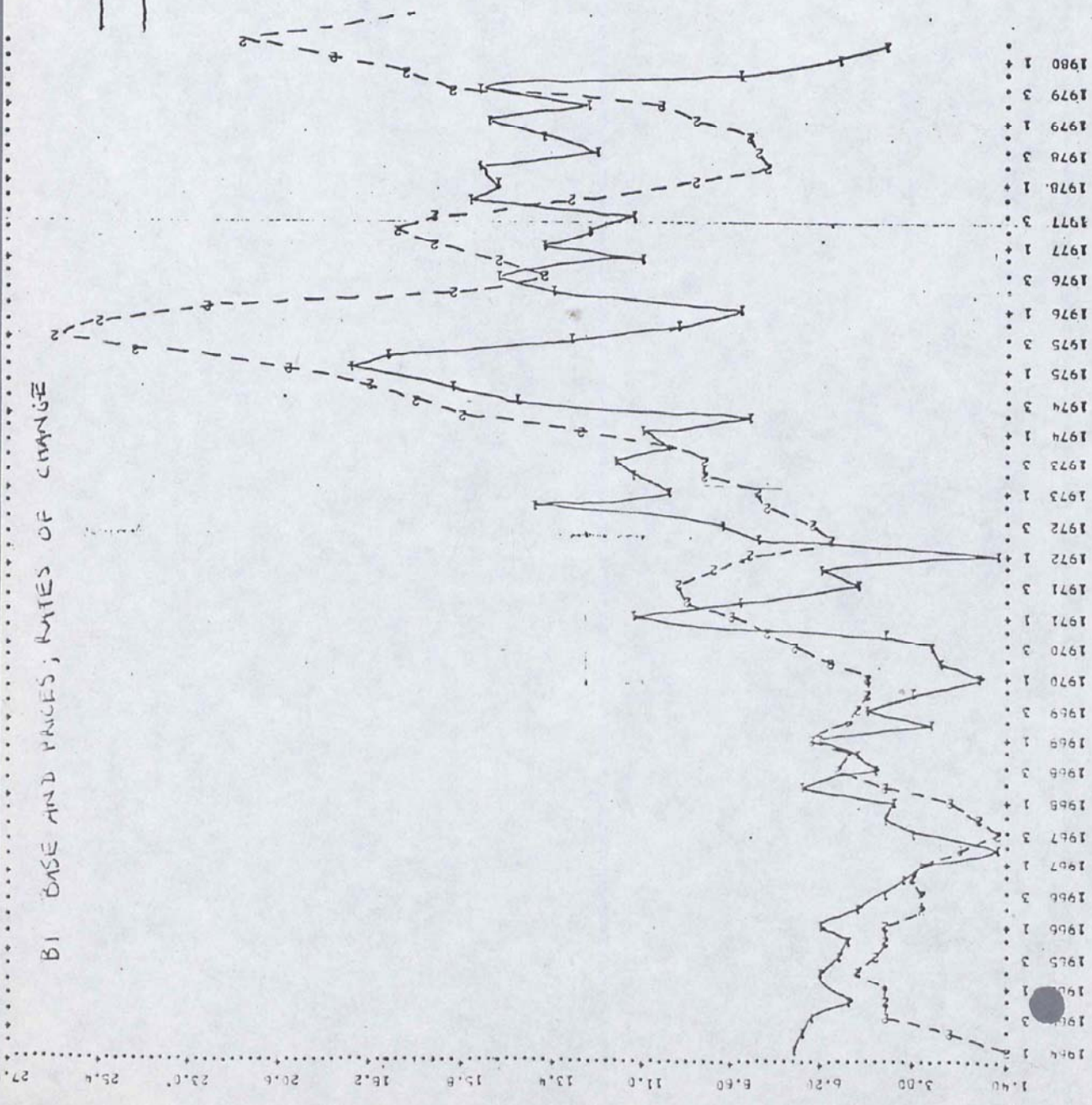
100  
80  
60  
40  
20  
0  
-20



1961 1962 1963 1964 1965 1966 1967 1968 1969 1970 1971 1972 1973 1974 1975 1976 1977 1978 1979 1980 1981 1982 1983

B1 BASE AND PRICES; RATES OF CHANGE

— prices  
 - - - base



B2 M1 AND PRICES: RATES OF CHANGE

prices  
M1

%

30.0

25.0

20.0

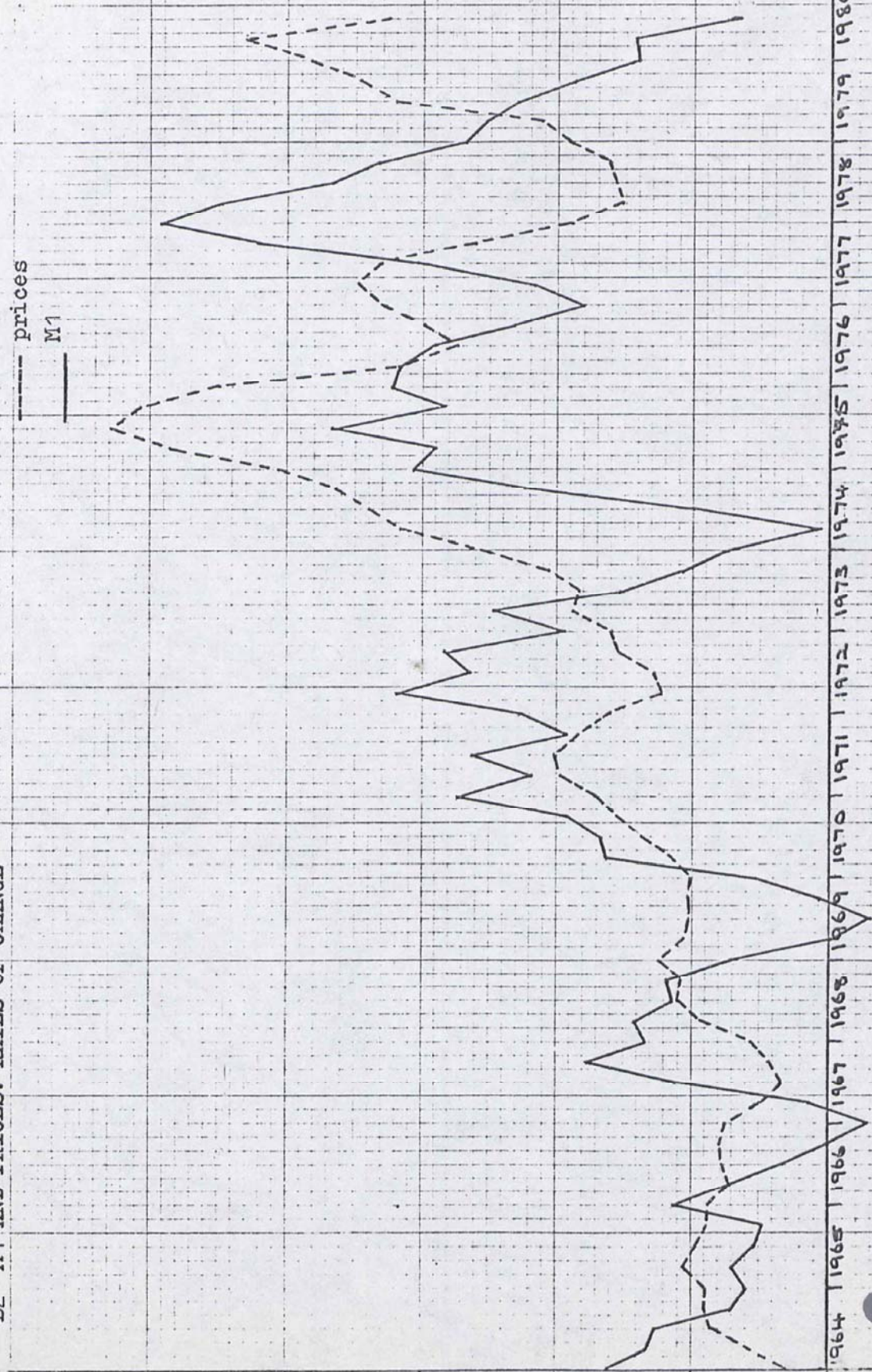
15.0

10.0

5.0

0.0

1964 1965 1966 1967 1968 1969 1970 1971 1972 1973 1974 1975 1976 1977 1978 1979 1980

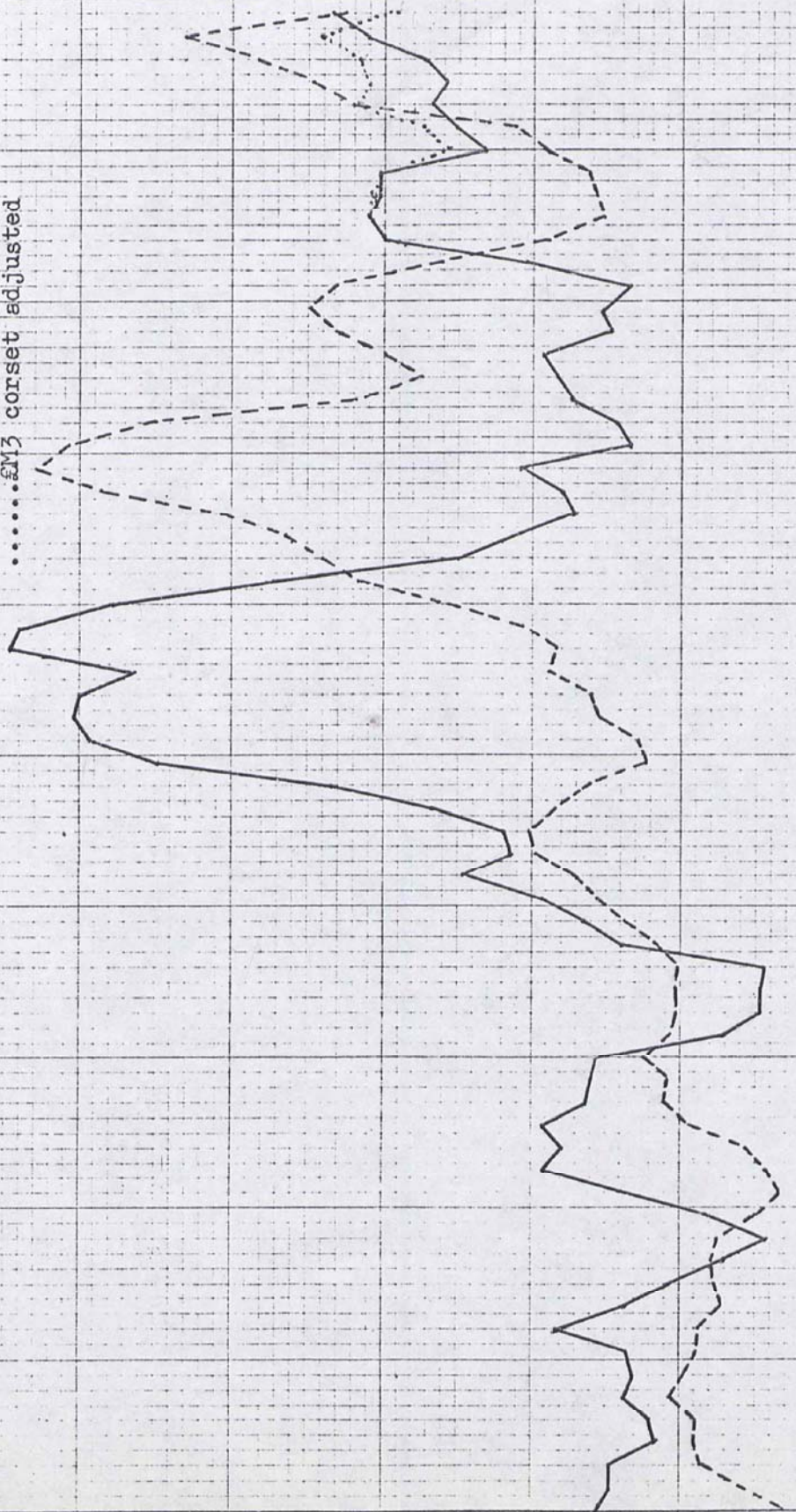


2

B3 £M3 AND PRICES: RATES OF CHANGE

----- prices  
——— £M3  
..... £M3 corset adjusted

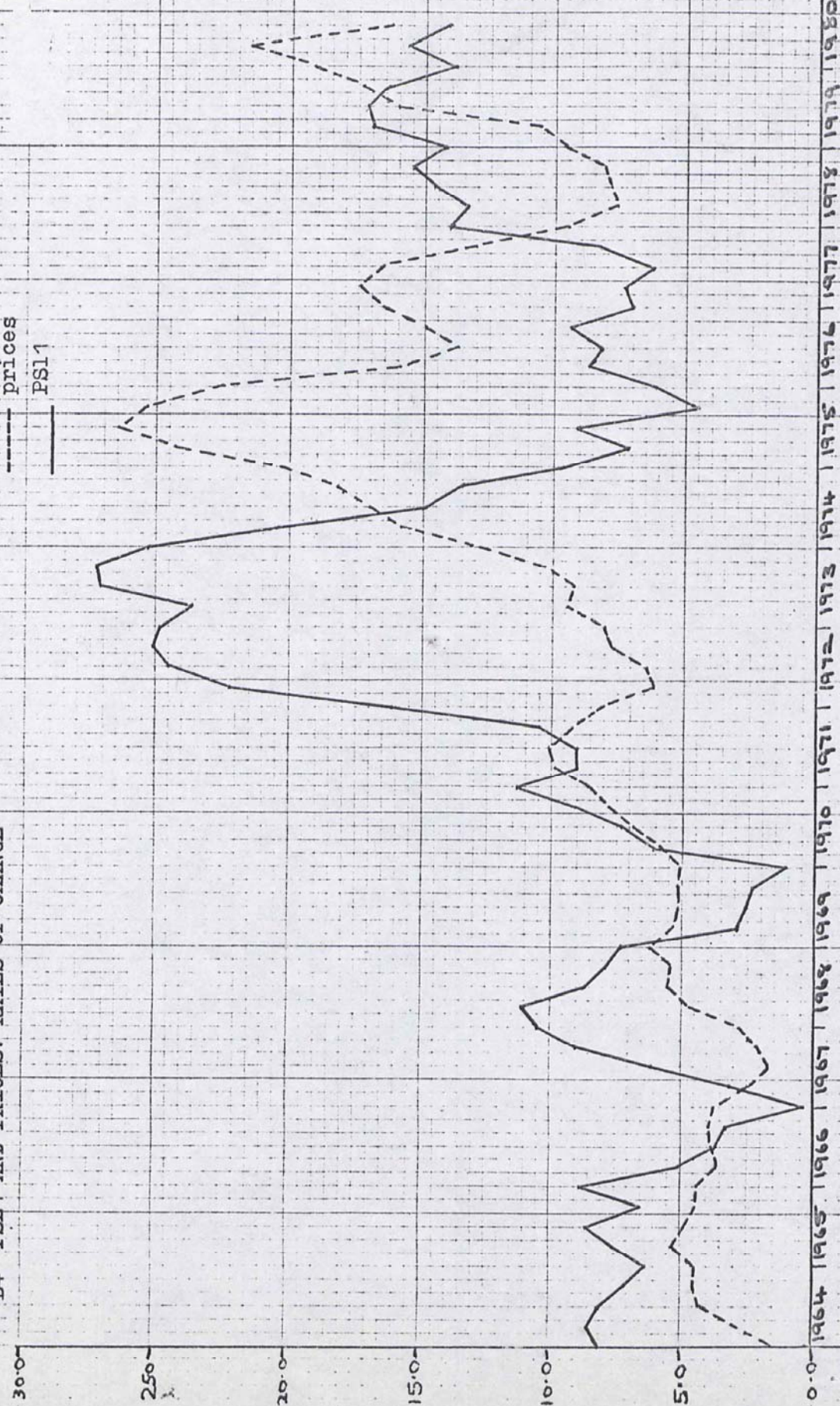
30.0  
25.0  
20.0  
15.0  
10.0  
5.0  
0.0



1964 1965 1966 1967 1968 1969 1970 1971 1972 1973 1974 1975 1976 1977 1978 1979 1980

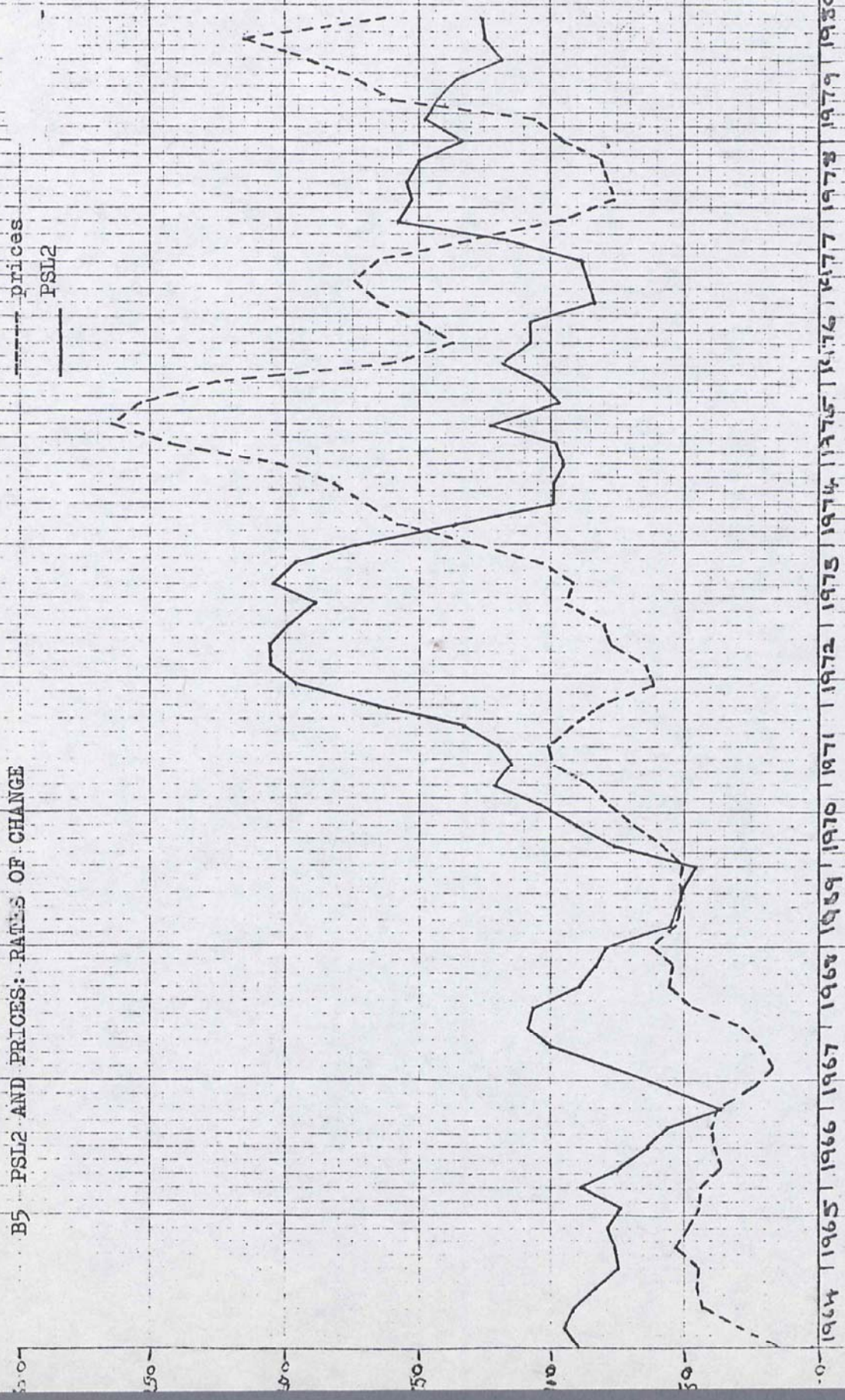
B4 PSL1 AND PRICES: RATES OF CHANGE

prices  
PSL1



B5 PSL2 AND PRICES: RATES OF CHANGE

prices  
PSL2

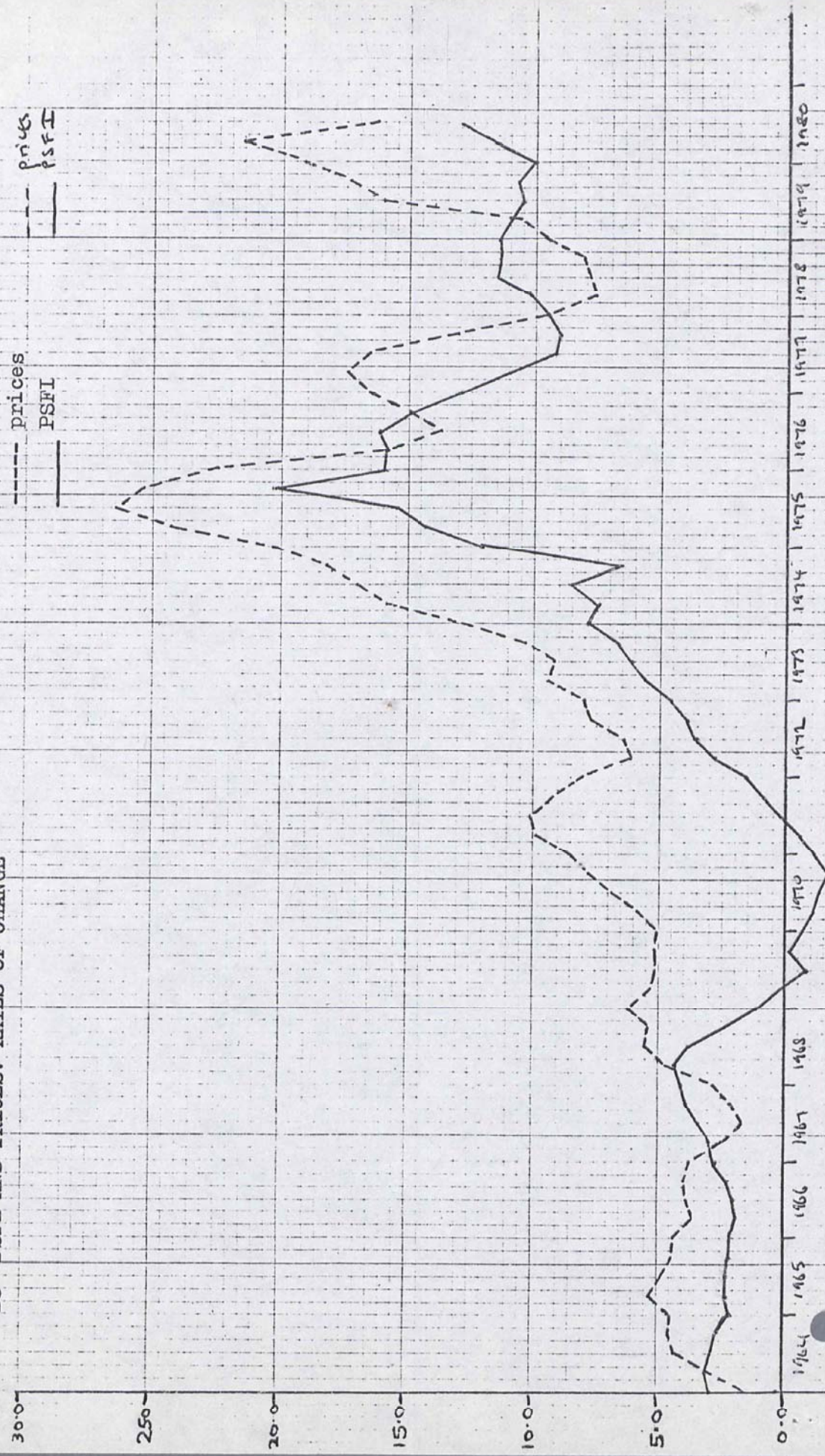


1964 1965 1966 1967 1968 1969 1970 1971 1972 1973 1974 1975 1976 1977 1978 1979 1980



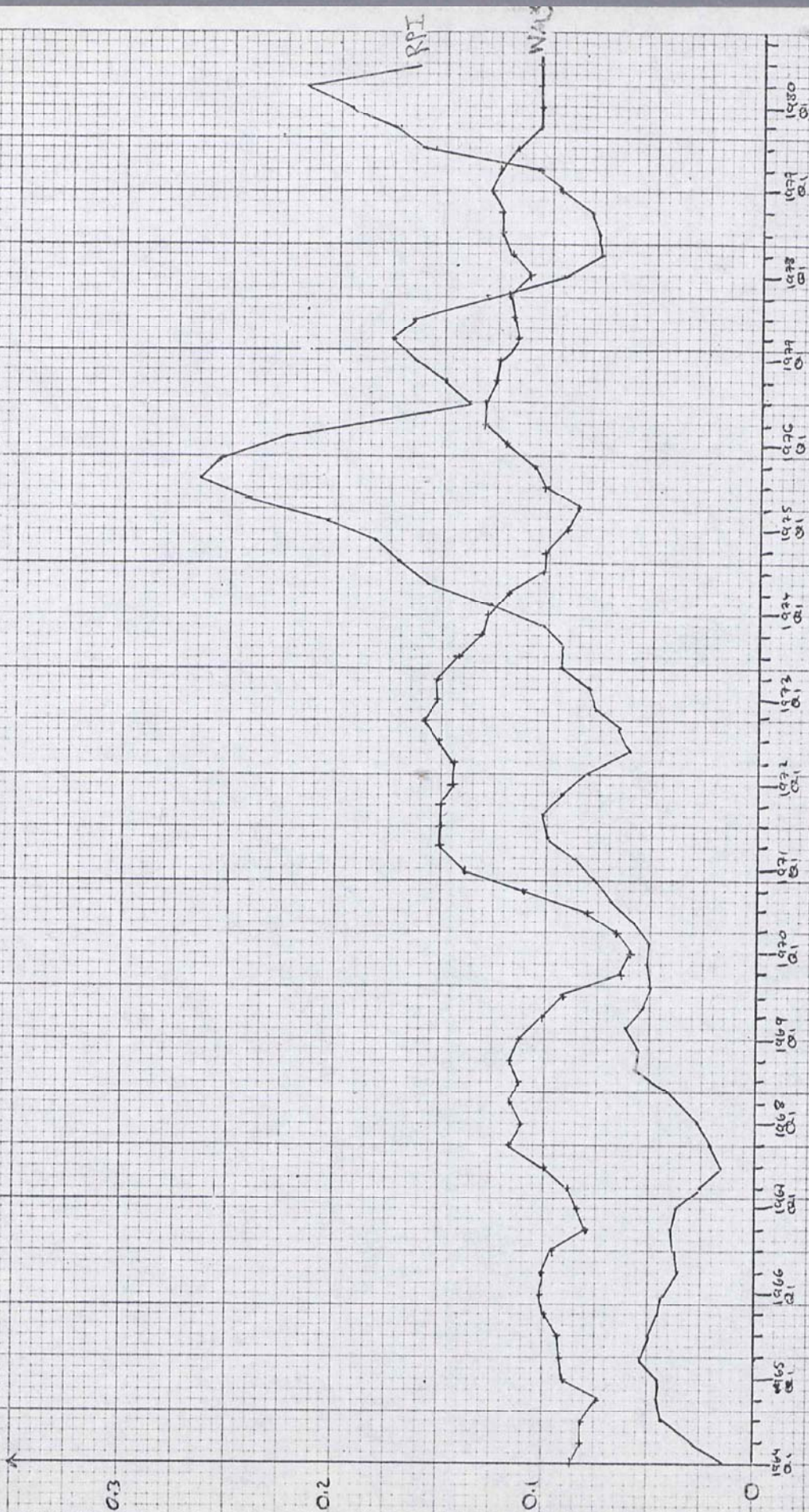
7

B6 PSFI AND PRICES: RATES OF CHANGE

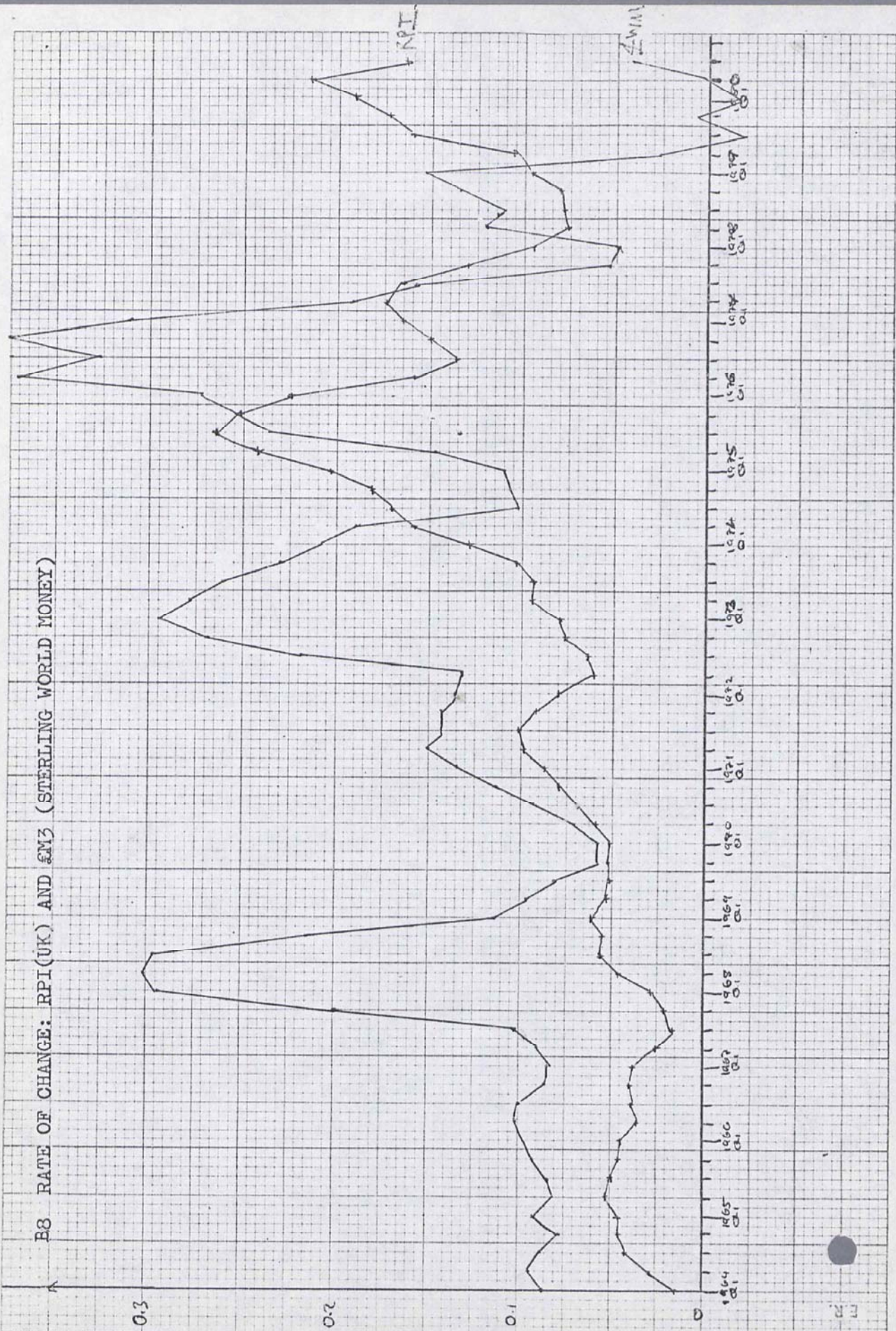


E.R.

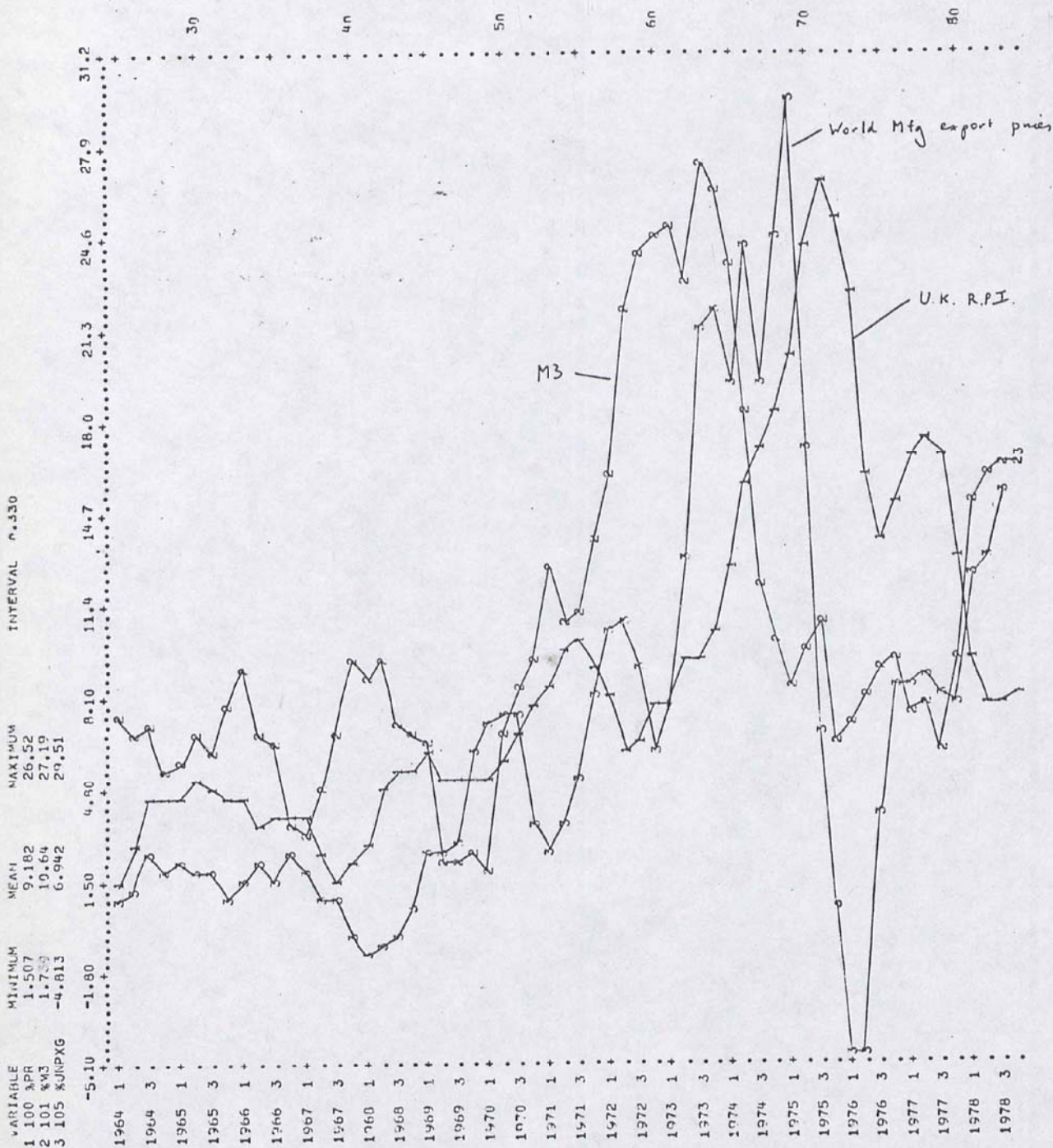
B7 RATE OF CHANGE: RPI(UK) AND WM3 (WORLD MONEY SUPPLY)

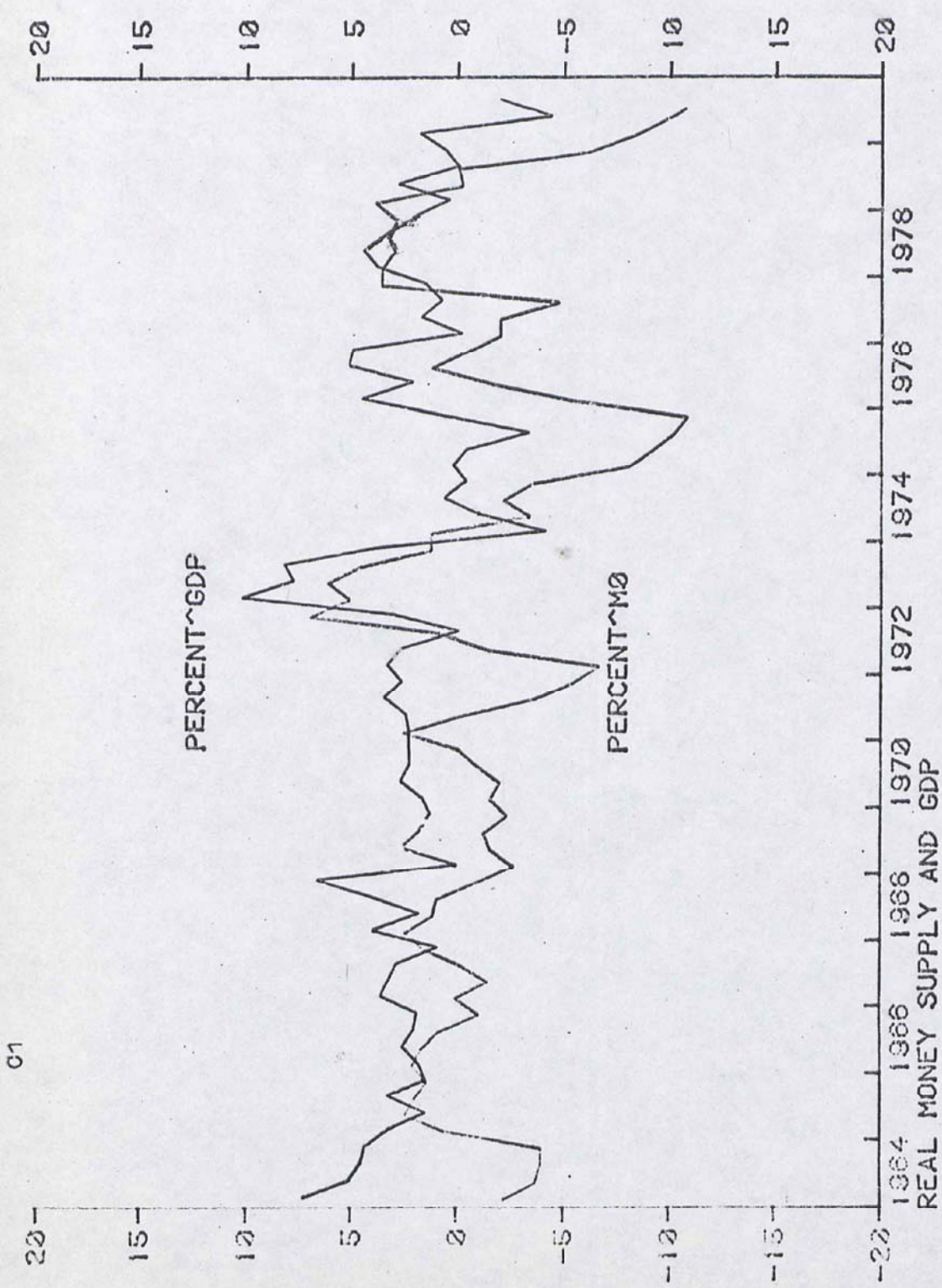


B3 RATE OF CHANGE: RPI(UK) AND £M3 (STERLING WORLD MONEY)



B9 WORLD MANUFACTURING EXPORT PRICES, UK, RPI, AND £M3:  
ANNUAL % CHANGE

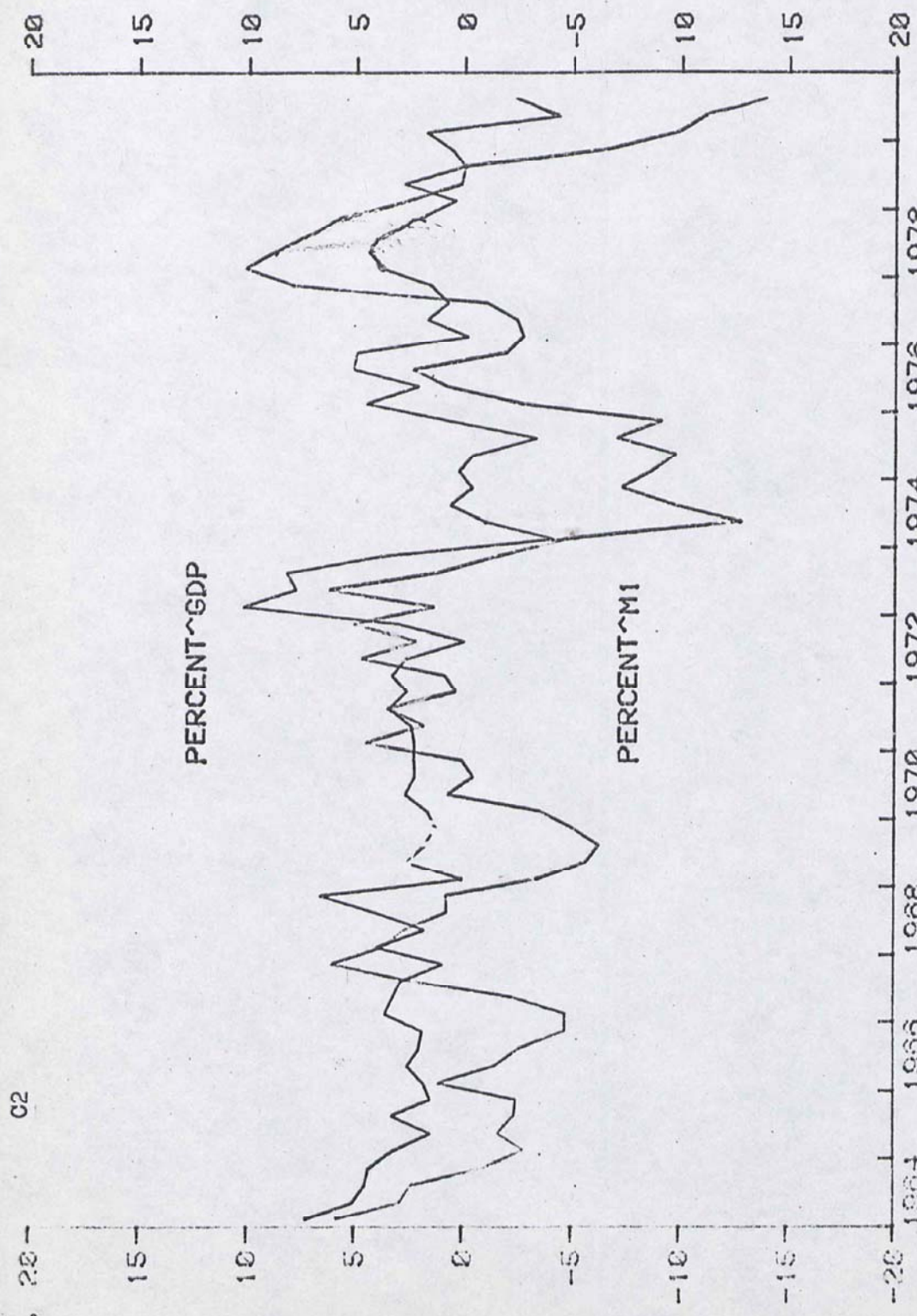




REAL MONEY SUPPLY AND GDP

C2

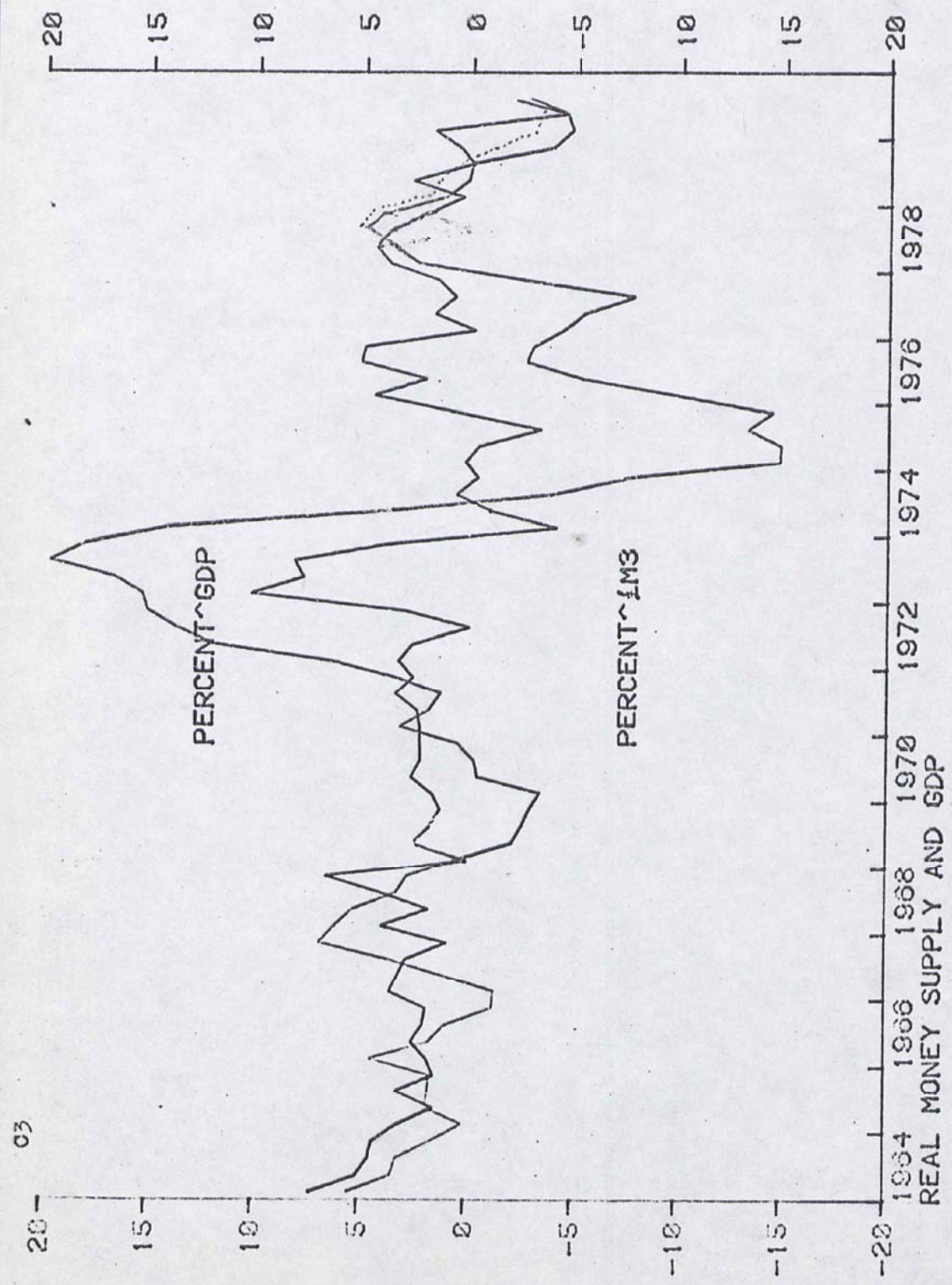
2



REAL MONEY SUPPLY AND GDP

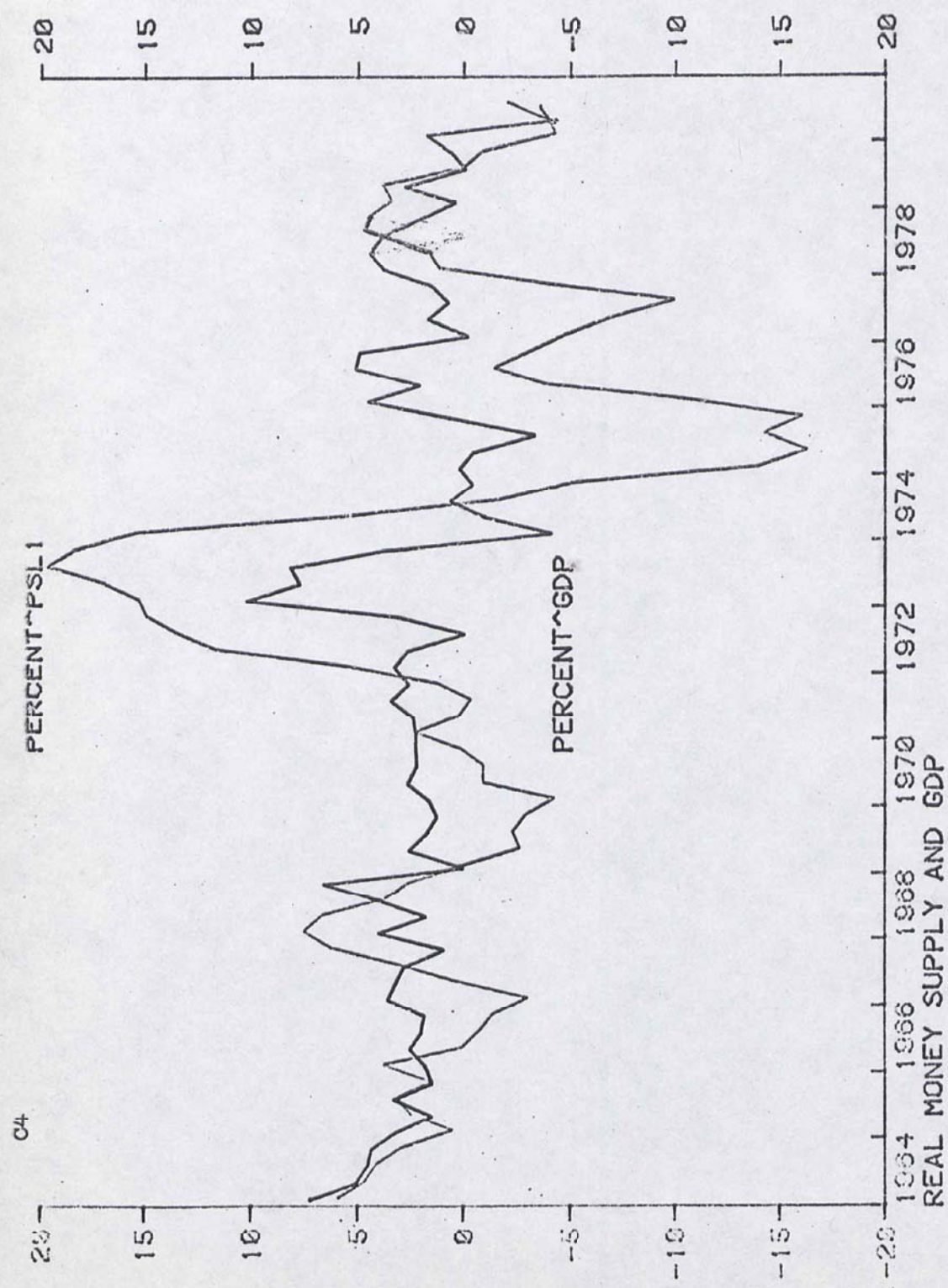
2

2



03

2



04

2



05

20

15

10

5

0

-5

-10

-15

-20

PERCENT~PSL2

PERCENT~GDP

1964 1966 1968 1970 1972 1974 1976 1978

REAL MONEY SUPPLY AND GDP

2

20

15

10

5

0

-5

-10

-15

20

1978

1976

1974

1972

1970

1968

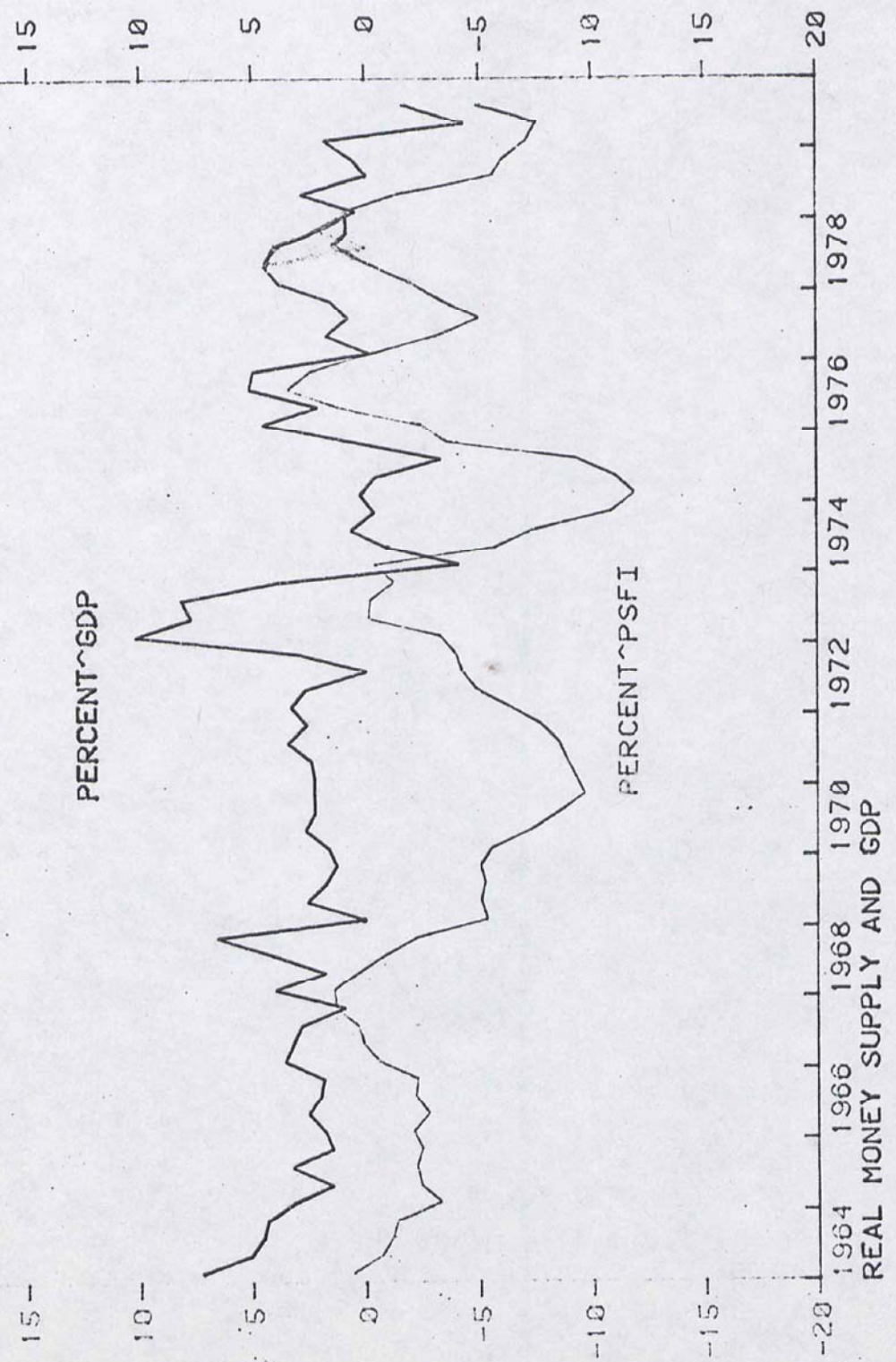
1966

1964

06

7

7



E.R.

# D1 RELATIVE MONEY SUPPLY

2.0

1.5

1.0

0.5

0.0

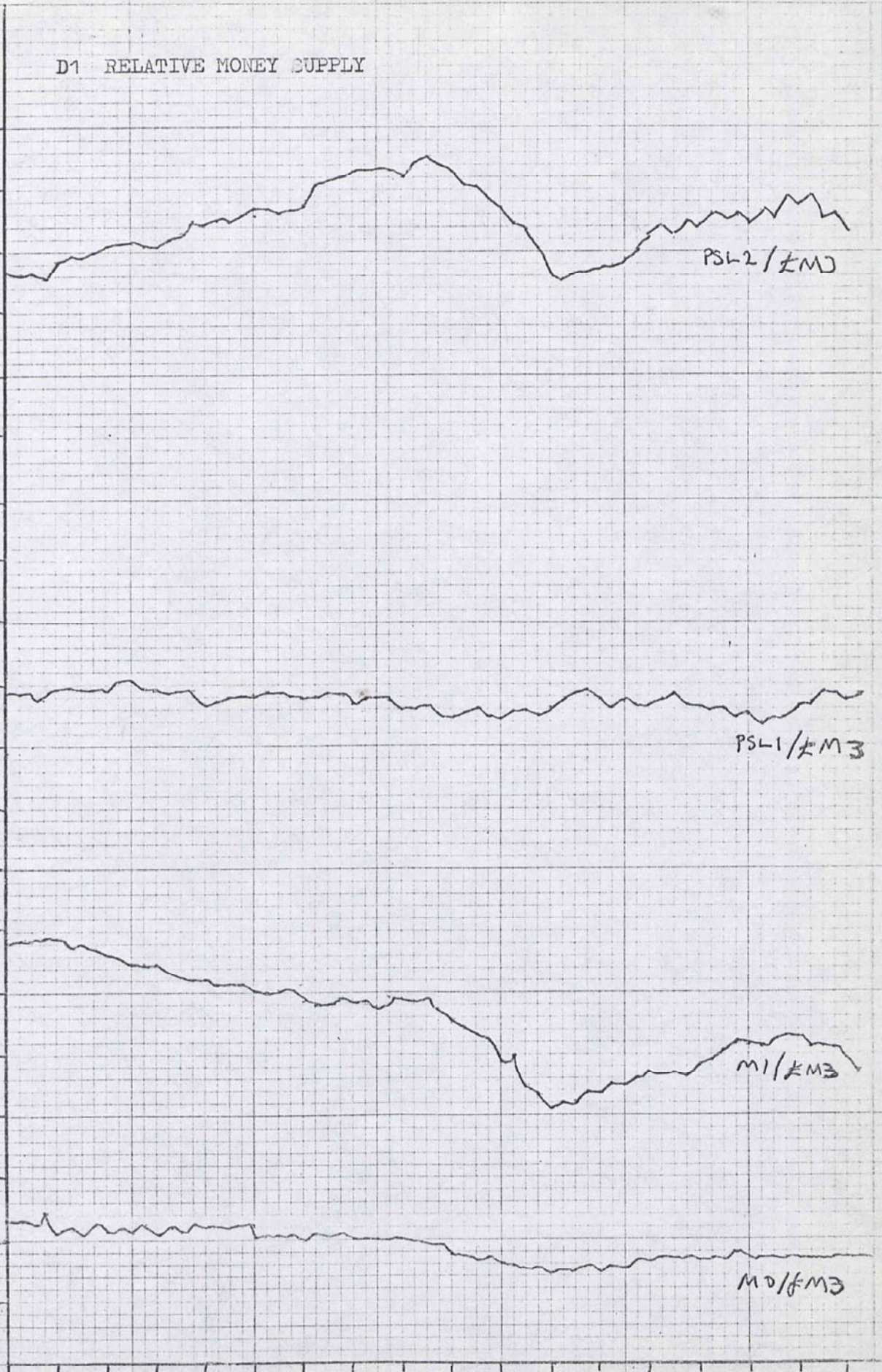
PSL2/£M3

PSL1/£M3

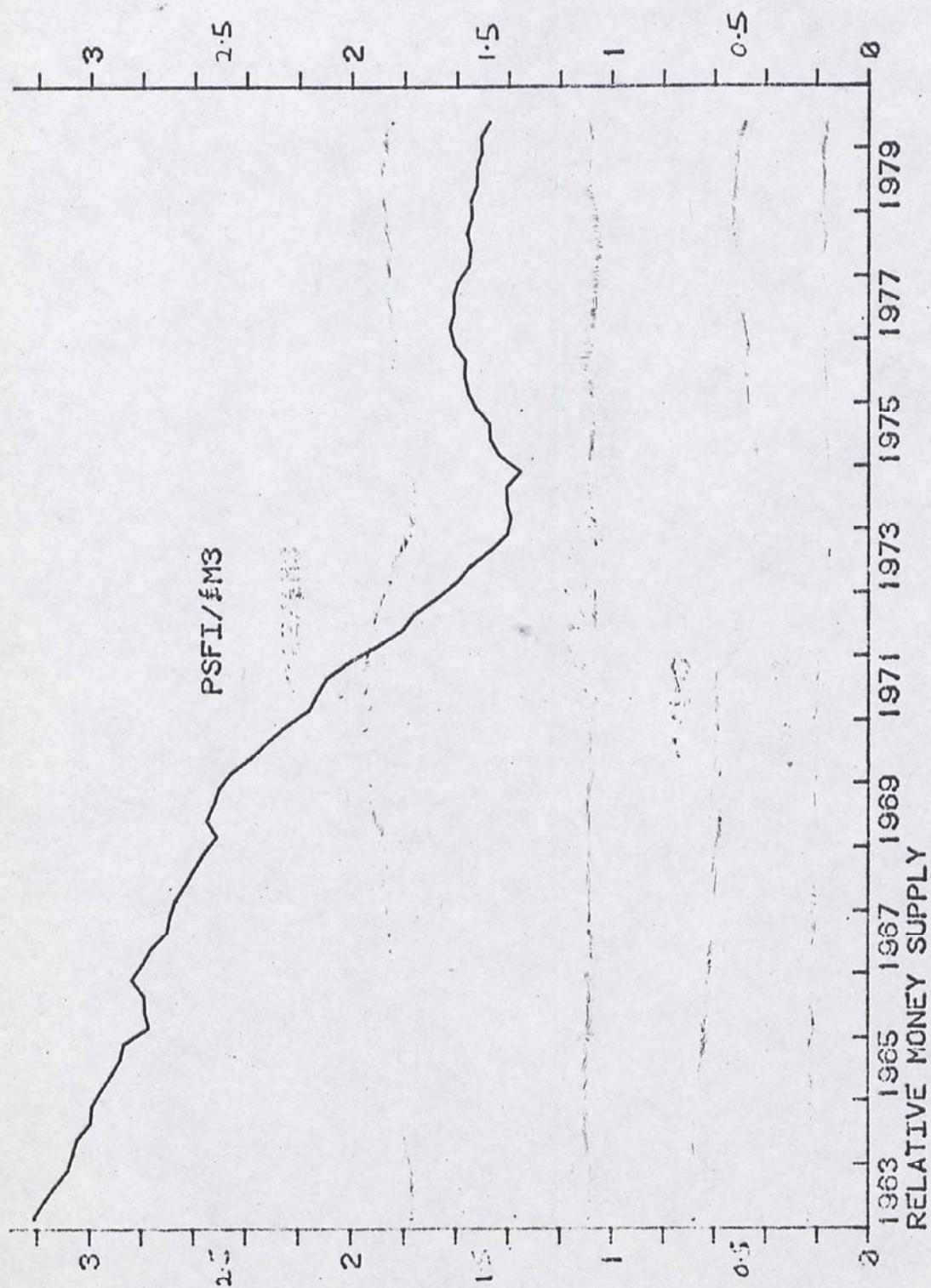
M1/£M3

M0/£M3

1963 1964 1965 1966 1967 1968 1969 1970 1971 1972 1973 1974 1975 1976 1977 1978 1979 1980



D2



PSFI/£M3

RELATIVE MONEY SUPPLY

D3 RATES OF CHANGE %  
MONEY SUPPLY

--- M3  
--- PSL2  
— M1

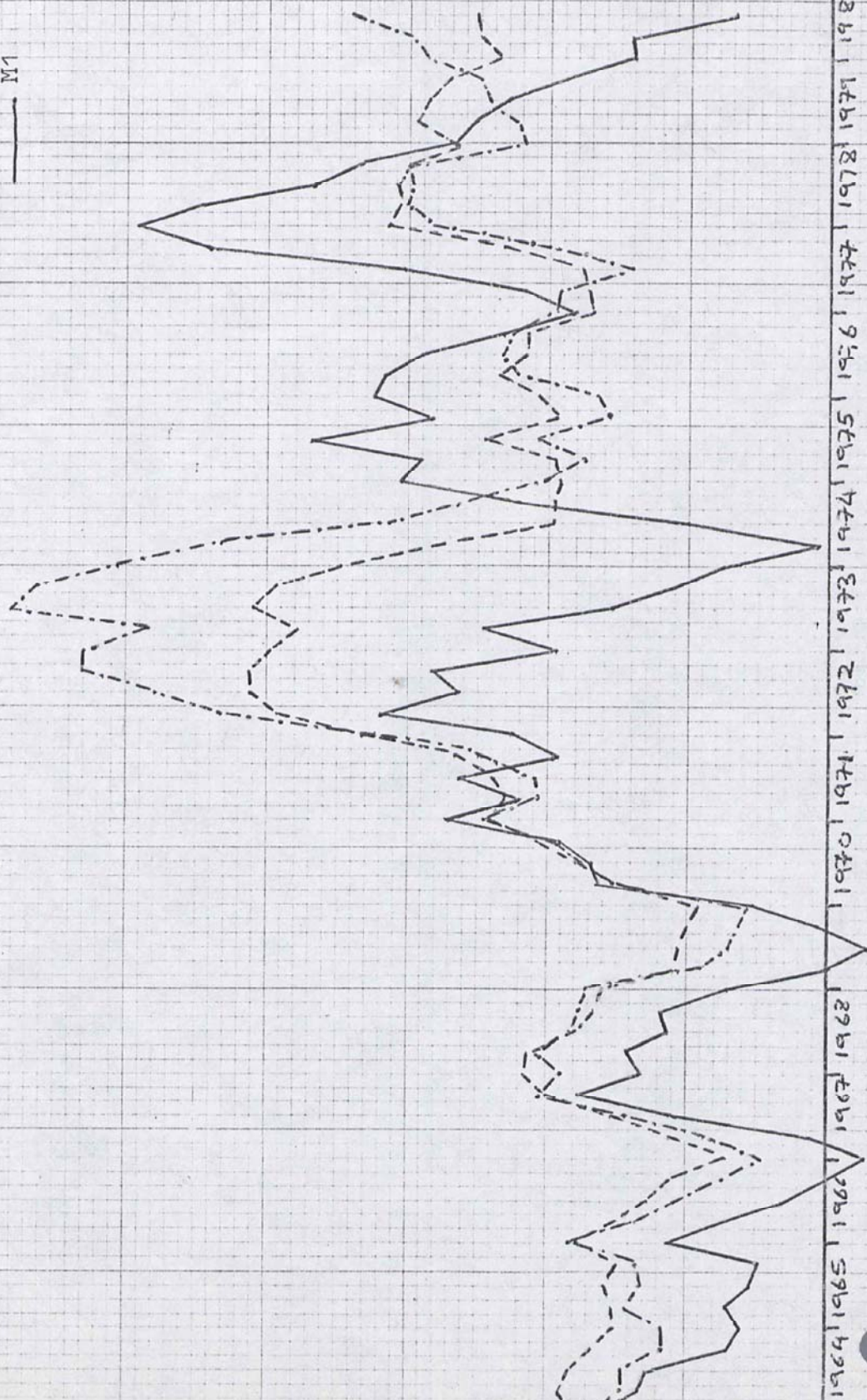
%

30

20

10

0



1964 1965 1966 1967 1968 1969 1970 1971 1972 1973 1974 1975 1976 1977 1978 1979 1980

D4 RATES OF CHANGE %  
MONEY SUPPLY

PSL2  
M3  
PSL1

++++

—

- - -

%

300

250

200

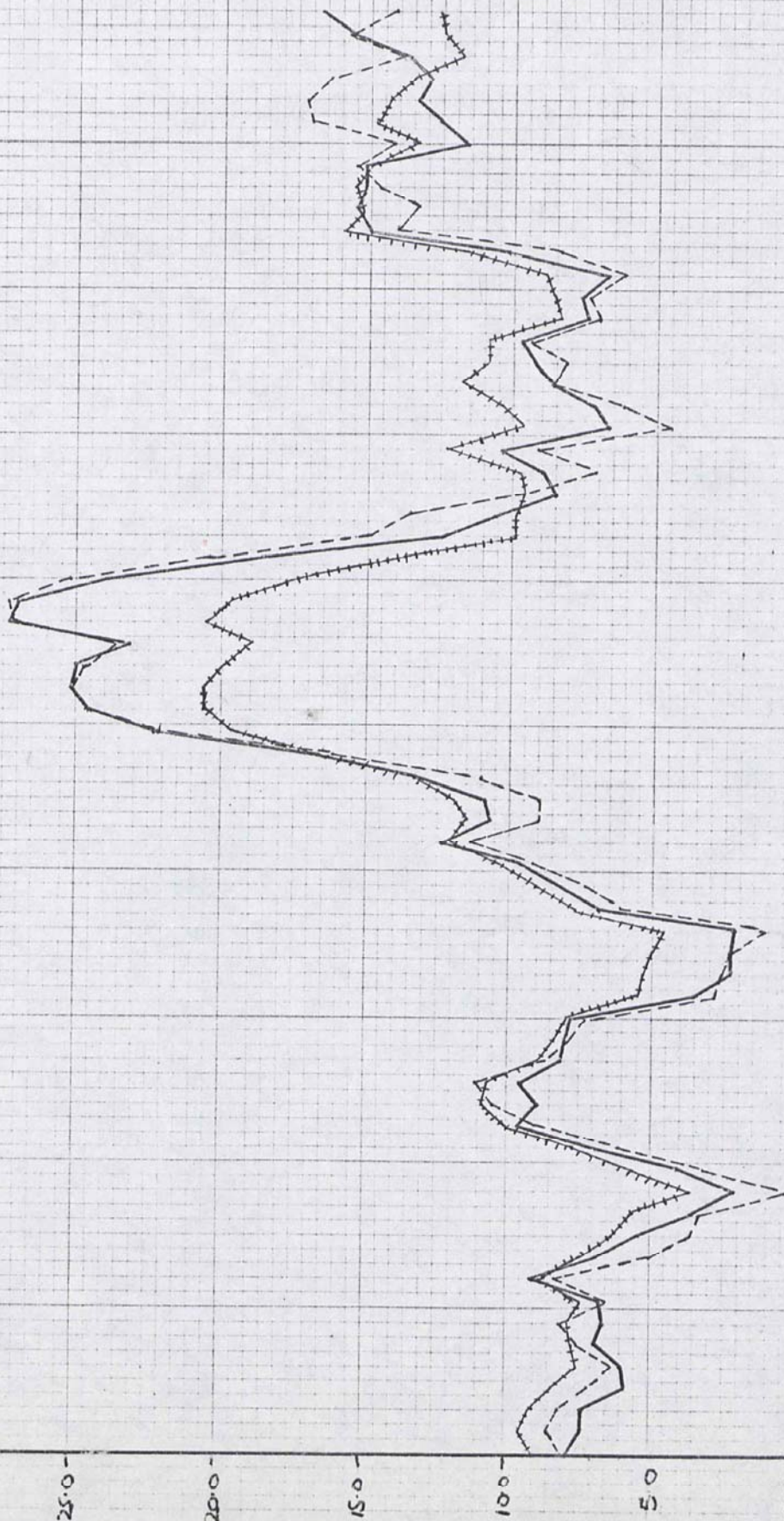
150

100

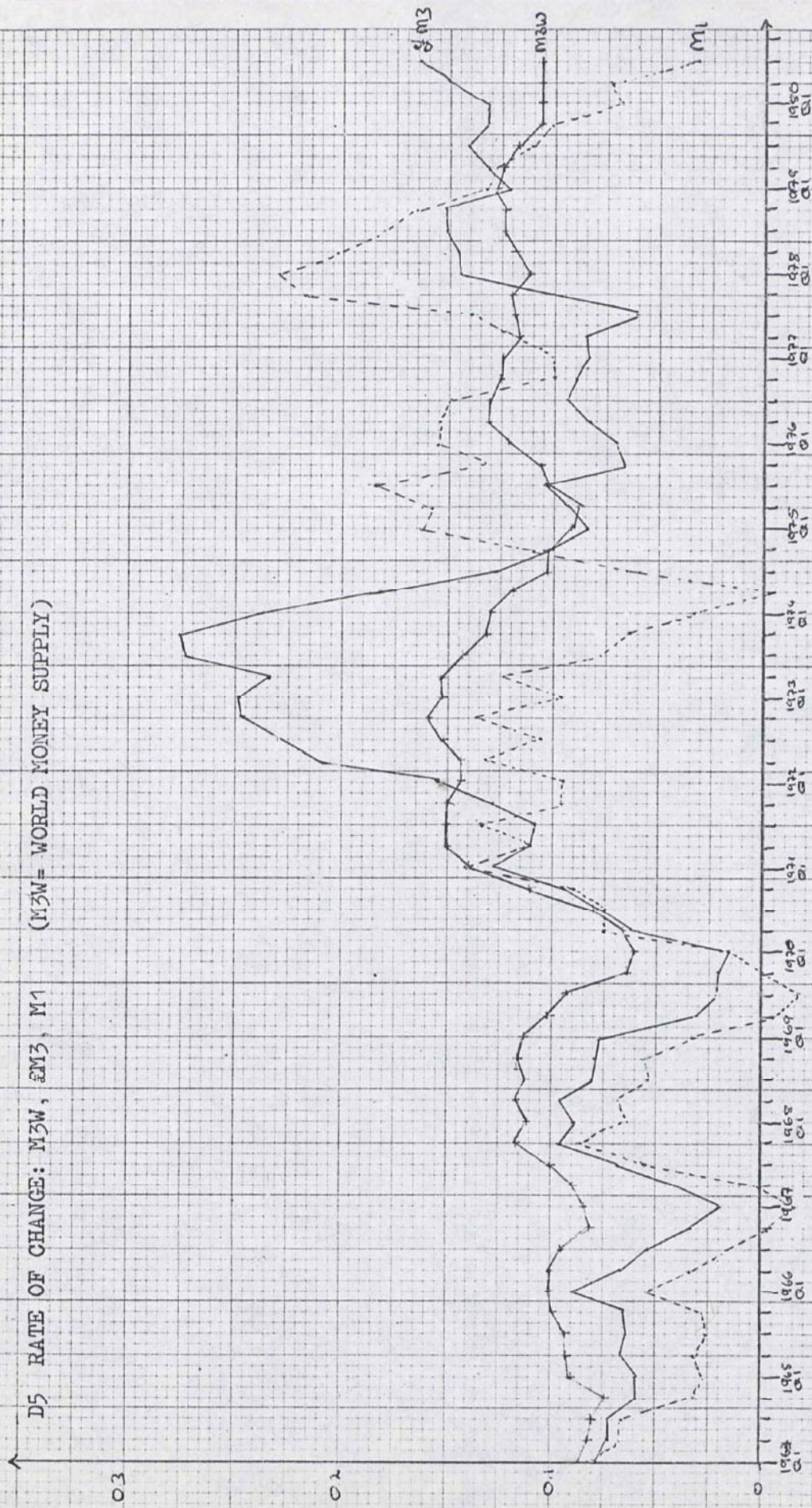
50

0.0

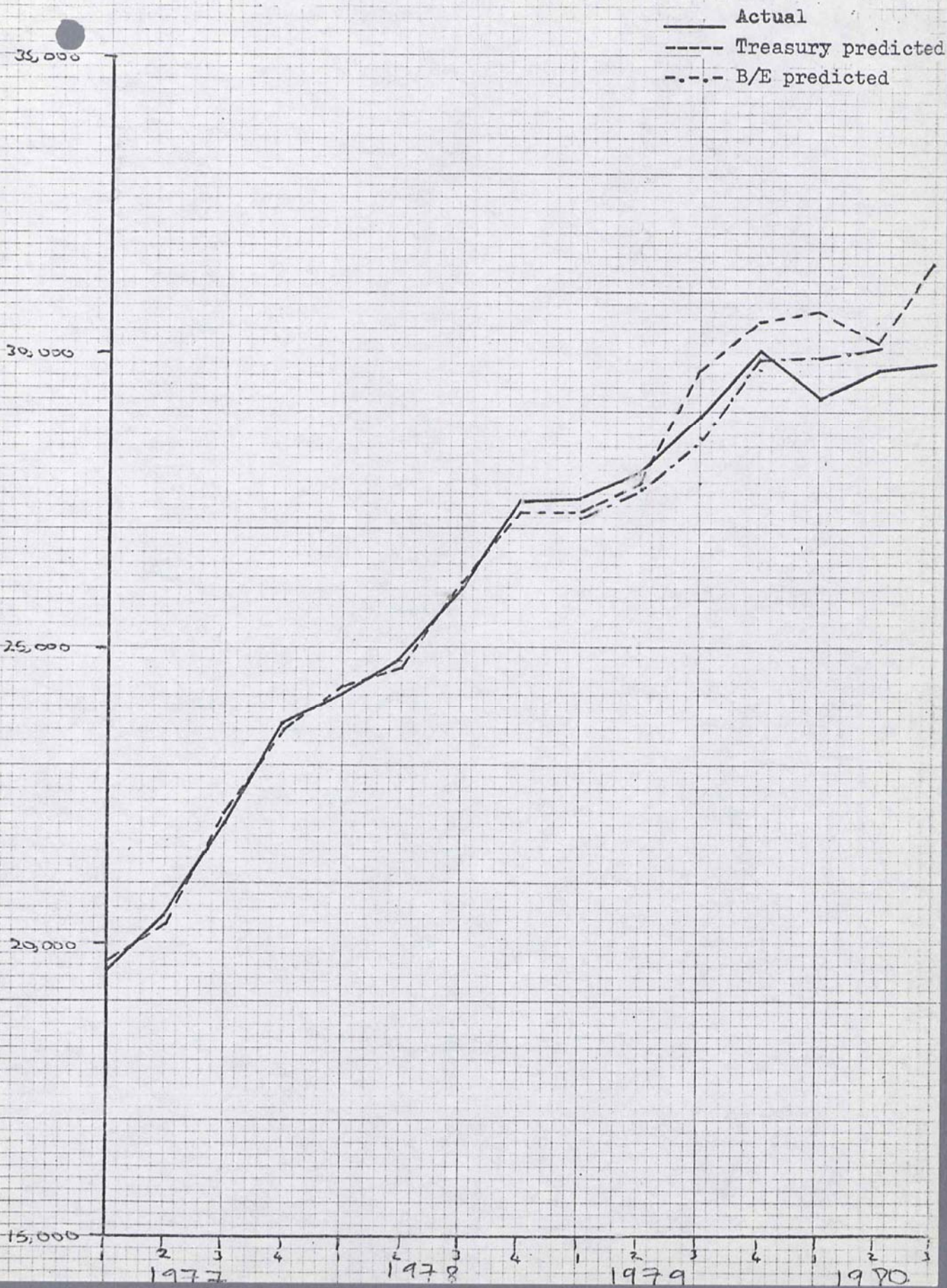
-50



D5 RATE OF CHANGE: M3W, £M3, M1 (M3W = WORLD MONEY SUPPLY)

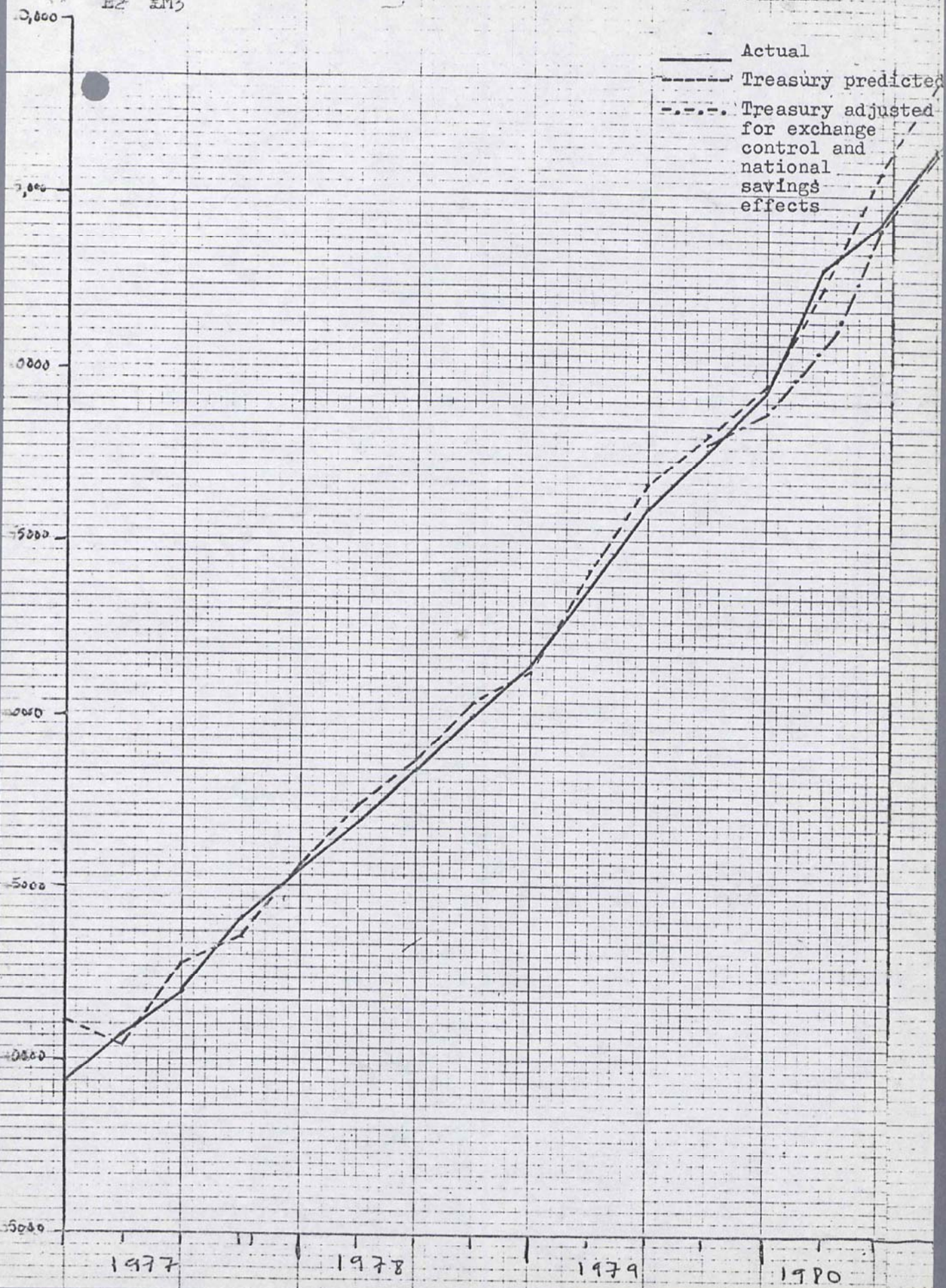


E1 M1

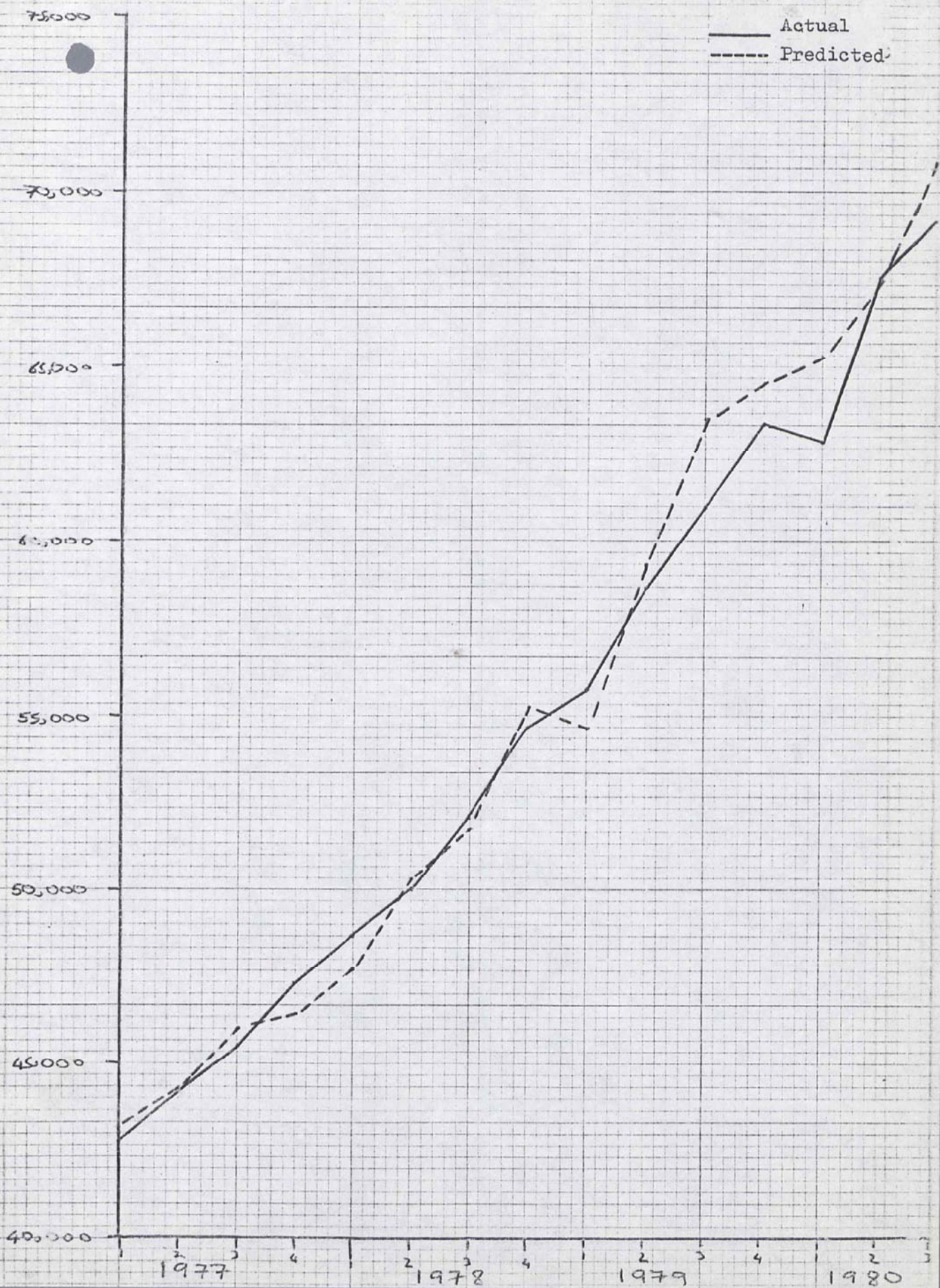




E2 £M3



E3 PSL1



E4 PSL2

— Actual  
- - - Predicted

120,000

110,000

100,000

90,000

80,000

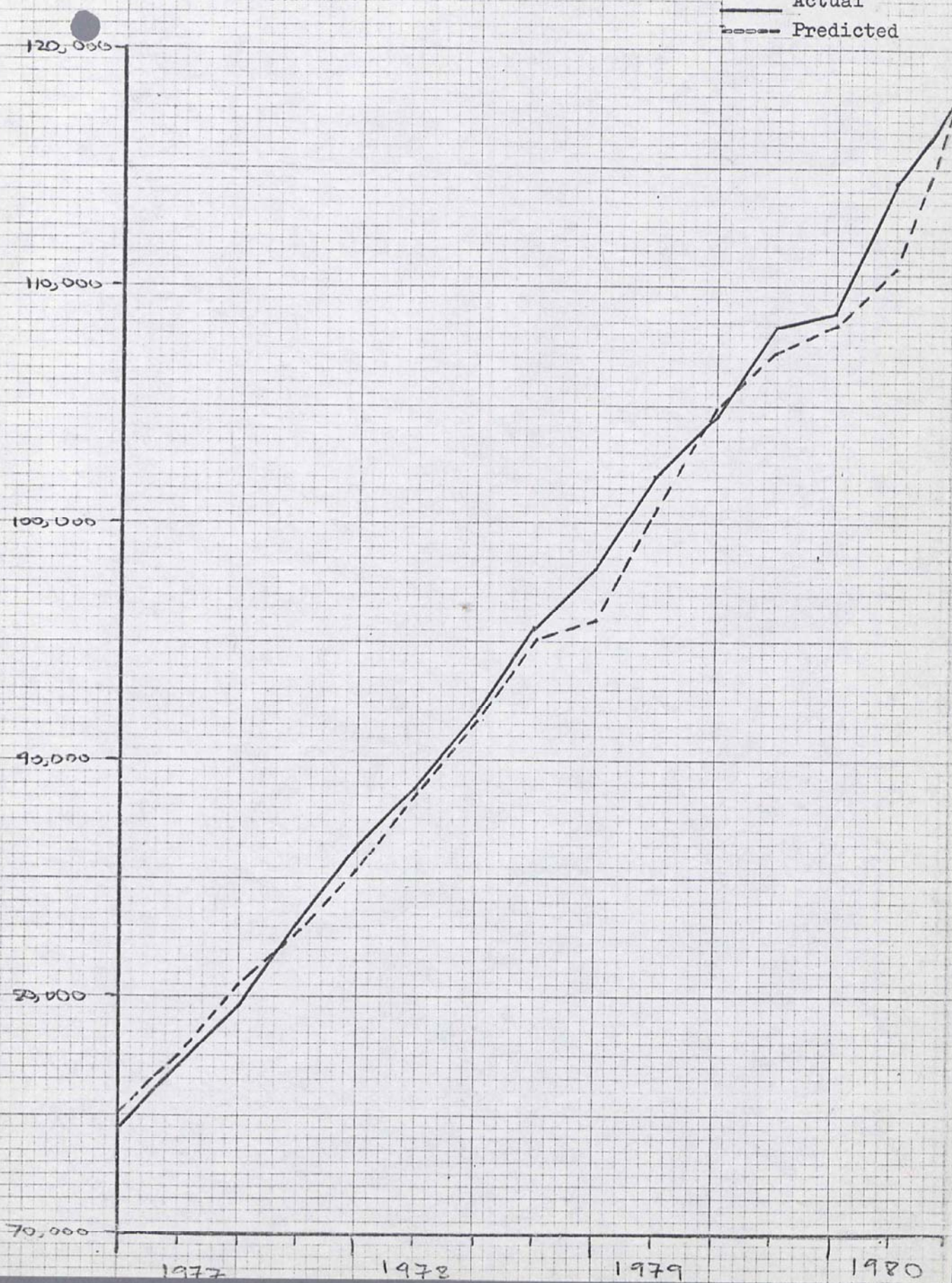
70,000

1977

1978

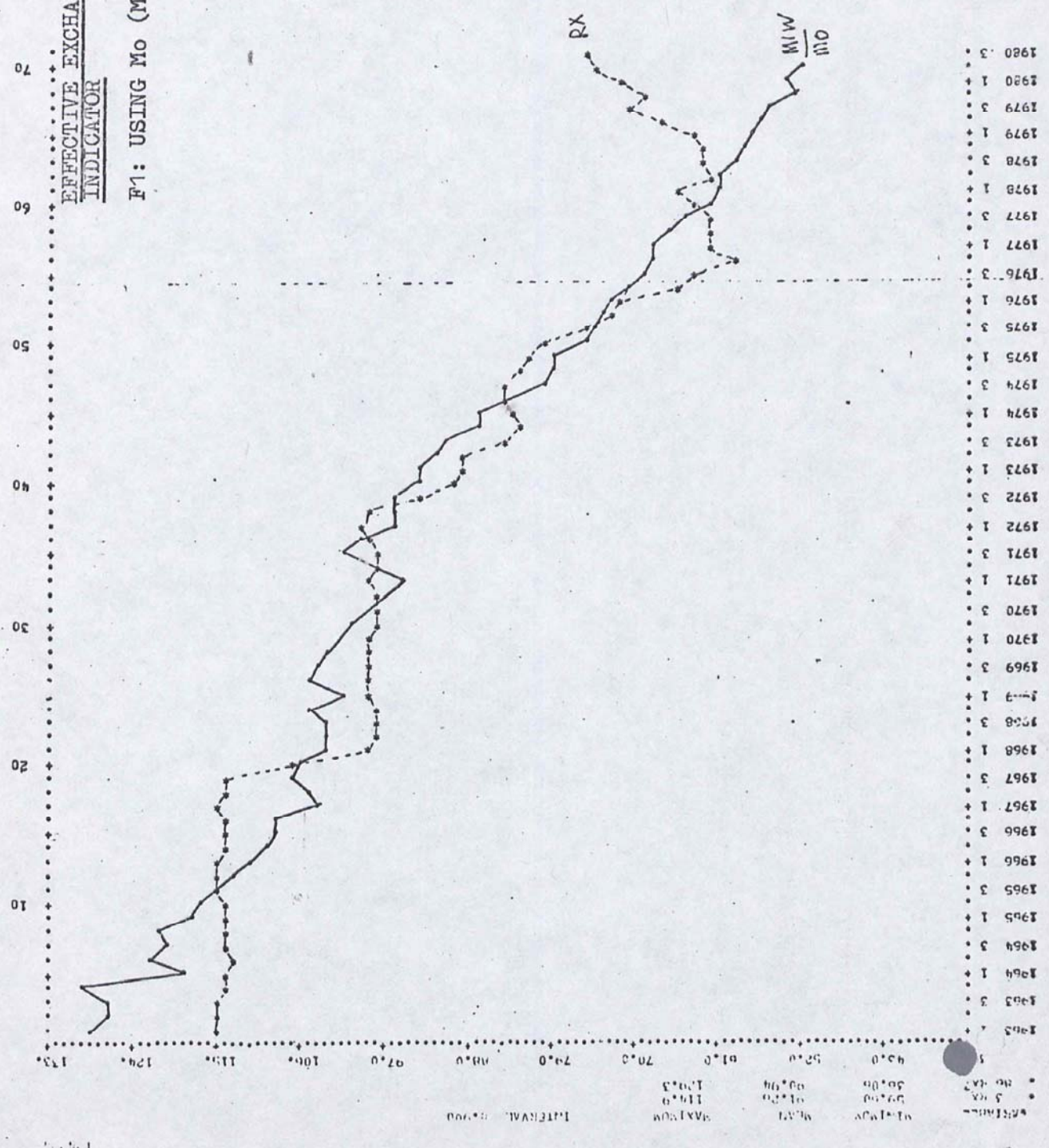
1979

1980



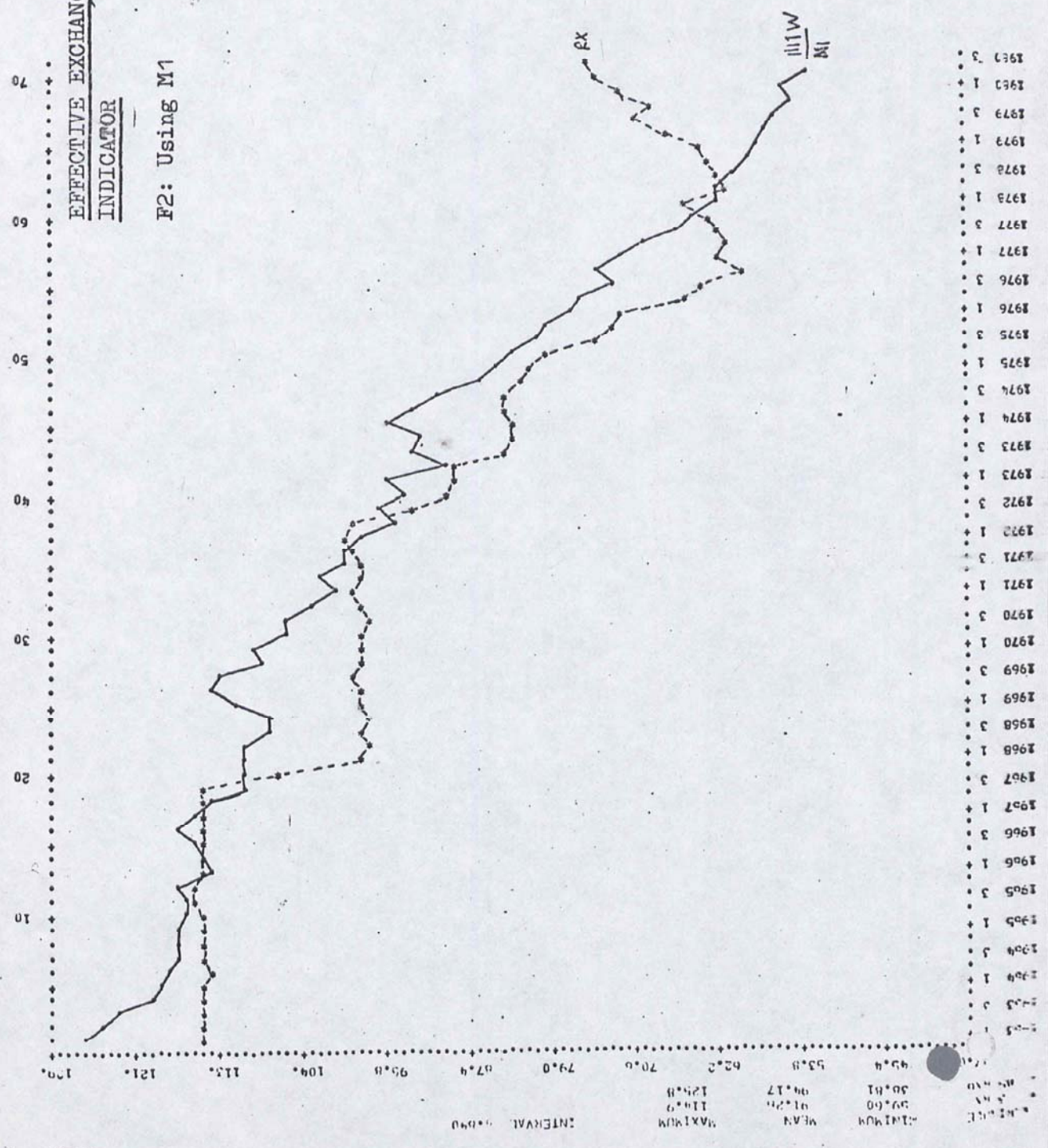
EFFECTIVE EXCHANGE RATE AND MONETARY INDICATOR

F1: USING Mo (Monetary Base)



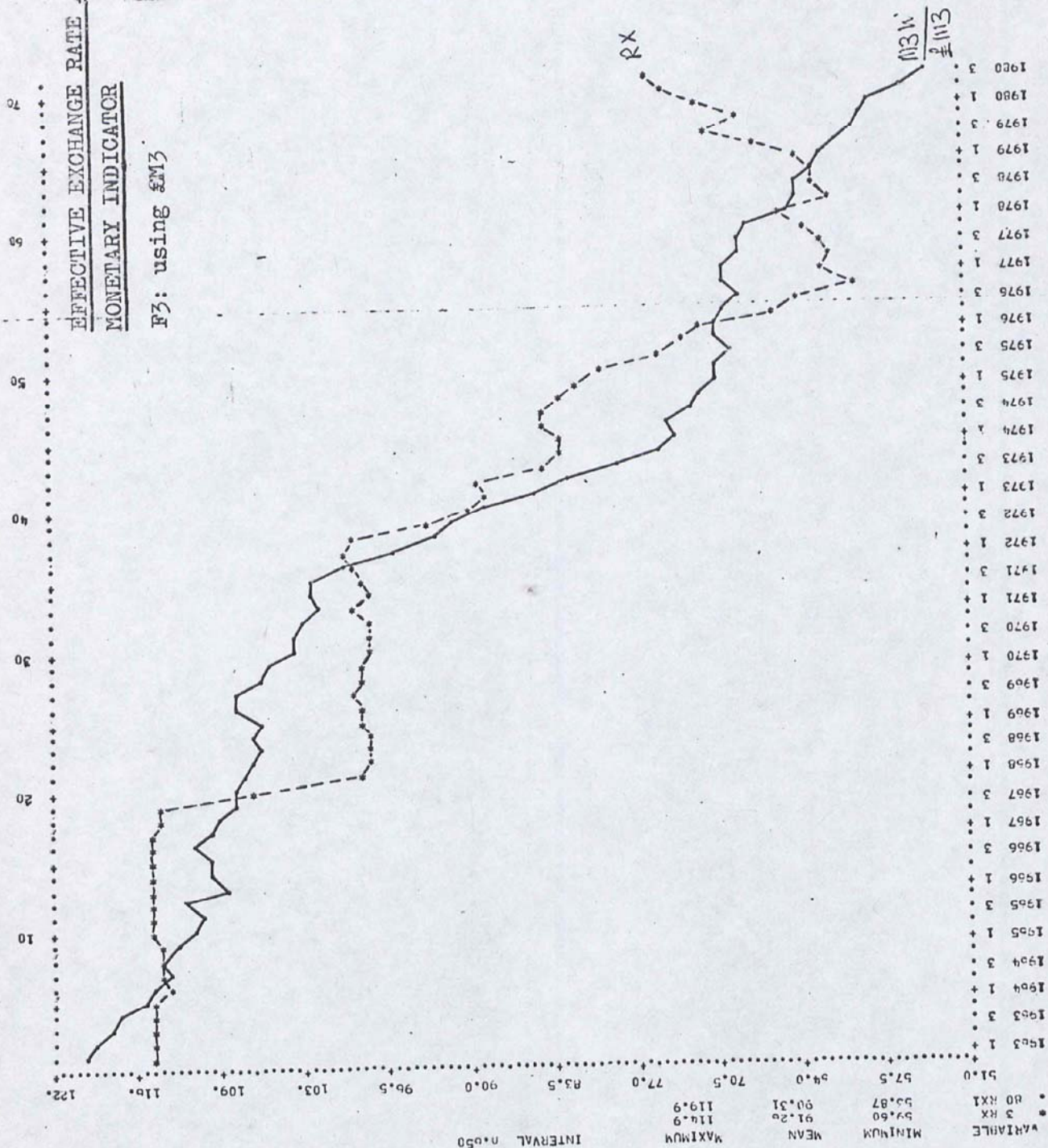
EFFECTIVE EXCHANGE RATE AND MONETARY INDICATOR

F2: Using M1



EFFECTIVE EXCHANGE RATE AND  
MONETARY INDICATOR

F3: using £M3



STERLING DOLLAR EXCHANGE RATE AND MONETARY INDICATOR:

F4 MONETARY BASE (Mo)

70  
60  
50  
40  
30  
20  
10  
0

2.80

2.70

2.50

2.40

2.39

2.22

2.10

1.98

1.86

1.74

1.62

1.50

1.38

1.26

1.14

1.02

0.90

0.78

0.66

0.54

0.42

0.30

0.18

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INTERVAL: 1.200-02

MAXIMUM

MEAN

MINIMUM

VARIABLE

01 MO

02 RATE

1.00

1.00

1.00

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1.00

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1.00

rate

MO(US)/MO

- 1980 1
- 1979 3
- 1979 1
- 1978 3
- 1978 1
- 1977 3
- 1977 1
- 1976 3
- 1976 1
- 1975 3
- 1975 1
- 1974 3
- 1974 1
- 1973 3
- 1973 1
- 1972 3
- 1972 1
- 1971 3
- 1971 1
- 1970 3
- 1970 1
- 1969 3
- 1969 1
- 1968 3
- 1968 1
- 1967 3
- 1967 1
- 1966 3
- 1966 1
- 1965 3
- 1965 1
- 1964 3
- 1964 1
- 1963 3
- 1963 1

determined to inflict low profitability upon companies there is little government can do. Over the past year, because of the pressure on companies there has been some acknowledgement generally of the problems that have been created by the lack of profitability of our industry.

~~\*~~  
↓  
4. There are three aspects to the government strategy for dealing with the long run unemployment problem.

(i) A reduction of inflation is a crucial and necessary part of this process; with it will come lower interest rates. Uncertainty will be reduced and it will be possible, once again, for companies to undertake investment decisions against a much more stable financial background. Already we have made significant progress.

*check* 11  
During the period of the last Labour government the average inflation rate was 15 per cent per annum. When this government came to office the inflation rate over the previous six months was 14 per cent per annum and accelerating. There was a backlash from the breakdown of incomes policy and substantial difficulties brought about by the oil price increase. Now the corner has been clearly turned and much more dramatically than almost anyone expected. Inflation has been coming down very quickly and will continue to do so in the early months of this year. The

/challenge



challenge now is to ensure that the inflation rate remains low and is brought down further.

(ii) A second aspect of strategy is to reduce the pressure upon the economy created by an excessive level of government spending. Unless this is done there will not be room for the private sector to prosper and create jobs. Some progress has been made in reducing the optimistic programmes of the previous government. However there are difficulties arising because of the effects of recession on expenditure, nationalised industries revenues and unemployment benefits. But the difficult decisions have now been taken and put in place so that once we come out of recession we will see a substantial reduction in the underlying level of <sup>public</sup> expenditure. A further

| /difficulty

*when you leave  
high now for the  
private sector you won't  
get the wealth creation.*

difficulty has been the impact of the end of pay policy <sup>and Clegg</sup> upon public sector pay. It was correct to adjust anomalies that had taken place under incomes policy but the result has been to increase the value of government spending very sharply. Government spending during this financial year will be 20-25 per cent higher than a year earlier. This has created bitterness and frustration in the private sector where overhead costs have risen sharply and made adjustment there more difficult. It has also shown the difficulties of attempting to reduce the growth of total monetary demand in the economy towards a target of 7-11 per cent when a substantial part of expenditure is growing at twice or three times that rate. That was a problem that was inherited; the adjustments of the anomalies are now complete and it is necessary and important that the growth of the value of public spending rises at most in line with the monetary targets, rather than substantially above them.

(iii) A third part of the strategy is to remove major market distortions from the economy to improve the supply side, lay the basis for wealth creation and increase employment in the long term. The average growth rate in the economy has been in severe decline during the past ten years. It is only by reversing the move towards greater government control and /interference

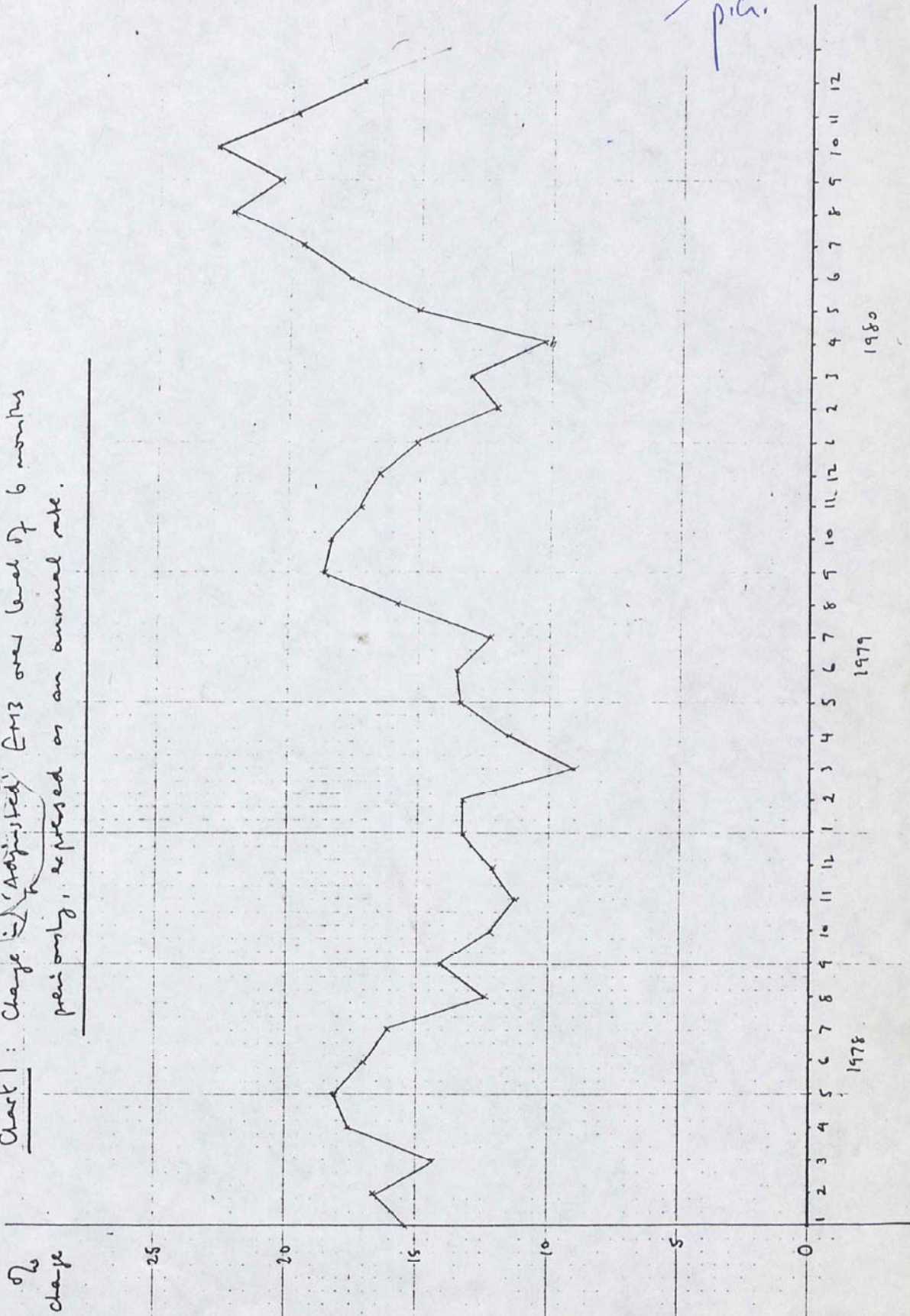
*As we will  
improve this!*

interference that the circumstances will be laid within which recovery can take place.

Considerable progress has been made in removing a large number of distortions within the economy. None of these changes has an immediate or large impact upon the level of output but over a period they could become very important and lay the basis for much better long term performance.

- Pay, price and dividend controls have been abolished; this was vital to improve the functioning of markets in general if we are to obtain the correct price signals showing which products are competitive and profitable and which skills are in short supply.
  
- Exchange controls have been abolished; in time this could well become an important mechanism towards improving the allocation of resources and activity within the UK and was long overdue. Now that investors are in a position of being able to choose where to invest their money this will place urgent and necessary demands upon our industry to meet international standards of performance.

Chart 1: Change in Adjusted EMS over level of 6 months  
 price only, expressed as an annual rate.

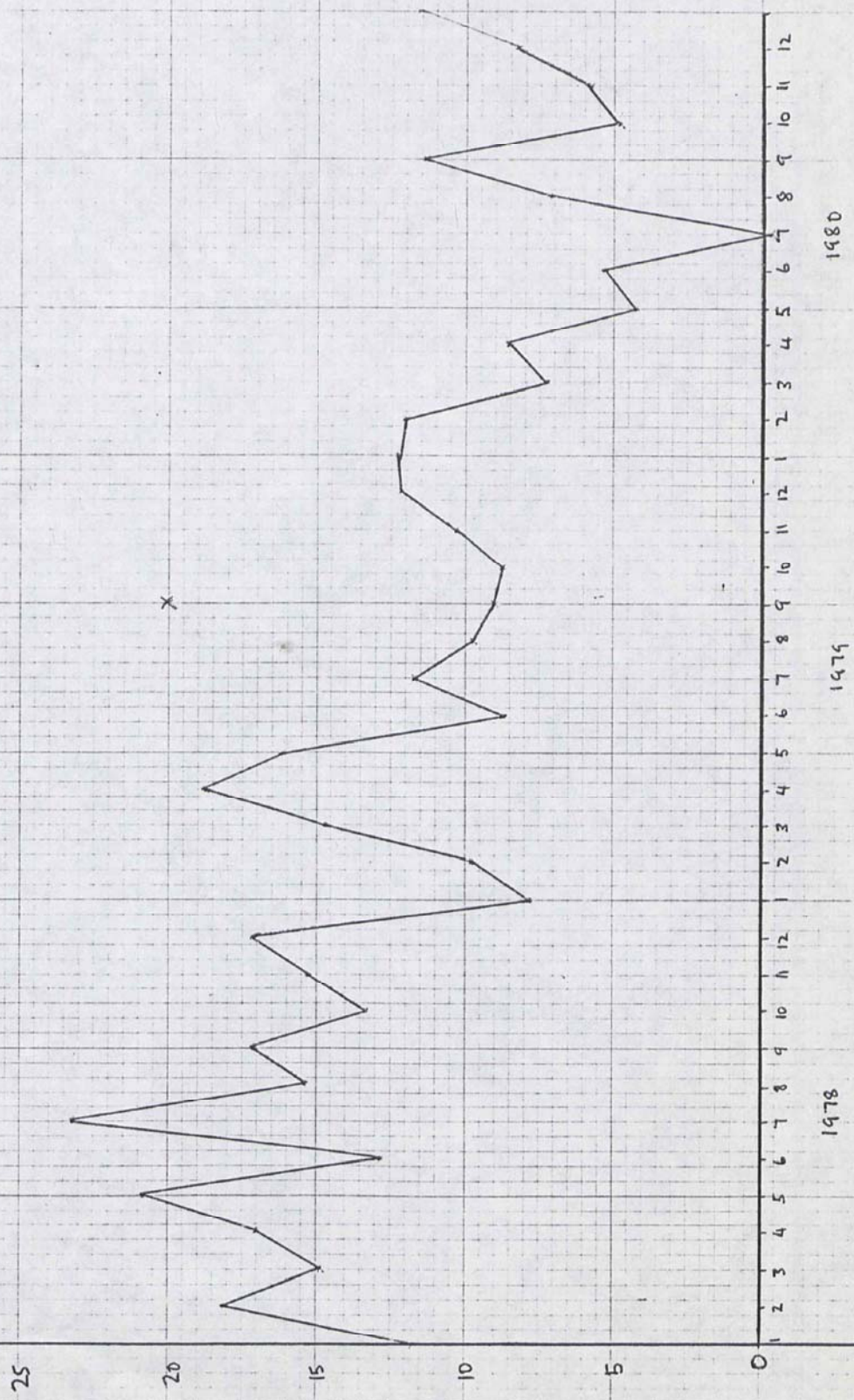


pic.

Change in Wide Monetary Base (M<sub>1</sub>) over level of  
6 months previously, expressed as an annual rate

523/1

% change



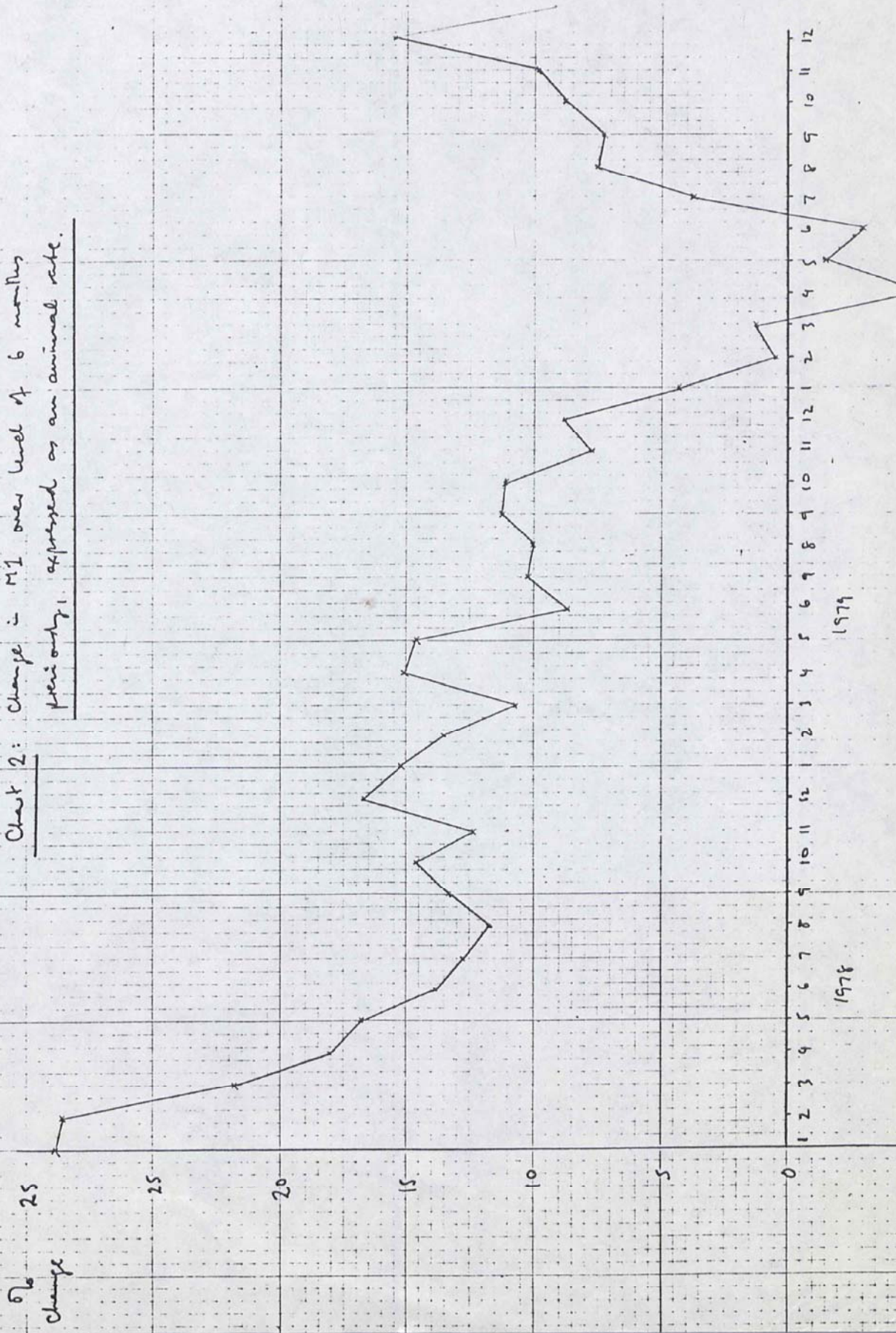
x

1980

1979

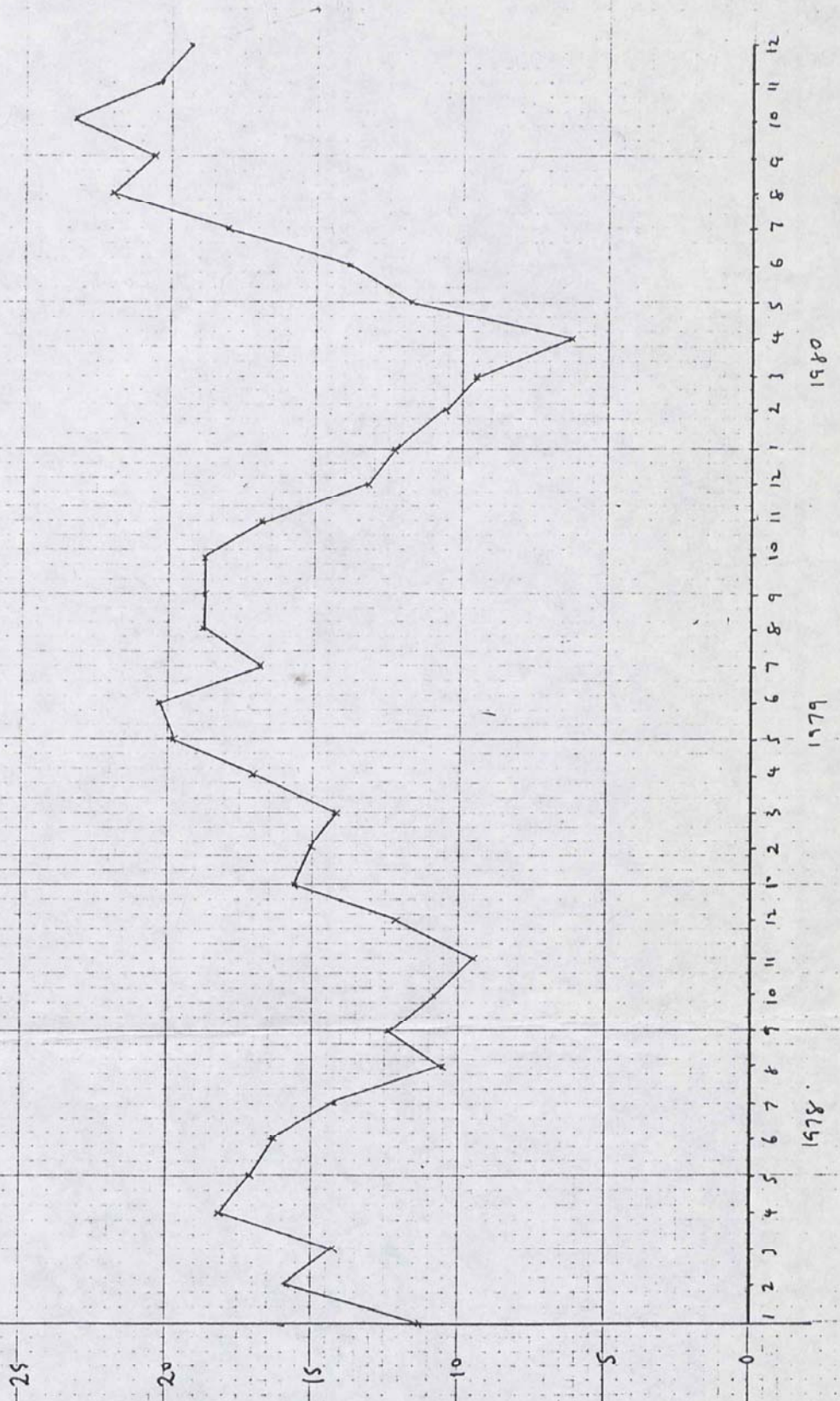
1978

Chart 2: Change in M1 over level of 6 months previously, expressed as an annual rate.



Change

Chart 3: Change in PSLI was level of 6 months previously, expressed as an annual rate



PRIME MINISTER

MONETARY BASE CONTROL

1. I propose that, now the budget is over, we try again to introduce MBC. In my view it is of considerable urgency.
2. At present there is no ostensible monetary control. We are not moving interest rates according to some rule about the excess of monetary ( $\text{£M}_3$ ) growth over target values. We need to control the base of the banking system and at present we have very inadequate means to do this.
3. There is a lot of liquidity in the system mainly in the form of interest bearing financial assets. In order to prevent an explosion in the means of payment, we ought to prevent these financial assets being converted into money. MBC would enable us to avoid such a monetisation.
4. Some problems of adaptation remain but they are minor. My contacts with discount houses have shown that these firms could very quickly adapt to MBC. Indeed in many respects such adaptation has already occurred. The other objections raised by the Chancellor - the behaviour of the building societies and the fate of the two gilt jobbers - need to be examined again, but I doubt if they should constitute a lasting barrier to MBC.
5. If you agree, I shall pursue this further with Middleton and Burns and then the Chancellor.

AAW

12 March 1981

cc Mr. Lankester  
Mr. Wolfson  
Mr. Hoskyns  
Mr. Duguid  
Mr. Strauss





*Prime Minister*

*2*

*Estimated CGBR*

*for Feb and March lower*

Treasury Chambers, Parliament Street, SW1P 3AG  
01-233 3000

*better than in last month's forecast.*

10 March 1981

*See also forecast*

*(at Flagstaff) for*

*April and May.*

*mt*

*ABTA*

*→*

T. Lankester, Esq.,  
No.10, Downing Street

*12*

*12/3*

*mt*

*12*

*12/3*

Dear Tim,

MONTHLY NOTE TO THE PRIME MINISTER ON THE BORROWING REQUIREMENT

I am enclosing this month's note for the Prime Minister. The CGBR for February will be published at 2.30 pm today, Budget Day, Tuesday 10 March.

The forecast of the CGBR for the year as a whole, which will be published later to day in the Financial Statement and Budget Report, is now put at £12½ billion. This is consistent with a PSBR of £13½ billion and is about £½ billion better than the forecast in last month's note. The reasons for this improvement are set out in the note.

The report includes a first shot at forecasts for April and May, including the effect of the Budget.

*Yours*

*John*

A.J. WIGGINS

MONTHLY NOTE ON THE BORROWING REQUIREMENT

MARCH 1981

Summary

- The provisional estimate of the CGBR in February is £737 million giving a cumulative total of £12,199 million. The Financial Statement and Budget Report will show an estimated CGBR for the year as a whole of £12,760 million. This is consistent with a PSBR of £13,455 million and is an improvement of almost £500 million compared with the forecast included in last month's note.

(paragraph 1 and 2)

- Higher receipts from Customs and Excise and lower lending to local authorities and public corporations in February account for most of the improvement.

(paragraphs 3 to 18)

- The Financial Statement and Budget Report will show a forecast of the CGBR in 1981-82 of £11,497 million and a PSBR of £10,566 million. Preliminary forecasts of the CGBR in April and May are included in this month's note.

(paragraph 19)

CGBR in February and in 1980-81 as a Whole

1. The provisional estimate of the CGBR in February is £737 million. This will be published, along with the cumulative total of £12,199 million, in the regular Press Notice at 2.30pm on Tuesday 10 March.
2. Later that afternoon, the Financial Statement and Budget Report will be published. This will show an estimated CGBR for the year as a whole of £12,760 million. This is an improvement of £490 million over the forecast of £13,250 million included in last month's note and is consistent with a PSBR of £13,455 million.
3. As the following table shows, most of the improvement can be accounted for by higher receipts from Customs and Excise and lower lending to local authorities and public corporations in February.

	<u>Improvement in February</u>	<u>Improvement in the forecast for the year as a whole</u>
	(£ million)	(£ million)
Customs and Excise	+200	+135
NLF net lending	+280	+330
Inland Revenue	- 50	-100
Supply Services	+250	+ 25
Other	+ 30	+100
	<u>+710</u>	<u>+490</u>

4. Customs and Excise: Receipts from Customs and Excise in February were some £200 million above forecast. About two thirds of this relates to VAT payments and about one third to excise duties. The surplus on VAT receipts followed a very large deficit in January and may indicate a shift in the balance of tax liabilities from manufacturers, who pay tax in the first month of the quarter, to retailers who paid tax in the second month. Excise duties were well over 10 per cent higher than expected. There is usually some forestalling of the Budget, and this had been allowed for in the forecast. However, it seems to have occurred a little earlier than assumed.

5. The revised forecast for the year as a whole allows for the effect of the Budget. The early withdrawals from bond in February in anticipation of the Budget have their converse effect after the Budget. Receipts of spirits and wine duties can be expected to slump immediately after 10 March. Tobacco duties, however, are deferred until the middle of the following month and the post-Budget reaction will not affect receipts until April.
6. Net lending from the National Loans Fund in February was £280 million less than forecast, the difference being about equally divided between local authorities and public corporations. The forecast for the year as a whole has been revised downwards by £330 million.
7. In last month's note, the forecast of lending to local authorities in February and March was revised upwards by some £370 million. This was largely on advice from PWLB about the effect of the decision to reallocate unused quotas among local authorities. But it was also consistent with independent information about local authorities total borrowing intentions.
8. The high levels of borrowing in February have failed to emerge. There is a risk that authorities are simply postponing their borrowing, especially from the PWLB, in the hope of lower interest rates in the last weeks of March. (The earliest date at which the PWLB would revise their interest rates after the Budget is March 14). The new, lower forecast for the year is consistent with a lower view of total local authority borrowing incorporated in the Financial Statement and Budget Report, and still allows for net lending to local authorities of some £200 million, £50 million higher than in March last year.
9. The forecast of net lending to public corporations in February and March was reduced in last month's note, but the outturn for February was even lower than expected. In view of this, and in the light for further information and advice from the Departments concerned, the forecast for the year as a whole has been reduced by a further £40 million. This relates mainly to borrowing by Water Authorities and the Post Office.
10. The forecast of lending to local authorities and public corporations is still very uncertain. It is difficult to predict their total borrowing, even at this late stage in the year. It is even harder to predict the balance of their borrowing between central government and the market and overseas; but, while that can result in large changes to the CGBR, it washes out within the PSBR.

11. Inland Revenue: Receipts from Inland Revenue in February were much as expected, although there was some shortfall in corporation tax. The forecast for the year as a whole, which has been reduced by £100 million, now incorporates the £1,326 million of petroleum revenue tax actually paid into the Consolidated Fund on Monday 2 March. This was about £80 million less than Inland Revenue were assuming two or three weeks ago.
12. Supply Services in February were about £250 million below forecast. However, most of this apparent improvement has been discounted as a timing effect. The impact of the new billing procedures to the Ministry of Defence occurred rather earlier than had been assumed. The forecast for the year as a whole, apart from the British Leyland transaction explained in paragraph 15 below, is virtually the same as in last month's note, but the distribution between February and March has changed.
13. The forecast allows for the sort of "end-year surge" which has occurred in past years. It allows for the recent Spring Supplementary Estimates, including £263 million on Defence. But, as in last month's note, the forecast also includes a precautionary allowance for a further possible overspend on Defence.
14. There are a number of other changes to the forecast. These are largely offsetting, none is significant, and the net effect is to reduce the forecast CGBR for the year as a whole by £100 million.
15. The main offsetting change is the incorporation of the effect of the financial transaction associated with the transfer of British Leyland shares from the National Enterprise Board to the Secretary of State for Industry. The forecast of Supply Services in March now includes the payment of £1,284 million to the National Enterprise Board; the corresponding repayment of public dividend capital is included in the forecast of "other" consolidated fund receipts, and the net effect on the CGBR is zero.
16. Table 1 attached gives further details of the outturn in February compared with the forecast given in last month's note. Table 2 shows the CGBR since April 1979 along with the new forecast for the year as a whole. Table 3 gives details of the cumulative outturn to the end of February, the new forecast for March, and the new forecast for the year as a whole. As already mentioned, the outturn to the end of February will be published in the Press Notice on Budget day and the forecast or "estimated outturn" for the year as a whole will be published in the Financial Statement and Budget Report. Comparison of the two will expose the full details of the forecast for March.

Table 3 also shows the Budget forecast for 1980-81 published last year. An explanation of the difference between that forecast and the estimated outturn is given in Part IV of the Financial Statement and Budget Report.

The CGBR in 1981-82

18. The forecast of the CGBR in 1981-82 shown in the Financial Statement and Budget Report is £11,497 million which is consistent with a PSBR of £10,566 million. The main components are shown in table 3 attached, along with preliminary forecasts for April and May. The total for the two months is £3,200 million, which is much the same as the total for April and May 1980. However, the forecasts for the individual months are at this stage very much a first shot. There has not been enough time yet for the normal departmental profiles to be compiled. For the most part, therefore, the forecasts are based on the pattern of expenditure and receipts in 1980-81, modified where possible for the impact of the Budget measures and other known differences.

## CONFIDENTIAL

TABLE 1

## CENTRAL GOVERNMENT BORROWING REQUIREMENT - FEBRUARY

£ million

	<u>Forecast</u>	<u>Outturn</u>	<u>Effect on CGBR</u>
<b>RECEIPTS</b>			
<u>Consolidated Fund</u>			
Inland Revenue	2,650	2,596	- 54
Customs and Excise	1,700	1,901	+199
Other	850	909	+ 59
<u>National Loans Fund</u>			
Interest etc receipts	300	289	+ 11
<b>Total receipts</b>	<b>5,500</b>	<b>5,695</b>	<b>+195</b>
<b>EXPENDITURE</b>			
<u>Consolidated Fund</u>			
Supply services and Contingencies Fund	6,000	5,743	+257
Other	300	260	+ 40
<u>National Loans Fund</u>			
Service of the national debt	650	659	- 9
Net lending	200	-80	+280
<b>Total expenditure</b>	<b>7,150</b>	<b>6,582</b>	<b>+568</b>
<b>Other funds and accounts</b>	<b>+150</b>	<b>+150</b>	<b>-</b>
<b>CGBR</b>	<b>-1,450</b>	<b>-737</b>	<b>+713</b>

## CONFIDENTIAL

TABLE 2  
CENTRAL GOVERNMENT BORROWING REQUIREMENT

£ billion

	In Month		Cumulative		
	1979-80	1980-81	1979-80	1980-81	Difference
April	1.3	0.9	1.3	0.9	-0.4
May	1.5	2.4	2.8	3.3	+0.5
June	1.0	1.3	3.8	4.6	+0.8
July	-	0.8	3.8	5.4	+1.6
August	1.1	1.6	4.9	7.0	+2.1
September	1.7	0.8	6.6	7.9	+1.2
October	0.1	0.1	6.8	8.0	+1.3
November	1.8	2.8	8.6	10.9	+2.2
December	1.6	2.3	10.2	13.1	+2.9
January	-2.5	-1.7	7.7	11.5	+3.7
February	0.3	0.7	8.1	12.2	+4.2
March	0.2	(0.6)	8.2	(12.8)	+4.5

Note: Some rows may not across add because of rounding. Each column is correctly rounded.

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TABLE 3  
CENTRAL GOVERNMENT BORROWING REQUIREMENT

	1980-81				1981-82		
	April to February	Forecast for March*	Estimated out-turn for whole year*	Budget forecast for whole year	Forecast for April	Forecast for May	Budget forecast for whole year
<u>Receipts</u>							
<u>Consolidated Fund</u>							
Inland Revenue	29,780	3,620	33,400	32,860	2,675	2,600	39,100
Customs and Excise	20,512	1,623	22,135	24,000	2,400	1,750	26,000
Other	8,033	3,246	11,279	8,555	560	710	10,424
<u>National Loans Fund</u>							
Interest etc receipts	4,081	689	4,770	5,050	280	250	4,900
<u>Total receipts</u>	62,406	9,178	71,584	70,465	5,915	5,310	80,424
<u>Expenditure</u>							
<u>Consolidated Fund</u>							
Supply Services	60,462	7,896	68,358	64,765	5,800	5,700	73,741
Other	2,860	330	3,190	3,460	280	280	3,756
<u>National Loans Fund</u>							
Service of the National debt	8,917	1,033	9,950	10,000	380	1,280	11,100
Net lending	3,048	323	3,371	2,905	400	160	4,034
<u>Total expenditure</u>	75,287	9,582	84,869	81,130	6,860	7,420	92,631
<u>Other funds and accounts</u>	+682	-157	+525	+1,352	-250	+110	+710
<u>CGBR</u>	-12,199	-561	-12,760	-9,313	-1,200	-2,000	11,497

\*The forecast for March and for the whole year includes the financial transaction associated with the transfer of British Leyland shares from the NEB to the Department of Industry. The figures for Supply Services includes the payments of £1,284 million to the NEB; the corresponding repayment of Public Dividend Capital by the NEB is included in the figures for Other Consolidated Fund receipts.

Note: Some rows and columns may not add due to rounding.

Mr Hankins (No 10)

BUDGET SECRET

Ami Amish

2

16

6/3

cc Mr Locke  
Mr Burns  
Mr Sedgwick  
Mr Denham  
Mr Unwin

~~MR TOLKIEN~~

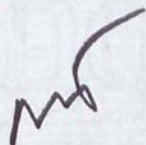
MEDIUM TERM FINANCIAL STRATEGY

You said that No 10 had asked to see the section of the FSBR covering the Medium Term Financial Strategy.

2. I attach a copy for you to send. There are still a few corrections to be made at the printers, but this is effectively the final text.



F CASSELL  
6 March 1981



# BUDGET—SECRET

## PART II

### MEDIUM-TERM FINANCIAL STRATEGY

1. The Government's objectives for the medium-term are to bring down the rate of inflation and to create conditions for a sustainable growth of output and employment. It is committed to a progressive reduction in the growth of the money stock and to pursuing the fiscal policies necessary to achieve this without excessive reliance on interest rates. The past year has seen greater monetary growth and public borrowing than was intended, but the Government is determined to ensure that the essential thrust of its financial strategy for the medium-term is maintained. The main proposals in the Budget are directed to that end.

2. The fiscal projections set out below are consistent with the Government's aims to reduce monetary growth and inflation. But the projected level of public expenditure implies a tax burden significantly higher than the Government would wish. For this reason the Government regards the level of public expenditure as requiring the most serious attention during the 1981 Survey.

#### Financial Developments in 1980-81

3. As explained in more detail in Part III, the recession has been worse than was expected a year ago, and in particular manufacturing output and employment have fallen sharply. Inflation, however, came down faster than was forecast and the prospects are for a further decline in the coming year.

4. With output and inflation both falling, the growth of nominal GDP slowed down considerably in the course of 1980-81. This helped to ease the upward pressures on interest rates. The year, however, was marked by major imbalances within the economy and these were a major factor behind the rapid growth of the broad measures of the money stock.

5. High pay settlements in the 1979-80 round coupled with the high exchange rate substantially increased the real disposable income of persons. A high proportion of this income was saved. This rise in personal

incomes, however, was largely at the expense of companies, whose profits were severely squeezed. Companies reacted to the pressures on them by reducing stocks and employment. The company sector thereby contained its financial deficit within reasonable bounds. Its actions helped to produce a large surplus in the current account of the balance of payments. They also increased the public sector's deficit. The fall in employment in the private sector and the high pay increases in the public sector, partly reflecting the staging of earlier awards, meant that the pay bill of the public sector rose twice as fast in 1980-81 as that of the private sector. This divergence contributed to the over-run of the PSBR.

6. The increase in the public sector's borrowing was not, however, as in previous recessions, accompanied by much fall in the private sector's demand for credit. Bank lending remained high for most of the year, partly reflecting the desire by companies to preserve their liquidity.

7. High personal saving and the limitation of the company sector deficit were reflected in a substantial increase in the net financial assets of the private sector as a whole. This rise in the private sector's financial wealth was probably an important influence on the growth of the wider measures of money supply, since the public's demand for liquid balances is, over time, related to the movement of its total holdings of financial assets. Real financial wealth had been depressed in 1979 by the effects of high inflation and high interest rates. The past year has seen it restored to a more normal level.

8. The difficulties of interpreting recent monetary developments are increased by the wide divergence between the various monetary indicators. All the measures of money stock fell in real terms during the winter of 1979-80; all showed some real increase from the spring onwards, but the increase was considerably greater for £M3 than for the other aggregates. Over the year to mid-February £M3 grew by 20 per cent.

TABLE 4  
GROWTH OF MONETARY AGGREGATES

	MI	£M3	PSL1	PSL2
Percentage growth February 1980-February 1981 ... ..	11	20	17	15

Handwritten annotations: A circle with '9' is connected to the 'MI' column. A circle with '17' is connected to the 'PSL1' column. A circle with '15' is connected to the 'PSL2' column. There are also some scribbles above the 'PSL1' and 'PSL2' values.

# BUDGET—SECRET

## MEDIUM-TERM FINANCIAL STRATEGY—continued

17 | A better guide to the true growth of broad money through this period is probably given by PSL1, which includes private holdings of bills as well as money, and so should have been less affected than £M3 by the corset and other distortions. This rose by ~~4~~ per cent during the year. The still wider measure of private sector liquidity, PSL2, which includes savings deposits and securities, rose by 15 per cent. Among the

narrower measures of money supply, M1 rose by only 1 per cent. This and other narrower measures of the money stock in fact fell in real terms over the year as a whole. Other indicators also suggest that financial conditions in 1980-81 were tight: the high exchange rate; high interest rates; the absence of any marked upward movement in the prices of houses or other real assets. 9 |

TABLE 5  
RANGES FOR GROWTH OF THE MONEY STOCK (£M3)\*

	1981-82	1982-83	1983-84
Percentage change during year ... ..	6-10	5-9	4-8

\* As the Green Paper on Monetary Control (Cmnd. 7858) explained, the way in which money supply is defined for target purposes may need to be adjusted from time to time as circumstances change.

9. Taken on its own, therefore, £M3 has not been a good indicator of monetary conditions in the past year. However, over the medium-term its velocity of circulation has been broadly stable, and for such a period the growth of £M3 can be more readily related to the growth of nominal income and overall fiscal stance. It can, therefore, provide a guide to the levels of public expenditure, revenues and borrowing likely to be consistent, over the medium-term, with the objective of bringing down monetary growth and interest rates. £M3 is accordingly being retained as the main target variable in the medium-term financial strategy, though as in the past year, the significance of short-run movements for interest rate policy will be interpreted in the light of other financial developments as well.

### The path for monetary deceleration

10. Some of the factors that have been identified as contributing to the rapid growth of £M3 in 1980-81 mean that it should not have the implications for future inflation which generally follow an increase in money supply. At the same time the high exchange rate and high real interest rates have ensured that monetary conditions remained tight and that progress in reducing inflation was maintained.

11. Nonetheless, it is important not to disregard the past year's rapid rise in setting targets for monetary growth for the later years of the medium-term financial strategy. As explained in the Budget Speech, the target range for £M3 in 1981-82 is to be set at the 6-10 per cent indicated in last year's FSBR. The precise target ranges for the following years will be decided nearer the time. Meanwhile it is the Government's intention to consider clawing back some of the past year's rapid growth of £M3 by permitting an

undershoot as and when the opportunity arises. In the present review of the medium-term financial strategy no allowance has been made for such clawing back in the later years of the MTF period. The ranges for 1982-83 and 1983-84 shown last year have therefore been retained. They are set out in Table 5 above.

### Fiscal policy

12. The Government intend that fiscal policy should be consistent with this declining path for monetary growth. The PSBR as a proportion of GDP will be brought down substantially over the medium-term, so as to create conditions in which interest rates can fall.

13. The illustrative tables in last year's Financial Statement and Budget Report were based on the public expenditure plans as they stood at that time and revenue projections that assumed that GDP grew by 1 per cent on average in the years 1980-83. Since those projections were made there have been some substantial changes:

First, the prospects for growth over the next two or three years, both in this country and in the rest of the world, have deteriorated: this both reduces projected revenue and increases projected expenditure.

Second, partly as a result of the lower activity, public expenditure plans in the new White Paper (Cmnd. 8175) are considerably higher than those published a year ago.

Third, the build-up of North Sea revenues looks like being slower than expected earlier, in spite of changes to the North Sea fiscal regime.

Fourth, the increases in other taxes and contributions announced last November and in the Budget will increase future revenues.

# BUDGET—SECRET

## MEDIUM-TERM FINANCIAL STRATEGY—continued

14. The first three of these changes all worsen the fiscal prospect. They have entailed substantial increases in the tax burden. The illustrative tables published last year showing the evolution of government expenditure, revenue and borrowing over the period to 1983-84 have been re-worked to take account of these changes.

15. For this purpose it has been assumed that GDP growth over the three years 1980-83 averages  $\frac{1}{2}$  per cent a year. Such a rate is broadly representative of the current range of outside forecasts. The reduction from the 1 per cent average for this period assumed a year ago mainly reflects the lower output now expected in 1981. If the economy develops in the coming year as now forecast, the assumption made for the three years would imply growth averaging about  $1\frac{1}{2}$  per cent in the last two years of the period.

### Public expenditure

16. The plans announced in the Public Expenditure White Paper (Cmnd. 8175) show a reduction of 4 per

cent in the volume of public expenditure between 1980-81 and 1983-84, about the same as in the plans published last year, but starting from a substantially higher level.

17. In assessing the implications for fiscal policy, it is helpful to look at expenditure in cost terms (i.e. including the assumed relative price effect, RPE), since this gives a clearer idea of their tax and financing implications. In the past year the relative cost of public expenditure has risen sharply, reflecting both the growth of earnings in the public services and the fact that the goods and services bought for the public services have not experienced the same downward pressures on their prices as those bought by consumers or private businesses. In cost terms (at 1979-80 prices) general government expenditure is projected to decline over the next four years—from £91½ billion in 1980-81 to £87½ billion in 1983-84. This is a bigger reduction than shown in the volume figures, and reflects some fall in the relative cost of government expenditure.

TABLE 6

### GENERAL GOVERNMENT EXPENDITURE

		1979-80	1980-81	1981-82	1982-83	1983-84
General government expenditure at 1980 survey prices <sup>(1)</sup>	77.9	79	79½	78	76½	
<i>At 1979-80 prices</i>						
General government expenditure in cost terms <sup>(2)</sup>	77.3	79½	79½	78	76	
Special sale of assets <sup>(3)</sup>	-1.0	—	—	—	—	
Shortfall, etc. <sup>(4)</sup>	—	—	-½	-½	-½	
National Accounts Adjustment <sup>(5)</sup>	2.9	2½	2	2	2	
Interest payments <sup>(6)</sup>	9.6	10	10	10	10	
Total expenditure in national accounts terms <sup>(7)</sup>	88.8	91½	91½	90	87½	

(1) Expenditure on programmes by central and local authorities and the contingency reserve. See Cmnd. 8175, Table 1.1, lines 1, 2 and 6. Debt interest payments are shown separately below. Since most plans are not decided in detail yet for the years after 1981-82 broad assumptions have been made about the share of general government in the total of expenditure on programmes shown in Cmnd. 8175, Table 1.1, for 1982-83 and 1983-84. For convenience, the whole of the contingency reserve is allocated to general government in all years in this table.

(2) Line 1 revalued to 1979-80 prices in cost terms, i.e. including projected relative price changes. For each category of public expenditure its relative price is the ratio of its deflator to the deflator for GDP at market prices. The figure for 1979-80 is equal to the sum of the lines for central government and local authorities in Cmnd. 8175 Table 4.6.

(3) Cmnd. 8175, Table 1.1, line 5 revalued to 1979-80 prices. Includes revenue offsets to planned expenditure and a small element attributable to public corporations.

(4) Cmnd. 8175, Table 1.1, line 7, revalued to 1979-80 prices with Budget measures added. Certain adjustments have been made in respect of public corporations. Includes the net effects of different economic assumptions from those used in Cmnd. 8175.

(5) Adjustment to convert line 2 to the definition used in national accounts statistics. Revenue offsets to planned expenditure and a small element attributable to public corporations are offset here. This differs from last year's treatment in which they were included on the expenditure side. For 1979-80 includes residual measurement differences.

(6) For 1979-80 as in Financial Statistics, February 1981. For 1980-81 and 1981-82, revalued figures for general government in line 13 of Table 14 of this report.

(7) For 1979-80 equal to line 4 of Table 2.4, Financial Statistics, 1981. This base year is chosen because it is the latest complete year for which output figures, and full details of relative prices, are available.

# BUDGET—SECRET

## MEDIUM-TERM FINANCIAL STRATEGY—continued

TABLE 7  
GENERAL GOVERNMENT RECEIPTS

	1979-80	1980-81	1981-82	1982-83	1983-84
<i>General Government Receipts at 1979-80 prices<sup>(1)</sup></i> (£ billion)					
Taxes on income, expenditure and capital ...	60.9	61	64	65	66 <sup>2</sup>
National insurance, etc. ... ..	12.0	12½	12½	13	13
Interest and other receipts ... ..	5.5	6	6	6	6
<i>Total Receipts</i> ... ..	78.4	79½	82½	84	85
of which:					
North Sea tax revenues <sup>(2)</sup> ... ..	2.3	3½	4½	4½	5½

(<sup>1</sup>) Converted to 1979-80 prices using the deflator for GDP at market prices, so that these projections are directly comparable with the expenditure projections in Table 6.

(<sup>2</sup>) Royalties, Supplementary Petroleum Duty (from 1981-82), Petroleum Revenue Tax and Corporation Tax from North Sea oil and gas production (before Advance Corporation Tax set-off).

18. Table 8 below sets these expenditure projections against an illustrative projection of government revenue. The assumptions made about GDP growth would imply a fall in public expenditure as a proportion of GDP from 44½ per cent in 1980-81 to 41 per cent in 1983-84.

### Revenue

19. The growth of government revenue over the medium-term will be strongly affected by the growth of output. Table 7 shows the estimates growth of real revenues (on the same price basis as that used for general government expenditure in Table 6) on the assumption that GDP grows by ½ per cent a year on average over the three years 1980 to 1983.

20. Revenue is projected on the conventional assumption of constant indexed tax rates and allowances at the proposed 1981-82 levels. National insurance

contributions in future years are assumed to be adjusted to maintain the balance of income and expenditure in the fund. It is assumed that the supplementary petroleum duty continues throughout the period. On these assumptions, total general government revenues are projected to rise by about 7 per cent in real terms between 1980-81 to 1983-84.

21. About a third of this increase is accounted for by rising revenues from the North Sea. With the proposed changes in the North Sea fiscal regime these are expected to rise by about 50 per cent in real terms over the three years. But even so the build-up of North Sea revenue is slower than was expected a year ago. This reflects, among other things, the further substantial scaling down of the projected output ranges and higher estimates of capital spending at tax-paying fields. The projections assume some modest increase in the world oil price in real terms after 1981.

TABLE 8  
PUBLIC SECTOR BORROWING

	1979-80 prices (£ billion)				
	1979-80	1980-81	1981-82	1982-83	1983-84
Total general government expenditure ... ..	88.8	91½	91½	90	87½
Total general government receipts... ..	-78.4	-79½	-82½	-84	-85
Implied fiscal adjustment ... ..	—	—	—	1	2
General Government Borrowing Requirement (GGBR)	10.4	12	9	7	4½
PSBR <sup>(1)</sup>	9.9	11½	8	6½	4
(as percentage of GDP at market prices) ...	5.0	6	4½	3½	2

(<sup>1</sup>) The difference between the GGBR and the PSBR—public corporation borrowing from the private sector and overseas—is consistent with Table 14 of this report for 1980-81 and 1981-82, and with Cmnd. 8175, Table 1.1, line 4 for subsequent years.

# BUDGET—SECRET

## MEDIUM-TERM FINANCIAL STRATEGY—continued

22. Receipts of non-North Sea taxes are projected to rise by about 4½ per cent in real terms through the period. The projected yield of these taxes is, of course, highly sensitive to the particular growth rate assumed for the economy.

### Money Supply and Public Sector Borrowing

23. The new projections of government receipts and expenditure are brought together in Table 8 to provide projections of the general government borrowing requirement and the PSBR.

### Comparison with Last Year's Projections

24. The PSBR for 1980-81 is now estimated at £13½ billion, compared with the forecast of £8½ billion in the Budget (see Part IV). The PSBR of £10½ billion forecast for 1981-82 is about £3 billion higher than that implied in last year's medium-term projections. General government expenditure in that year is now put about £6 billion higher in cash than was then projected, and revenue about £3 billion higher. A substantial part of the increase in the forecast of expenditure in both 1980-81 and 1981-82 is attributable to the recession being worse than expected, with spending on social security benefits, special employment measures, redundancy fund payments and, in 1981-82, external finance for nationalised industries especially affected. In addition, debt interest payments and some expenditure on goods and services are also higher than forecast a year ago. The main influence on the revenue forecast is the real increase in taxes in the Budget.

25. These changes carry through into the projections for later years. Moreover, the increase in expenditure over the levels projected a year ago is greater when expressed in cost terms than in cash or volume—mainly because the general price level is now lower than was expected a year ago (which has the effect of increasing the RPE). The figures in Tables 6, 8 and 9 of last year's Financial Statement and Budget Report can be approximately translated to the ~~1978-79~~ price base used this year by inflating them by 16½ per cent (which was the rise in the GDP deflator between the two years as estimated at the time of the 1980 Budget).

26. As was stressed when the projections were introduced last year, the particular course shown for the PSBR should not be interpreted as a target path. It is a projection of the course of the PSBR based on the assumed growth of GDP and present public expenditure plans that should be broadly compatible with the monetary objectives. Fiscal policy in any particular year will be operated so that the PSBR for that year will be consistent with declining monetary growth in the particular circumstances of the time. Because the level of activity in the economy is below that assumed in last year's projections, the path for the PSBR shown in these projections is rather higher than that shown last year. By 1983-84 the PSBR is assumed to be about 2 per cent of GDP at market prices (compared with 1½ per cent assumed last year).

27. The PSBR path shown requires, on the assumptions made, a "fiscal adjustment". As in last year's projections, this implies that—given all the assumptions—on present tax rates and expenditure plans the PSBR ratio could be met with some margin to spare for fiscal relief. However, the higher levels of public expenditure now projected inevitably mean that the margin is substantially smaller, and occurs later, than in last year's projections. Moreover, it is also starting from a higher tax base, reflecting the real tax increases proposed for 1981-82. In broad terms the fiscal adjustment implied for the later years would do no more than offset the rise in the personal tax burden in the ~~present~~ year. Although this does not prejudice the achievement of the Government's monetary policy and financial strategy, it is clearly unsatisfactory in the context of the Government's wider economic objectives.

28. The projections shown above fall within a very wide range of possible outcomes. They should be taken as no more than illustrative of one particular evolution of the economy. If the economy were to evolve in a different way, the projections of public finances could be substantially affected. The policy response to such changes would depend on their nature, but although the revenue and expenditure figures could change substantially, the intention would be to hold firmly to the main thrust of the financial strategy—which is to bring about a progressive reduction in the growth of money supply and inflation over the medium-term.

at 1978-79 prices

Coming

18 19



*C. J. P. A. USA: Visit to  
Washington during  
Jan 81*

Treasury Chambers, Parliament Street, SW1P 3AG

01-233 3000

5 March 1981

Tim Lankester Esq  
Private Secretary  
Prime Minister's Office  
No.10 Downing Street  
LONDON SW1

*Dear Tim, P 73*

SECRETARY REGAN'S REMARKS TO THE CONGRESSIONAL COMMITTEE

The Chancellor asked me to send you a copy of a letter which Sir Kenneth Couzens has written to Mr Beryl Sprinkel about the remarks Secretary Regan made to a congressional committee on 27 February.

I am copying to Roderick Lynde in the Foreign Office.

*Yours ever,*

*P S*

P S JENKINS  
Private Secretary





H M Treasury

Parliament Street London SW1P 3AG

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Sir Kenneth Couzens KCB  
Second Permanent Secretary  
Overseas Finance

3 March 1981

PERSONAL

Mr Beryl Sprinkel  
Under Secretary Designate,  
Monetary Affairs  
US Treasury  
15th Street NW  
WASHINGTON DC 20020

*Dear Beryl*

You may have heard that what Secretary Regan said to a Congressional Committee about Mrs Thatcher's economic policy on 27 February probably received more publicity in the UK than it did in the United States. It was reported prominently in the Financial Times and the Times, and on the radio.

2. The only transcript I have so far received comes from the British Broadcasting Corporation. If this transcript (attached) is correct, I am afraid that the Committee heard one or two mistakes of fact. Since, as has been repeatedly said during Mrs Thatcher's visit to the United States, the main thrust of the economic policies of our two governments is so similar, it would be a pity if either side misunderstood what the other was doing or trying to do, or were misinformed about the environment in which the attempt was being made. So I hope you will forgive me if, with the Chancellor's agreement, I send you one or two corrections.

3. First, the proportion of the working population in Britain which, on the widest possible stretch of the term, could be regarded as working for government is 30%, not 60%. This includes everybody working for any kind of local authority and the employees of all state-owned industries and of the National Health Service. The great majority of them are not working for the Government, though they are in the public sector.

4. Secondly, Mrs Thatcher's Government reduced the top rate of tax on earned income from 83% to 60% and on investment income from 98% to 75%. They did this in their first budget a few weeks after taking office. They also raised substantially the levels of income at which these maximum rates were reached.

5. Thirdly, they did not try to control the foreign exchange markets. The reverse is true. They completely abolished all exchange controls after 40 years in the autumn of 1979 and they have permitted the exchange rate to be determined strictly by market forces. They did not join the exchange rate arrangements of the European Monetary System. So it is hard to say that "their efforts to control the foreign exchange markets were unsuccessful". As believers in market forces, they didn't make any.

6. Fourthly, "they ruined their export trade" is a bit of an overstatement. British exports had to be achieved in a harsher environment. But the volume of British exports rose 1.75% in 1980 over 1979 and their dollar value increased by 27½%. For comparison, the value increase of Japanese exports in the same period was 25% and of US exports 22½%. And value is what pays the import bill and looks after the current account.

7. Fifthly, the story about the high pay increases (so-called Clegg increases, after the Committee which recommended them) in the public services in 1979 needs correction. Mrs Thatcher decided she must honour the pledge of the preceding Government on these increases, though she would certainly say they were excessive and damaging, especially in 1980. It is incorrect to say that the workers who received these "catching up" increases were not highly unionised. They were in fact all completely unionised and negotiated on a national basis.

8. As you know, everyone in Government in Britain greatly hopes that the programme of your Government will succeed. It is in the interests of the whole Western world that it should and Mrs Thatcher has already applauded the principles on which that programme is constructed. We all recognise that in our parallel efforts we are coping with disadvantages you do not have: a higher rate of inflation to begin with; a much bigger public sector, with several major nationalised industries; much more unionisation, especially in the public sector; a much weaker economy at a lower level of productivity; and the need to make a start with the programme at the onset of a major oil price increase and recession instead of after the worst had passed.

9. So there are good structural reasons why the struggle ought to be easier for you than it is for us. But it is unhelpful, and also unrealistic to suggest that we have failed because of policy mistakes whereas you won't because you won't make any. Our Government does not accept that it has failed, as you will have gathered from Mrs Thatcher. We have after all reduced our rate of inflation faster in 1980 than any other major country. Anyway, as our Chancellor remarked, Finance Ministers have to stick together. They don't have many other friends when the going gets rough!

10. We much look forward to seeing Secretary Regan and yourself in London on 12 April - if not sooner.

My best regards. Yours sincerely

*Ken Couzens*  
K E COUZENS

enc

DONALD REGAN'S CRITICISM OF MRS THATCHER'S ECONOMIC POLICY

Transcript from BBC Radio 4, Today, 27 February 1981

PROGRAMME PRESENTER: .... He was giving evidence to a Congressional Committee and was asked what mistakes the British Government had made in the economic sphere. Well he took a deep breath because he had an awful lot to say about this:

REGAN: ..... nonetheless, when Mrs Thatcher and her Party came into power practically 60% of the population in Gt Britain in one form or another was working for the Government. Luckily we don't have that in this country; And at the same time Mrs Thatcher was faced with a rate of inflation that was even greater than we have today. She also admits that the tax cuts that she proposed were not nearly as great as perhaps they should have been. You will recall that in the so called unearned income area her suggestion was from 93% down to about 80%, and in the earned area from 83% to 63%. But having done that they then raised the value added tax, VAT, there wasn't that much incentive therefore in her tax cuts in order to get her economy really started again. One other feature that happened at that time; they tried to control the foreign exchange markets. Their efforts were not successful. As a result, what happened brought the £ really up in value. So high in fact that they ruined their export trade. Therefore the programme that she had designed did not produce the stimulative effect that she wanted. Now right after that there were a large number of workers who were not highly unionised, who had not had pay increases to the equivalent of what some of the highly unionised areas of the country had. She gave pay increases in the neighbourhood of 22 to 28% within the first year of being in Government. This had to have an explosive inflationary effect. Now contrast that with what we're trying to do. What we're trying to do here is to give incentive tax cuts right across the board and to bring down, over a 3 year period, unearned income to the 50% range. At the time we're doing this this has a great impact on our capital/<sup>gains</sup>situation, it gives greater incentive

save, to invest. We are also really deeply into budget cuts. And the Budget cuts are going to really get federal spending, fiscal responsibility if you will, where we want it. Accompanying that we have monetary reform. Now in England they did not get the M3 under control. M3 over there continued to grow at a rate of 12 to 15%. Our money is going to stay under control. The deficits that we're projecting for '82 and '83 will be financed more out of private savings than out of printing of money or monetising our debts. We think that our programme is much more sensible, much more comprehensive, and with a greater degree of chance of success than the British experience.

PA(CFR/e)

CHANCELLOR OF THE EXCHEQUER

MS

PRIME MINISTER

This briefing is too technical  
 for our purposes; we can perhaps  
 get a simplified line tomorrow.  
 You might like to glance through  
 it very rapidly. I have flagged  
 a couple of pages which suggest  
lines for you to follow.

MS 4/3

cc Chief Secretary  
 Financial Secretary  
 Minister of State (C)  
 Minister of State (L)  
 Sir Douglas Wass  
 Mr Burns  
 Sir Kenneth Couzens  
 Sir Anthony Rawlinson  
 Mr Ryrie  
 Mr Middleton  
 Mr Britton  
 Mr Cassell  
 Mr Evans  
 Mr Monck  
 Mr R I G Allen  
 Mrs Gilmore  
 Mrs Lomax  
 Mr Riley  
 Mrs Stamler  
 Mr Turnbull  
 Mr H J Davies  
 Mr Shields  
 Mr Aaronson  
 Mr Folger  
 Mr Springthorpe (Parly)  
 Mr Lennon  
 Mr Ridley  
 Mr Cropper

PS/Governor - Bank of England

TREASURY COMMITTEE MONETARY REPORT: BRIEFING

The Treasury Committee's Monetary Report will be published (with a press conference) at noon tomorrow. CFR's have already gone out (copies are being distributed within the Treasury separately) so that the Press "heavies" will almost certainly give the Report advance coverage tomorrow morning.

2. I attach briefing that we have prepared. The spadework has been done by Mr Shields, but it reflects discussion with Mr Burns and others. It is in three sections:-

- A summary of the Report;
- Some "bull points" to use;
- Further defensive briefing.

3. In a sense the strength of the Report lies in the fact that it has no strongly defined position so that there is a bit of something in it for everyone. The two most potentially damaging areas are the doubt cast in Chapter 8 on the causal relationship from monetary growth to inflation (though the Committee remain basically agnostic on this); and the strictures in the same Chapter on the costs of reducing inflation by restrictive monetary policy. The main weaknesses of the Report are (as in previous reports) the absence of any coherent alternative strategy; the failure to assess the costs of not attacking inflation by some such strategy as the Government are pursuing; and the sheer wetness of the Report on a number of issues (eg on the exchange rate where the analysis ends simply with an exhortation to the Government to keep methods of influencing the rate under review). All these points are covered in the briefing.

#### Reactions tomorrow

4. We shall need to decide tomorrow what sort of profile to adopt. If we are allowed to, a low profile would be better. We do not wish to contribute <sup>to</sup> enhancing the Report's status; and you will not in any case want to be drawn into anticipating in any way next week's Budget statement. But I suspect that it may be difficult to maintain this, particularly if a vigorous press conference follows prominent background coverage in tomorrow's morning's papers. In this case you will need to consider in the course of the morning whether you (or, say, the Financial Secretary) should make any comment on the record; and whether Mrs Gilmore or others should intensify press briefing through the usual channels. We can make a first judgement when we see tomorrow morning's press. We can then consider further in the light of the press conference at which we shall have representatives.

Prime Minister's Question Time

5. The Prime Minister will also require briefing for Question Time tomorrow afternoon. If you agree, I think it might be useful if this note and the briefing went over to No 10 tonight. Again, if circumstances allow it would be better for the Prime Minister herself to maintain a fairly low profile. She will (quite justifiably) be able to claim not to have had time to read the Report; and she will not want to anticipate the Budget (though without implying that the Budget will necessarily address itself specifically to the Report). But, if pressed, the Prime Minister might also find it necessary to draw on some of this briefing and to deal with the Report in fairly robust terms. In particular both she and you would obviously want to make it absolutely clear that the publication of this Report does not mean that there will be any change of policy (perhaps adding that the Report seems to contain a good deal of misunderstanding of present policies - witness the ill-founded criticisms of the rigidity of the MFS).

6. If the briefing is sent to No 10 it might be helpful if we were to make further contact with Mr Lankester around lunchtime tomorrow in the light of the morning's developments.

Official Government reply

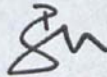
7. We shall also need to consider in due course whether there should be a formal written Government reply. We are not obliged to do so. We could, for example, argue that the Budget Speech and speeches during the Budget Debate contained as much reply as the Government intended to give. But I suggest we keep the options open and consider this again after the Budget. We may decide that it is positively in our interests to put some further written comments on the record.

Report agreed with the Treasury?

8. I understand that Mr Du Cann has claimed that the Report was agreed with the Treasury. This seems to be the same kind of canard

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that he more or less perpetrated last summer. If it comes up publicly, it should be emphatically denied. As you know, the Report was sent to us by the Committee in draft in the usual way with a request for purely factual comments. Our opinions were not sought and in sending our comments I made it clear in writing that this did not imply in any way Treasury agreement to the opinions or judgements in the Report.



J B UNWIN

4 March 1981



## SELECT COMMITTEE MONETARY REPORT: SUMMARY

There are two main themes in the Report:-

- i) scepticism about the causal relationship from monetary growth to inflation; and
- ii) a rejection of a policy based on inflexible targets for a single monetary aggregate (particularly £M3) set for a period of years.

On the positive side, however, the Report:-

- i) "welcomes the Government's readiness to announce medium and longer term objectives which express its policy intentions"; and
- ii) it does not offer any specific policy alternatives.

Its general thrust is that economic policy should be conducted in a more eclectic, pragmatic way. It recommends that more attention should be paid in a counter-inflationary policy to the possible short-term costs in terms of lost output and to movements in the exchange rate.

Two additional aspects of the Report which might attract particular attention are:

- i) the doubts it casts on the relationship between the PSBR and £M3; and
- ii) the theoretical possibility it raises that policy directed at maintaining the monetary target could amplify rather than dampen fluctuations in economic activity.

The final chapter of the Report is entitled "summary and conclusions" and it provides a succinct chapter-by-chapter review of the main Report, including direct quotes from the relevant chapters. In brief, the arguments are as follows:-

Chapters 1 and 2: Introduction and "Method of Enquiry"

These chapters set the scene for an analytical review of the Government's objectives and ways in which the methods adopted for achievement of these objectives can be subject to empirical testing. In fact, however, very little empirical evidence was

provided to the Committee except by the Treasury (and this was treated rather grudgingly in the Report.)

### Chapter 3: The Conduct of the Government's Monetary Policy

It is accepted that although the £M3 target in 1980/81 overshot by a long way, the Government did make strong efforts to achieve it and monetary conditions remained tight throughout the period. There is also implicit agreement that it was right for the Government not to go further in the autumn in terms of cutting the PSBR or keeping interest rates higher.

### Chapter 4: Principal views about main issues of Monetary Policy

The following useful (although somewhat expedient) classifications are provided of the views put to the Committee, divided into four "schools of thought":-

- (i) New Classical (eg Minford, exponents of rational expectations);
- (ii) Gradualists (eg Laidler, Friedman);
- (iii) Pragmatists (eg Tobin, Bundesbank); and
- (iv) Anti-Monetarists (eg Kaldor).

There is also a balanced summary of the evidence put to the Committee by the Treasury on behalf of the Government.

### Chapter 5: Objectives, Targets and Indicators

The distinction between intermediate targets and indicators is spelt out. The credibility of an intermediate target in terms of its relationship to the Government's ultimate objective and the Government's power to control it are seen as crucial factors. Tobin and the Bundesbank are quoted in support of monetary targets being made "conditional" on measures of international competitiveness although it is acknowledged that whilst an "unconditional" target that had to be abandoned repeatedly would damage credibility, so would a "conditional" target if it became a licence for unpredictable reversals of policy.

Chapter 6: Money, Interest Rates and PSBR

This Chapter, although acknowledging carefully the impact of interest rates on the relationship between the PSBR and the money supply in the short term, is very sceptical about the constraints imposed on the PSBR by the money supply and the effect of using discretionary changes in the PSBR to meet a £M3 target. It quotes Treasury papers and many outside witnesses in evidence of the diversity of relationships which can exist between changes in the PSBR and £M3 (depending on the origin of the change in the PSBR) and points out that action taken to correct deviations of £M3 from target may counterbalance the moderating effect that the automatic stabilisers in the PSBR would otherwise have during a recession. It notes, however, that the Authorities did not take action of this kind in 1980/81 itself.

Chapter 7: Monetary Policy, Exchange Rate and International Competitiveness

Various possible influences on the nominal and real exchange rate over the last two years are examined. North Sea Oil is identified as probably an important factor, but monetary policy (in its conduct and perception) is thought to have been an important direct and indirect influence. It is also suggested that external factors and the recent re-emergence of sterling as a financial asset have perhaps given a boost to sterling which may not be sustained. Although direct controls are unlikely to be effective, some tactic which would allow some pressure to be taken off sterling is thought to be a useful element of policy. The possibility is raised of taking some account of both the money supply and the exchange rate, as well as the objective of inflation, in setting monetary instruments. A recommendation is also made that revenue from North Sea Oil should be used to facilitate structural change.

Chapter 8: Money, Output and Inflation

Considerable doubt is cast on the causal relationship from growth in the money supply to inflation, although the summary does carefully speak of it being the direct causal link which is in doubt. But even if the link does exist, it is thought

much more likely that monetary policy would have to work through higher unemployment (via the "Phillips curve") and the exchange rate than simply through the formation of revised expectations in labour or products' markets. Thus the costs in terms of unemployment of a restrictive monetary policy are thought to be very high (with estimates derived from the Treasury model being used to show an expensive short-term "trade-off"). The Report even mentions claims that there may be permanent costs without sustained benefits.

#### Chapter 9: Control of the Money Supply

The MFTS is criticised as over-rigid. £M3 is also considered to be a misleading indicator, although the Government's "apparent move away from £M3 as the sole monetary indicator" is welcomed. Conditional targets or some alternative, more flexible approach to monetary targets year-by-year would be preferred. Whilst it is noted that the Government has not used its stated instruments (PSBR, interest rates) more intensively this year to achieve its target, this is not in itself a criticism of Government action. There seems to be no enthusiasm for monetary base control and the Committee does not produce any new views on monetary techniques.

#### Chapter 10: The Development of Policy

This is mainly a plea for a formalised but eclectic approach to setting policy instruments. Econometric models would be used to give advice on how the ultimate objectives of policy could be achieved at least cost to the economy (relying very much on Jeremy Bray's familiar themes). It is acknowledged that the state of the art is not sufficiently developed for this to be used on its own to provide automatic solutions, but suggests that more resources should be devoted to "policy optimisation" work in the Treasury and Bank and by the Committee itself. Access to the Treasury model, and evidence based upon it, should also be improved subject to cost considerations.

HF3  
H M Treasury  
4 March 1981

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SELECT COMMITTEE MONETARY REPORT: MAIN POINTS

Although the Committee's Report is generally critical of the use of monetary targets, in many important respects it does endorse elements of the Government's policy. In particular, it does allow certain "supportive lines" to be referred to as follows:-

SUPPORTIVE LINES

QUOTATIONS

- |  |   |
|--|---|
| i) acknowledges the link between growth in the money supply and inflation;   | i) "Over the long term the money supply and price level appear to have moved together." (Conclusions and 8.27)  |
| ii) welcomes the Government's readiness to announce medium and longer term objectives which express its policy intentions;   | ii) "We welcome the readiness of the Government to announce medium and longer term objectives which express its policy intentions (Conclusions and Chapter 9.48)."  |
| iii) recognises the Government's commitment and success in achieving tight monetary conditions in 1980;  | iii) "Although the monetary target for the first year of the MTFs was significantly overshoot, there has been no doubt about the Government's wish to reach its monetary target and it has made considerable efforts in that direction ..... monetary conditions have been tight." (Conclusions and Chapter 3.34) |
| iv) accepts the Government's view that external factors such as North Sea Oil and the surpluses of other oil producers, as well as the Government's monetary policy, were responsible for the high level of sterling and that some of the rise may well be transitory. | iv) "Some, but not all, of the recent rise in sterling would appear to be due to policies designed to achieve monetary restriction." (Conclusions and Chapter 7.48)   |

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SUPPORTIVE LINES

- v) doubts that direct controls or intervention can bring about a significant, sustainable change in the exchange rate and accepts that there would anyway be consequences for the money supply;
- vi) recognises that departure from an intended path for the PSBR in the middle of a recession would not necessarily endanger the objective of reducing inflation — as the Chancellor said in his November statement to the House;
- vii) states that the tightness of monetary policy is not completely measured by a single monetary aggregate as was made clear in the Government's Green Paper on Monetary Control;
- viii) acknowledges that the MFTS was a bold experiment intended to change expectations;
- ix) refrains from criticising any specific policy actions taken by the Government, implicitly endorsing those made since last November;

QUOTATIONS

- v)"it is possible to operate some controls or exert influences upon capital movements and thus the exchange rate in the short term. Such controls may not be as effective in holding the exchange rate in conditions of serious long term disequilibrium." (Conclusions and Chapter 7.50).
- vi) "It may be possible to depart from the target paths for PSBR and monetary growth in the middle of a recession without endangering the objective of reducing inflation...". (Chapter 6.29).
- vii) "The tightness of monetary policy is not adequately measured by one monetary aggregate." (Chapter 3.27)
- viii) "The MFTS was a bold experiment intended to change expectations about the future of the economy." (Conclusions and Chapter 9.47)
- ix i"Policy optimisation is a development rather than a replacement of the forecasting exercises in the Treasury and elsewhere." (Chapter 10A.3)i

However, the Report also contains several fundamental criticisms of Government policy which are bound to receive extensive coverage:

- (i) the lack of evidence of a direct causal relationship from money supply to inflation (conclusions and chapter 8.27)
- (ii) the potentially high costs of a tight monetary policy in terms of unemployment (conclusions and chapter 8.21)
- (iii) the limitations of  $\text{£M3}$  as an indicator of monetary conditions (conclusions and chapter 9.45)
- iv) the "rigidity" of the MTFs (conclusions and chapter 9.45)

Against this, there are two notable omissions from the Report which can usefully be commented upon:

- (i) no coherent alternative anti-inflationary strategy is presented; and
- (ii) no assessment is made of the likely costs of not pursuing a policy designed to bring down the rate of inflation.

SELECT COMMITTEE MONETARY REPORT: DEFENSIVE BRIEFING

1. Monetary growth doesn't cause inflation

→ Committee accepts that over the long term the money supply and price level have moved together. Their doubts are in fact about whether there is a direct or simple causal relationship. But it is clear that monetary growth is a necessary condition for continued inflation and that only if it is successfully controlled can inflation be brought down.

2. Costs of tight monetary policy too high

→ Costs of not having a responsible monetary policy would be higher and would be long-lasting. We are now experiencing some of the short-term costs in terms of unemployment and output of tightening monetary policy, but these would have been substantially reduced if wage settlements had been conducted responsibly.

3. Treasury model shows no simple relationship between M3 and inflation

In the short run, many factors can affect this relationship. But in the long run there is no escaping the fact that the money supply and inflation do move together as the Committee acknowledges.

4. Treasury econometric evidence refutes money as sole cause of inflation

Treasury paper shows importance of money in long run. But in the short run - as the paper indicates - other factors can be significant.

5. Treasury model shows enormous costs of tightening monetary policy

Treasury model simulations are only one possible method of assessing consequences of policy changes, and are subject to very great uncertainties. There are well established difficulties of using models to estimate the effects of major policy changes aimed at changing people's general attitudes and expectations.



6. Wrong to use £M3 as the sole monetary indicator

Green Paper on Monetary Control pointed out very clearly that £M3 was never intended as the sole indicator. But because of familiarity to market and close connections with fiscal policy it is the best one to use for the target aggregate itself.

7. £M3 a misleading indicator

Particular problems this year relating to ending of the corset. £M3 is also less sensitive than narrow aggregates to levels of interest rates. But the special nature of the recession last year, with a high level of personal savings and at the same time a high level of bank borrowing by companies helps to account for the rapid growth of all the broad monetary aggregates. But there is no reason why these attributes should cast doubts on its usefulness as a medium-term indicator or target.

8. MTFS too rigid

The Government needs to present its intermediate targets in an easily comprehensible and direct form. But in no sense was the MTFS for the period up to 1983/84 an overly-rigid framework<sup>for</sup> setting those targets. It was made clear last year that precise rates of growth within the period would need to be determined at the time.

9. Target should be inflation rate, not money supply

The ultimate objective of our economic strategy is to bring down the rate of inflation and sustain it at a low level. To achieve that it is necessary to control the rate of growth of the money supply. Money supply is more directly within our power to influence and specific monetary targets give a clearer guide to the private sector of the fiscal and monetary stance we shall adopt.

10. Controlling the exchange rate

Committee agree that direct controls aimed at keeping the exchange rate down are unlikely to be very effective and they have no policy

to offer themselves. They also suggest that a combination of factors - North Sea Oil, the surpluses of other oil producers, monetary policy - have recently pushed up the exchange rate and point out the possible inflationary consequences of aiming to bring it down.

11. Account should be taken of exchange rate in setting monetary targets

Monetary targets must be set clearly and demonstrably with reference to the ultimate objective of reducing inflation. The exchange rate is an important route through which monetary policy will bring down the rate of inflation. But it is only one of many factors which can affect the speed with which this comes about. In setting the instruments of monetary policy over a short period it is appropriate to look at a variety of indicators - real interest rates, the exchange rate, all the monetary aggregates - but the £M3 target retains primacy especially in the medium term.

12. Germany and Switzerland successfully switch between monetary and exchange rate targets

These countries have followed responsible and successful monetary policies for years. Their inflation rate has consequently stayed low. We are not yet in this position. To bring about continued deceleration in inflation from a high level, it is useful to maintain a single, clearly expressed monetary target.

13. Government failed to foresee how severe the effects of their policies would be

The 1980 Budget forecast gave a good indication of the fall in total output that year. However, as the Committee acknowledges, the level of the exchange rate in 1980 and the severity of the recession could not have been precisely forecast by conventional techniques. In fact, the exchange rate was higher than was assumed and there were underestimates of the fall in manufacturing output and the rise in unemployment. Nevertheless, had wage settlements been lower - as they were in other countries - then the impact of the recession on industry in particular would undoubtedly have been smaller than it turned out.

14. Monetary targets haven't changed expectations

We are now seeing signs that attitudes are changing. People are beginning to understand that our policies are bringing down the rate of inflation and that they must adapt their behaviour accordingly. The more moderate wage settlements we are now seeing in the private sector are an indication of this.

15. Monetary strategy has just been "old-fashioned deflation"

No. Workers realise they have a choice between higher wages and jobs. It is up to them.

16. Dangerous to make £M3 target the determinant of the PSBR path

Treasury evidence pointed out that in the short run many factors can affect the relationship between the PSBR and £M3. But it also made clear that, in the medium term, if we are to maintain control over the money supply and achieve moderate real interest rates, we do need to bring down the size of the PSBR. To the extent that the PSBR rises as a result of the recession, it is usually possible to accommodate this increase in an unchanged monetary target, without implying an excessive level of real interest rates.

17. Monetary target should be dependent on prospects for economy  
(Bank of Canada)

Essential for success of counter-inflationary strategy that have targets which decelerate year by year.

18. Better to use policy optimisation techniques

As Report acknowledges, econometric models have considerable limitations, both in explaining the economy and as a basis for determining policy. Although techniques are improving, we note the reservations expressed in the 1978 "Ball" Report about devoting resources to this area.

19. Access to the Treasury Model is too costly

It is an inescapable fact that access to models of this kind is expensive. It would in principle be desirable for academics to have cheaper and easier recourse to the model, but the Treasury cannot undertake to bear the heavy costs this would involve. We note the Committee's proposals to discuss with the SSRC how the needs of the Committee and Parliament can best be served.

20. North Sea Oil revenue to be used to promote structural change

Revenue from North Sea oil is already helping to reduce the PSBR and allowing us to pursue our monetary strategy at lower interest rates. This is crucial aid to the private sector.

21. Fuller public debate needed on monetary control

Since the Green Paper was issued last March, there has been an extensive opportunity for the public to comment on the issues raised and two seminars have been held by the Treasury and the Bank. Discussions are continuing, but the changes announced to date in monetary control techniques have been evolutionary and generally welcomed and there is still opportunity for ample public debate.

HF3  
H F Treasury  
4 March 1981

From: the Rt. Hon. Edward du Cann, M.P.



HOUSE OF COMMONS  
LONDON SW1A 0AA

~~From [unclear]~~ PA  
(CF file)ms  
I wouldn't regard  
this as helpful.

But it is not  
excessively critical.

I am.

not.

12  
..

For your private Eye. 7/3

The report will  
attract attention, but  
hope is overall effect  
will be helpful to us.

It is the only careful &  
serious study. Σ.

Publication

Thursday

Summary and Conclusions

1 & 2 Introduction and Method of Enquiry

- 1 In this report we examine the Government's monetary policy as it has been presented and implemented since June 1979. During the course of our enquiry we took oral and written evidence both from academics on the theories underlying different approaches to monetary policy and from practitioners, such as central banks, on the implementation of different policies. We published most of the written evidence as two volumes of "Memoranda on Monetary Policy" during 1980 and publish the oral and remaining written evidence as Volumes II and III of this Report. We found it helpful to distinguish between different schools of thought on the main issues of the enquiry. To be examined properly their theories have to be formulated precisely and tested against the evidence in the most rigorous ways available. We have therefore tried, where possible, to examine their conclusions in the light of empirical evidence.

Chapter 3 - The Government's Monetary Policy and the Way in which it has been conducted

- 2 It is clear that the Government firmly committed itself to the achievement of the monetary targets embodied in the Medium Term Financial Strategy, using interest rates and control of the Public Sector Borrowing Requirement as its main instruments of control. The Chapter continues by seeking to find out, in the light of the failure to achieve £M3 targets in 1980, whether the Government has followed its intended monetary policy or whether it was blown off course by unforeseen economic factors. The Government's actions on interest rates and the PSBR are analysed and the tightness of monetary conditions considered by examining monetary aggregates other than £M3, interest rates, the growth

of the money supply in real terms and the behaviour of the exchange rate.

- 3 We conclude that, although the monetary target for the first year of the MTFIS was significantly overshot, there has been no doubt about the Government's wish to reach its monetary target and it has made considerable efforts in that direction. However, it has not used all the policy instruments to the fullest extent possible, having moderated upward pressure on interest rates and decided against trying to cut the PSBR to the level it stated was consistent with its monetary target. Despite this, monetary conditions have been tight. The world recession has not so far been a major unforeseen factor in the operation of UK monetary policy, since it was already forecast by the Treasury at the time the MTFIS was announced.

#### Chapter 4 - Principal Views about the main issues of monetary policy

- 4 After setting out the Treasury's view of how changes in monetary policy work their way through the economy, we grouped positions of other witnesses into four schools: the "New Classical" school which sees monetary policy as being quickly effective in reducing inflation with little impact on output, the "Gradualist" school which sees monetary policy as working to reduce inflation more slowly and at rather greater cost to output, the "Pragmatist" school which suggests that the output cost of monetary policy is very significant and suggests the addition of further policies to reduce inflation, and the "Anti-Monetarist" school which denies the effectiveness of monetary policies altogether. Inevitably these divisions are to some extent arbitrary but they have been adopted for ease of exposition. Their terms used are purely descriptive and are not intended to imply any approval or disapproval.

## Chapter 5 - Objectives, Targets and Indicators

- 5 The Government's emphasis on a single monetary aggregate (£M3) is put into the general context of economic objectives. The Chapter discusses the use of economic instruments (such as interest rates or fiscal policy) to reach those objectives and the role of "intermediate targets" such as £M3 both as a link between instruments and objectives, and as indicators of how the economy is moving. The general form such intermediate targets should take is also discussed.

## Chapter 6 - Money, Interest Rates and the PSBR

- 6 This Chapter examines the relationship between money, interest rates and the Public Sector Borrowing Requirement, in particular the government's contention that control of the money supply requires control of the PSBR (fiscal policy). This is of particular importance when the PSBR is, at present, increasing partly as a result of the recession. We also consider the issue of "crowding out", that is whether, even when there are unemployed resources, the expansionary effect of an increase in government spending financed by borrowing will be offset by a fall in private demand resulting from higher interest rates. We note the distinction between the size of the public sector and the size of its borrowing requirement and, in an annex, set out the concept of the "real" public sector borrowing requirement.
- 7 This discussion leads us to make various observations. In the Medium-Term Financial Strategy the Government describes a path for the PSBR which it believes to be consistent with progressive reductions in monetary growth. Such a path is the consequence of the Government not wishing to reduce monetary growth "by excessive reliance on interest rates" and reflects its view that reduced



money supply growth must be accompanied by reductions in the PSBR. We believe that there were risks attached to such a subordination of fiscal policy to monetary targets. In a recession caused by a fall in private domestic demand, built-in automatic stabilisers tend to raise the PSBR which in turn, with unchanged interest rates, may lead to an increase in monetary growth above the target. Meeting MTFIS targets may then require either a rise in interest rates or a tightening of fiscal stance. Either of these would tend to counterbalance the moderating effect the automatic stabilisers have on the recession. In these conditions, additional sacrifices of output may be made to meet monetary targets with the object of reducing inflation.

#### Chapter 7 - Monetary Policy, the exchange rate and international Competitiveness

8 The principal issue we examine is the extent to which the recent dramatic decline in UK competitiveness can be ascribed to monetary policy and how much is due to other factors. We describe the views of our witnesses on how they expected that monetary policy might affect the exchange rate and hence competitiveness, output and inflation. We note the difficulties which surround an empirical explanation of the present high level of Sterling. We discuss the effects of North Sea oil on the economy, both on the exchange rate in the short term and on the structure of the economy in the long term. Finally we discuss the views of our witnesses on how the exchange rate might be influenced, together with the risks involved in the various proposals.

9 Most of our witnesses suggested that one of the first effects of the pursuit of tight monetary targets would be to raise the exchange rate while downward pressure on wages and prices would act more slowly. The result would be a rise in the real exchange rate and fall in the level of international competitiveness. This, it is suggested, is a principal transmission mechanism of monetary policy in an economy with a floating exchange rate.

10

Some, but not all, of the recent rise in sterling would appear to be due to policies designed to achieve monetary restriction. Although the £M3 target itself was overshoot in mid-1980, both the announcement that determined efforts will be made to achieve future monetary targets leading to expectations of falling inflation in the UK and the effect of deepening recession on the balance of payments will have re-inforced the effects of tight money. The benefit of North Sea oil to the current account will also have strengthened sterling.

11

However we believe that external factors and the re-emergence of sterling as an international asset will have considerably intensified these effects. The boost which this has given to the exchange rate is a precarious one. The factors at present giving strength to sterling may weaken or indeed disappear quickly. The problems of lack of competitiveness would then be removed, but a rapid reversal of the exchange rate appreciation would bring its own problems, notably severe inflationary pressure. The Government should re-examine the role of sterling and methods for influencing the exchange rate to prevent the economy being cursed with this modern version of the "sterling problem".

12

We have received evidence that, while it is possible to operate some controls or exert influences upon capital movements, the controls are unlikely to be effective in holding the exchange rate in conditions of serious long-term disequilibrium. The practical way forward appears to be to take some account of both the money supply and the exchange rate as well as final objectives in setting the instruments of monetary policy.

13

We have received some conflicting evidence on the impact of North Sea oil on the economy. Whatever one's views on these arguments, the Government must find some way of using the growing fiscal revenues to tackle the problems of structural change. In terms of future prospects for growth, employment and competitiveness these issues of structural change (such as the effect of worsening competitiveness on the manufacturing sector) would seem to be of greater importance than the effects of broad aggregates such as M3 and the PSBR.

Chapter 8 - Money, Output and Inflation

14 The focus of interest in this Chapter is on the effect monetary policy may have on inflation and output. We first set out the varying views of our witnesses on the speed with which monetary policy might reduce inflation and the cost in terms of lost output and extra unemployment. We then examine econometric evidence, particularly estimates of the scale of output loss accompanying reductions in inflation following a tightening in monetary conditions. Estimates of this are derived from the Treasury model. The prospects for economic recovery and the possibility of inflation rising with recovery are discussed.

15 Although over the long term the money supply and price level appear to have moved together we have not been convinced by evidence of a direct causal relationship from growth in the money supply to inflation. Indeed, the Treasury's own evidence tends to refute suggestions of any simple relationship in the short and medium term.

16 One of the ways in which it was suggested that monetary policy would combat future inflation was by changing inflationary expectations. We discuss the view that monetary policy can work directly, through expectations, to reduce inflation without significantly affecting output. We conclude that in the light of experience this view is over-optimistic. Prices in the financial markets, notably the exchange rate, certainly appear to be swiftly affected by changes in monetary policy. Labour and product markets are not however affected in the same way and any movement is much slower. It is unrealistic to suppose that negotiated wages and administered prices respond rapidly and automatically to announcements about

monetary policy, however credible they may be. The influence of monetary policy on wage and price inflation does not therefore appear primarily through the setting of targets or through expectations, but rather through the lowering of economic activity and the appreciation of the exchange rate that results from the pursuit of monetary targets. This has certainly been the experience of 1980.

17 The Treasury's evidence from its model of the economy suggests that the cost of reducing inflation by policies designed to reduce the growth of the money supply is high. <sup>According to the simulations on the</sup> ~~model~~, after 4 years a lasting fall in the rate of inflation of about 1% per annum can be achieved at a cumulative cost over four years equivalent to 4% of a single year's GDP and a year's additional unemployment for 2.5% of the labour force (650,000 man years).

18 Such a cost may not be equally spread; the experience of 1980 is that losses of economic activity have been particularly concentrated on the manufacturing sector to a much greater extent than was officially forecast.

19 The Treasury's view suggests that unless the inflation rate falls very rapidly (to below about 5% throughout 1981-82 and 1982-83) achievement of the Medium-Term Financial Strategy's monetary targets will mean that the Government's monetary stance will remain contractionary. Assuming that a recovery does occur we have received conflicting evidence on whether the economy's growth path is permanently affected by the initial monetary restriction. We also received conflicting evidence on whether a

recovery of output would bring renewed inflation. If for instance an eventual restoration in competitiveness was brought about by a fall in the exchange rate the gains in terms of lower inflation brought by its initial rise may not be lasting. There are those who see this kind of mechanism working to such an extent that they fear that a return to high levels of employment will see inflation returning to its initial level, with the recession having achieved no lasting purpose.

#### Chapter 9 - Control of the Money Supply

20 In this Chapter we consider whether  $\text{£M3}$  is an appropriate aggregate for use as an intermediate target, whether it can and whether it should be controlled. We discuss whether the experience of 1980 suggests that there are basic flaws in the MTFs or that the transitional difficulties were greater than the Government expected. We also consider the use of alternative methods of monetary control, such as Monetary Base Control, and the case for using additional targets (monetary and non-monetary).

21

The Government is committed to a Medium-Term Financial Strategy in which monetary growth (as measured by £M3) is kept within steadily declining target ranges over four years. The Authorities have so far pursued these targets with the use of interest rates and fiscal policy. They have not, however, found themselves able to use these methods sufficiently strongly to bring their chosen measure of monetary growth (£M3) within its target range for the first year of the MTFS.

22

An alternative to present methods of control might be to move towards control of the monetary base. Depending on how this was implemented it might succeed in affecting the money supply either by causing banking business to move elsewhere (a problem of a kind which has led the Authorities to eschew the use of direct controls), or it might operate by allowing large fluctuations in interest rates including rises to levels at present judged unacceptable.

23

What is clear to us is that little is at the moment known about the possible effects that a change to monetary base control may have on the services that banks and building societies offer to their customers. We understand that discussions are taking place between the Bank of England and the financial institutions. However a change of this nature would have far reaching practical consequences and there is a need for a fuller public debate on the issue.

24

The Authorities have so far chosen not to use direct controls, and have indeed removed controls on capital movements and abolished the supplementary special deposits scheme previously used to check the growth of £M3. While these actions may in the future make £M3 a better indicator of financial

conditions prevailing in the UK they have reduced the value of the monetary targets, for the current year at least. The Government now suggest that other monetary and non-monetary variables are better indicators of the tightness or otherwise of underlying monetary conditions. If so, the current position of EM3 well above its target range makes it a misleading indicator, appearing to presage greater increases in interest rates and/or more fiscal contraction than the Authorities intend to impose.

25

We welcome the apparent move away from £M3 as the sole monetary indicator. A problem for the Authorities is, however, the specification of a financial strategy which takes account of more than one monetary indicator. A possible solution might be that adopted by the Bank of Canada, i.e. to use a single aggregate as an indicator, so that it is clear whether it is within its target range, but to make that target range dependent on the behaviour of a broad range of economic and financial information. The policy optimisation methods considered in Chapter 10 are directed at such an approach with the addition of an indicator system suggesting the action needed to correct deviations from the target."

26

The Medium Term Financial Strategy was a bold experiment intended to change expectations about the future of the economy. As we conclude above, we believe that the view that monetary policy will quickly affect wage and price expectations is over-optimistic. This clearly will not happen if the monetary targets themselves are not credible. Unforeseen



external developments (such as a rise in the real price of oil)  
make achievement of immutable targets set for a period of several  
years difficult, if not impossible. We were warned by other  
Central Banks who have pursued monetary targets that the  
effective use of such devices is by no means a mechanical  
procedure. It evidently requires a degree of judgement and  
flexibility in the choice of the monetary aggregate, and in the  
setting and resetting of the targets for it, to ensure that the  
pursuit of such an intermediate target is consistent with and not  
inimical to progress in achieving the ultimate objectives of  
policy on which there is substantial agreement, namely growth,  
less inflation and higher levels of employment.

27

We welcome the readiness of the Government to announce  
medium and longer term objectives which express its policy  
intentions. However events have shown that the Medium-Term  
Financial Strategy was not soundly based. It was over ambitious  
in the first year, and in setting unconditional targets for a  
four year period. In any future financial and economic strategy  
it would be wise to allow for modification of the tactics in the  
light of developments.

#### Chapter 10 - The Development of Policy

28

In this Chapter the question of how the design of economic policy and the econometric evidence on which it is based can be improved is discussed, with emphasis on improving the use of the various available macro-economic models. The use of policy optimisation methods is discussed and in an Annex to the Chapter Dr Bray discusses in particular the work of the Programme of Research into Optimal Policy Evaluation.

29

The Committee concludes that while care is needed in the use and interpretation of econometric analysis, it is an important tool in the design and testing of policy which has not been used efficiently in the design of monetary policy, or economic policy generally. We are not satisfied that present arrangements produce the most useful model based evidence for the Committee, for Parliament, or for the public. We believe that access to the Treasury model for academic researchers, business users, Members of Parliament and the Committee itself could usefully be improved but the cost would have to be considered.

30

We therefore propose to discuss with the Social Science Research Council and with the forecasting and model building teams, how the needs of the Committee can be more fully met and at what cost. The Committee recognises that these needs are in fact an operational requirement for Parliament rather than requirements of academic research. If it appears that funds are required to meet the requirements for Parliament, the Committee will recommend accordingly.

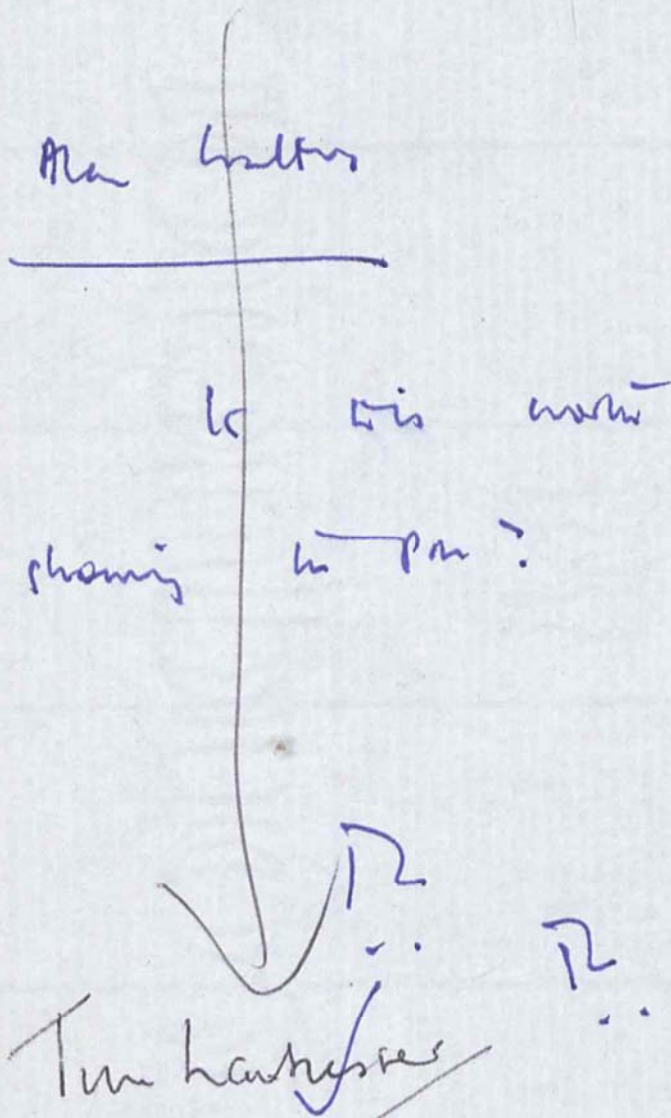
31

We believe that recent advances in the field of policy optimisation should be experimented with by the Treasury and Bank of England on their models to see to what extent they may usefully extend their modelling procedures. The Committee would wish to be kept informed of the results of this work and that on the National Institute and London Business School models.

32 The selection of appropriate intermediate targets, the relative weighting of intermediate targets and final objectives, and the detailed design of a strategy require more detailed evidence than the Treasury have yet been prepared to give or the Committee is yet equipped to provide for itself. To move from one narrowly defined strategy to another, without full justification, testing and debate on the new strategy would not engender confidence. While sympathetic to the principle of a medium term economic strategy, in the period in which it is being developed the Committee believe a more pragmatic approach is required in which competitiveness and final objectives are given greater weight than in 1980.



10 DOWNING STREET



No. The PM has the general picture and this calculation is rather artificial (see assumption 2 for example) and contentious. AW.

010

CONFIDENTIAL  
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Qa 05259

To: MR LANKESTER

From: J R IBBS


27 February 1981

Illustration of the Effects of Exchange Rates and Inflation

1. I believe there is increasing understanding of the effect which the exchange rate has on the competitiveness of companies which trade internationally. However, the relative significance during the last two years of on the one hand a stronger exchange rate, and on the other a higher inflation rate than in other countries, may not be so well understood.

2. To illustrate the relative effect which the exchange rate and differential inflation have had, and how as a result the situation in the United Kingdom has differed from that in Germany, I recently asked ICI to calculate how their 1979 trading results for Europe overall, including the UK, would look in 1981 if adjusted for the exchange rate and inflation changes that have occurred. I asked them also to make the corresponding calculation for a notional identical business located entirely in Germany.

3. The results of these calculations are shown on the attached sheets I and II. The assumptions are listed in the Annex. The calculation assumes the same cost structure in both companies in 1979 and the same volume in both 1971 and 1981. It excludes the effects of the recession, changes in the US dollar price of oil, improvements in operating efficiency, and assumes that prices have moved in line with local inflation rates. These overall assumptions have the effect of under-stating both the absolute deterioration which has actually occurred in ICI's situation and the relative position compared with Germany. However, they do enable the exchange rate and inflation effects to be disentangled from other influences in a rational unexaggerated way. I would emphasise that the figures relate to the totality of ICI's European business and take proper account of those parts that can be protected from exchange rate and inflation effects; for

  
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example, because international competition does not occur or because they have a commanding position through technical excellence.

4. The calculation shows clearly on sheet I that out of a total loss of profit of £487m. (profit £429m. to a loss of £58m.) the effect of the exchange rate has been more than three times greater than that of unfavourable differential inflation. Sheet II shows that the same circumstances that produce this change leave a German competitor with an unchanged profit margin.

5. The loss of profit in the UK has been too large to be offset by cost reduction. The variable cost consists of raw materials and energy. (Any unfavourable movements in energy prices above the general rate of inflation are not included in the calculation.) They cannot be rapidly reduced and improvement is likely to be largely matched by competitors. The 1981 salary bill (which includes what would be termed 'wages' in most companies) would have to be more than halved to achieve the required saving. A substantial reduction in numbers and improvement in working practices has been achieved so that the actual increase in the salary bill will be substantially less than the rate of inflation. However, this gain will be more than offset by the unfavourable factors given in paragraph 6 below.

6. The calculation is intended to highlight the inflation and exchange rate components of present difficulties. In a number of respects it understates the real problem. UK and Continental chemical prices have not kept pace with inflation. The raw material costs have increased more than inflation because of oil price increases. Continental economies have been slower than the UK to reflect increases in world energy prices to consuming industries. UK customers subject to the same pressures are in decline and there is a fall in volume on this score as well as from the general recession.

7. The two important conclusions I should like to emphasise are first the sheer size of the exchange rate effect, and second the way in which

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exchange rate and inflation changes have left a corresponding German business unscathed. The latter has serious implications in terms of giving the Germans the ability to steal a march in the long term race through having cash available to invest in improvement and innovation.

8. I am sending a copy of this minute to Sir Robert Armstrong.

✓R/

Atts.

	<u>1979</u> <u>Trading</u> <u>Account</u>	<u>1979-81</u> <u>Effect of</u> <u>Local</u> <u>Inflation</u>	<u>1979-81</u> <u>Effect of</u> <u>Exchange</u> <u>Rates</u>	<u>1981</u> <u>Trading</u> <u>Account</u>
	£m	£m	£m	£m
<b>SALES</b>				
Sensitive to £	1055	+327	-	1382
DM	1814	+200	-447	1567
US\$	648	+168	-63	753
	3517	+695	-510	3702
<b>VARIABLE COSTS</b>				
Sensitive to £	945	-296	-	1250
DM	50	-6	+12	44
US\$	650	-169	+64	755
	1654	-471	+76	2049
<b>GROSS MARGIN</b>	1863	+224	-434	1653
<b>SALARIES</b>				
Sensitive to £	680	-211	-	891
DM	130	- 14	+ 32	112
	810	-225	+ 32	1003
<b>FIXED COST</b>				
Sensitive to £	330	-102	-	432
DM	130	- 14	+ 32	112
	460	-116	+ 32	544
<b>DEPRECIATION</b>	164	-	-	164
<b>PROFIT (H)</b>	429	-117	-370	-58
<b>PROFIT/SALES %</b>	12%			-2%



	<u>1979</u> <u>Trading</u> <u>Account</u>	<u>1979-81</u> <u>Effect of</u> <u>Local</u> <u>Inflation</u>	<u>1979-81</u> <u>Effect of</u> <u>Exchange</u> <u>Rates</u>	<u>1981</u> <u>Trading</u> <u>Account</u>
	<u>DM</u>	<u>DM</u>	<u>DM</u>	<u>DM</u>
<b>SALES</b>				
Sensitive to £	11160	+1228	-	12388
DM	2521	+ 655	+591	3767
US\$				
	13681	+1883	+591	16155
<b>VARIABLE COSTS</b>				
Sensitive to £	3906	-430	-	4336
DM	2529	-658	-592	3779
US\$				
	6435	-1088	-592	8115
<b>GROSS MARGIN</b>	7246	+795	-1	8040
<b>SALARIES</b>				
Sensitive to £	3151	-347	-	3498
DM				
	3151	-347	-	3498
<b>FIXED COST</b>				
Sensitive to £	1789	-197	-	1986
DM				
	1789	-197	-	1986
<b>DEPRECIATION</b>	637	-	-	637
<b>PROFIT (H)</b>	1669	+251	-1	1919
£m	429 (3.89)			383 (5.00)
<b>PROFIT/SALES %</b>	12%			12%

ASSUMPTIONS1. Exchange and Inflation

	<u>1980/79</u>	<u>1981/80</u>	<u>1981/79</u>
Inflation UK	18%	11%	31%
US	13.5%	11%	26%
DM	5.5%	5.5%	11%
Exchange £/DM	3.89 to 5.00		
£/US\$	2.12 to 2.30		
DM/US\$	1.83 to 2.17		

2. The model assumes that Selling Prices and Costs will move in line with inflation in the currency to which they are sensitive.
3. Sales outside Europe, £607m are treated as US\$ sensitive, Sales to Europe, £1000m as DM sensitive and £41m US\$ sensitive.

The UK sales by business area are classified:-

£ Sensitive

Agricultural  
General Chemicals  
Paints  
Pharmaceuticals  
Plant Protection  
Explosives

DM Sensitive

Fibres  
Organics  
Petrochemicals  
Plastics

SECRET



Exec PD  
At 7.  
re B  
15

10 DOWNING STREET

Exec PD.

From the Principal Private Secretary

23 February 1981

Indexed Gilts

The Prime Minister has seen the Chancellor of the Exchequer's minute of 18 February 1981 about indexed gilts and agrees that he should proceed as he proposes.

I am sending a copy of this letter to Tim Allen (Bank of England).

C. A. WHITMORE

CS

John Wiggins, Esq.,  
H.M. Treasury.

SECRET

SECRET file

jh

Subject



bc Walters  
Wolfson  
Sir R. Armstrong

ECON POL

14

10 DOWNING STREET

From the Private Secretary

19 February 1981

The Prime Minister held a meeting yesterday evening with the Chancellor of the Exchequer and the Governor to discuss short term interest rates. Mr. Middleton and Mr. Walters were also present. They had before them the paper which you circulated with your letter of 17 February.

It was agreed that it would be a mistake to reduce MLR today. If there was to be a reduction, it should now not take place until the Budget. In reaching this conclusion, it was argued firstly that it would be difficult to rationalise in advance of the monetary and fiscal decisions to be announced in the Budget. In particular, it would be easier to justify a reduction when the Chancellor had made his substantial revenue raising proposals. Also, more time was needed to construct a convincing rationale. Second, the PSBR for the first three quarters of 1981/82 would be announced today (Thursday) at a figure of over £13 billion, and this was likely to be badly received by the market. Third, the exchange rate had not appreciated as much as might have been feared after the publication of the trade figures.

It was generally agreed that some reduction in MLR on Budget Day would be desirable, although a final decision could not be taken until nearer the time. The Prime Minister expressed the view that a 1 per cent reduction - though no more than that - should be feasible. It was also agreed that, as the Governor had argued at the meeting on 11 February, any reduction would have to be justified by a number of factors - including the state of the real economy, the exchange rate and the real level of interest rates. It would not be possible to justify a reduction purely in terms of the prospects for the monetary aggregates however defined. It was going to be difficult enough to stay within the monetary target over the coming months: to reduce MLR would probably increase the risk of overshoot.

I am sending a copy of this letter to Tim Allen (Bank of England).

John Wiggins, Esq.,  
HM Treasury.

J.P. LANKESTER

SECRET

KRB



Treasury Chambers, Parliament Street, SW1P 3AG

01-233 3000

PRIME MINISTER

INDEXED GILTS

When the Governor and I discussed indexed gilts with you, you invited us to consider the timing of the issue and to report back.

2. We are agreed that the Budget would be the best time to announce an indexed gilt. The Bank have tied up in advance over £500 million of funding for banking March which begins next Thursday, and hope to achieve further sales ahead of the Budget, particularly if the hopes of lower MLR, which were quashed last week, should revive. In any event the market will need longer than usual to digest the (complicated) prospectus and will be better able to assess the stock in the Budget context.

3. If we wished to issue before the Budget we should need to do so very soon, so as not to have a situation in which the period between issue and call included Budget day itself. An announcement in the next week or so might in any event be technically impracticable. On the other hand, we do not wish to delay the announcement any longer than necessary. The longer we do delay the greater the risks of a leak which could cause considerable damage to our conventional funding programme.

4. On balance, therefore, we think the Budget is the best time for an announcement, with the first call on 26 or 27 March.

5. You might wish to know that we would propose, in the first place, to issue a tranche of £1 billion with calls spread

✓ Alan Walters

Alan Walters

13

Alan Walters agrees with these proposals.

(The issue will be auctioned).

see Econ Pol: Budget: p 5-

Yes no.

Content?

R

19/2

S E C R E T



over three months, with a 2 per cent real coupon and a maturity of 15 years.

6. I have proposed a solution to the eligibility problem to the Secretary of State for Trade.

7. I am copying this letter to Gordon Richardson.

(G.H.)

18 February 1981

S E C R E T



Prime Minister  
to see.  
Duty Clerk 17/2/81

Treasury Chambers, Parliament Street, SW1P 3AG  
01-233 3000

17 February 1981

Dear Tim,

Interest rates

I attach a paper prepared in the Treasury for discussion at the Prime Minister's meeting tomorrow.

I am copying this letter, and the paper, to Tim Allen at the Bank of England.

yours ever

John Wiggins

## INTEREST RATES

1. This note first sets out the new arrangements for determining short term interest rates after the Budget. It then examines the factors which might be taken into account, both before the Budget and in taking decisions under these arrangements.

The New Arrangements

2. Under the arrangements announced by the Chancellor in his statement on 24 November, the Bank will reduce its discount window (last resort) lending - indeed it has already done so. Instead it will rely on open market operations. Cash will be injected and withdrawn from the system by purchasing or selling bills. The objective, each month, will be to keep the interest rate on 7 day money within a 2% band, with a further outer band of 1% on either side to allow for fluctuations on individual days. These bands would be operating rules for the Bank; they would not be disclosed to the market.

3. There are a number of advantages in these arrangements:

a. shifts of the band would be smaller and more frequent than with MLR.

b. the market will have more of a role. It will influence short rates of maturities longer than 7 days.

c. the authorities will not fully control day to day swings in interest rates within the band. The terms on which cash is available to the banking system will be less predictable. The banks may be rather more cautious about their lending and about offering open-ended overdraft facilities than at present.

The institutions will thus have a controlled foretaste of the increased volatility of interest rates than might follow from a fully fledged monetary base regime.

4. Decisions on the centre point of the band each month, and whether interest rates will tend to the top or bottom of it within the month will still be taken by the authorities. The new



arrangements still leave the Government with the task of settling the criteria to be taken into account in making these decisions - though perhaps less of a problem in having to justify each move.

#### Criteria for Determining Interest Rates

5. The present position is that interest rate changes should be made in relation to changes in the monetary aggregates - particularly but not exclusively  $\text{£M3}$ . There have been difficulties with this:

a. the response of  $\text{£M3}$  to changes in the level of short term interest rates is uncertain and difficult to predict. It may even be perverse in the very short run. The problem is that much of  $\text{£M3}$  is interest bearing and thus responds to the structure rather than the level of interest rates, and the long run effect of interest rate changes can take time to build up.  $\text{£M3}$  reacts more strongly to changes in fiscal and funding policy.

b. Experience suggests that  $\text{£M3}$  on its own may not be an adequate measure of monetary conditions.  $\text{£M3}$  has also been affected by the corset so it has not given a true reading, though it should be more accurate from now on.

6. There may be a case for looking at the narrower aggregates and other factors more closely than we have done in the past for purposes of short term interest rate management. The narrow aggregates respond more certainly to changes in the level of interest rates, though the effects also take a while to build up. M1 in particular changes to a much greater extent than  $\text{£M3}$  for a given change in short rates. Moreover the narrow aggregates seem to have as good a relationship to the final objective of reducing inflation.  $\text{£M3}$  could then assume a role as a medium term objective to be achieved over the whole MIFS period rather than in one specific year.

7. Since the autumn, it cannot be said that changes in  $\text{£M3}$  have had much influence on interest rate decisions. We have however had a comfort that the narrower aggregates have grown slower. M1 has in particular been within the target range set

for £M3. It is open to question whether this is reasonable; on past relationships M1 would be expected to be below £M3 for a given effect on inflation. The relationships between the aggregates observed last year are in any case unlikely to carry through in the same way next year, so it is also necessary to examine the implications of other factors - <sup>the inflation rate,</sup> the exchange rate and the real economy which might be taken into account in setting interest rates.

8. The following paragraphs consider what might be implied by the various indicators.

£M3

9. £M3 has grown at an annual rate of 21% since the present 7-11% target range was set in February 1980. Allowing for the effects of the corset, the increase was around 18%. It has grown slower in the last 3 months - an annual rate of 13% - but February and March could well see figures of over 1% and the rate of increase for the target period will be close to 18%.

10. Looking ahead, we face the task of persuading the markets that a PSBR of  $\pounds 11\frac{1}{2}$  bn after the tax changes in the Budget is consistent with the MTF5 figure of 6-10% growth in £M3 next year, given experience this year. The task is not so difficult as it might appear because, assuming we claw back none of last year's excess this year, the starting level for £M3 will have risen sufficiently to accommodate the rise in nominal incomes. Last year we began the target period with £M3 low relative to incomes. A target growth of £M3 of between 6-10% for the next financial year would be considerably nearer to the expected growth in nominal incomes, than when we set last year's target. But in practical terms we have to persuade people to hold a high proportion of the increase in financial assets which the PSBR and current balance implies, in a form other than bank deposits. Both in relation to its past performance and future prospects, it is impossible to make out a case for an early lowering of interest rates based solely on £M3. Indeed we should need all the favourable impact on expectations from lower inflation to avoid higher interest rates.

M1

11. The narrow aggregate about which we know most is M1. Over the target period it has risen by around 8% so far, but has grown rather more rapidly over the last 3 months. M1 is of course much more responsive to lower interest rates. At the interest rates required to give us a chance of keeping £M3 to the MTF5 path, we think that M1 might grow by about 14% next year. A rise in interest rates would probably be needed to achieve a target rate of growth for M1 of 8%.

12. Looking to the future, with interest rates falling, M1 can be expected to grow relatively rapidly. If we experimented for example by bringing interest rates down to equal the inflation rate, M1 growth could rise to around 20%.

The Monetary Base

13. Though we are planning to publish the numbers in March there is, as yet no series for the monetary base. So it is difficult to mount a public argument now for changing interest rates by praying movements in the base. Moreover the interpretation of the numbers is open to doubt given past institutional arrangements.

14. Over the last 11 months the base has increased by around 4% as has the non-interest bearing component of M1, but the series is an erratic one and by April on our figuring the figure could be as high as 12%, when compared with the same month a year earlier. The base will move rather like M1 though not so certainly, in response to interest rate changes. But our knowledge of its behaviour is limited.

The Narrower Aggregates: the Past

15. The monetary squeeze looks different when looked at over past periods in terms of different aggregates. If we examine changes in the real money supply for this purpose, it can be seen that whereas £M3 is about back to its historic trend, both M1 and the monetary base are still some way below. But they are both recovering. And the prospects of more rapid growth in these aggregates in future, together with our expectation that they will grow substantially quicker than £M3 next year, means that it is difficult to take full credit for the past low growth rate in setting our objectives for next year.

16. To sum up then, it is not easy to construct a case based on the observed movement of the monetary aggregates for a sustained fall in interest rates. The past behaviour of narrow aggregates might be used to support a case for a limited further fall. There might also be a case for a limited fall based on the possibility of more favourable developments in  $\text{EM3}$  later in the financial year. But this would imply a commitment to raise interest rates again if the narrow aggregates do move ahead rapidly as we should expect, and if  $\text{EM3}$  fails to fall. The analysis and numbers above could of course turn out to be wrong - the picture might turn out to be a good deal better than we think. But as of now the numbers do not show it.

#### The Exchange Rate

17. A case for lower interest rates would have to be supported by reference to other factors. The most obvious of these is the exchange rate. This is higher than anyone thought, partly for reasons connected with North Sea oil and seems likely to stay so. The exchange rate does part of the job which tight domestic monetary conditions are supposed to do in bringing down inflation. It is part of the total monetary picture. In an open economy it is one of the main ways in which monetary restraint affects inflation. But it also affects activity and output. If the exchange rate has overshot, a case could be made out for lower interest rates and a greater expansion of the domestic money supply for as long as at least some of the overshooting lasts. If the exchange rate overshoots temporarily the inflation rate reduction is brought forward at the cost of an acceleration in inflation when the exchange rate falls back later on. But any benefit to inflation is important in the battle against inflationary psychology.

#### Inflation and Real Interest Rates

18. The inflation rate has fallen while nominal interest rates have remained high. Real interest rates have now risen - though it is an impossible task to measure them accurately as they depend on expected inflation. They have risen sharply from the negative interest rates we experienced earlier in the year. But other OECD countries are also experiencing equally high real

interest rates.

#### The Company Sector

19. The high exchange rate has a severe effect on the liquidity and profitability of industry. It had been hoped to offset some of this effect by fiscal means, but the high PSBR for next year rules out large scale help for companies. Lower interest rates would be an effective way of helping companies, particularly as low profitability means that many of them cannot get tax relief for the interest at present charges. This would be true whether or not the exchange rate falls in response to the lower interest rates.

#### The Real Economy

20. The Treasury forecast envisages a small improvement in output next year, but investment and exports are expected to weaken. It might be thought that these conditions are so tight that an easing of monetary policy, at least temporarily, is indicated.

#### Restating the Strategy

21. It is essential to restate the medium term monetary strategy in a way which restores credibility.  $\text{£M3}$  will continue to be the centre piece of the strategy - perhaps with its medium term nature emphasised. The question then is whether movements of short term interest rates can be decoupled for medium term movements in  $\text{£M3}$ . Though it will be impossible and unwise to attempt to do this completely fiscal policy and funding policy - which is still under examination - would be seen as the main means of achieving medium term control. There are two broad possibilities for month by month decisions:

##### a. The Narrow Aggregates

Greater emphasis on the narrow aggregates would tend to suggest higher rather than lower rates consistent with the MTFs. Extra formal targets might simply multiply the problems of monetary control.

b. Inflation and real interest rates. Inflation is expected to remain around 10%. This would point to a further reduction in interest rates. The movement of the monetary aggregates could look very uncomfortable, but not completely unconstrained.

22. The position with the exchange rate and the real economy is different. One possibility would be to relax the stance of policy - both in the short and medium term - to take account of this. For example we could raise the upper and lower ends of the target range to 5-11% to accommodate more monetary growth. The high PSBR for 1981-82 reinforces the case for a move in this direction. But this has to be balanced against the need to maintain the expected thrust of the strategy.

23. This is however a very different proposition to adjusting monetary policy in order to achieve some particular objective for the exchange rate or the real economy.

24. The exchange rate responds uncertainly to small changes in relative interest rates, intervention and changes in the money supply unless there is a sharp change in confidence when it can respond all too quickly. Steering by the exchange rate could mean very wide divergence of the money supply from any target path. The response of the real economy to lower interest rates would of course be very slow, though companies would be helped over a difficult period.

25. The case for lower short term interest rates depends on the balance of factors outlined above. A downward move now would have to place a lot of emphasis on the movement of real interest rates and inflation. Given the prospects for monetary growth, a lot of weight would have to be placed on these arguments if we are not to raise expectations of higher interest rates later in the year or even sooner. It has to be recognised that it may be very difficult to reconcile these moves with the MTFs, unless we could argue convincingly that  $\text{£M3}$  growth would slow down eventually or that monetary growth above the upper end of the target range would not imply higher inflation.

#### An Immediate Move

26. Against this background, the case for an immediate move in interest rates could be viewed in two ways:

- a. It could be seen as getting a small change in interest rates in using the real interest rate argument, with very little immediate effect on  $\text{£M3}$  before the Budget.

b. It could be seen as heralding a sustained fall in interest rates for reasons which cannot be supported by the observed changes in the monetary aggregates. It would be a short step if this came to be believed to move into an exchange rate policy, as the most obvious alternative indicator - where we reduced interest rates until the exchange rate does move.

27. There is clearly some difficulty in mounting a complicated explanation of the sort required immediately before the Budget. The risk of a misleading signal would be very great, given the monetary background and what we know - but what the market does not know - about the PSBR.

17.2.81

TABLE 1: RECENT MOVEMENTS IN THE PRINCIPAL AGGREGATES

	M1	"Adjusted" EM3	PSL2
(i)			
% changes in the month:			
January	0	0.7	1.2
December	1.6	0.6	0.7
November	0.8	1.9	1.7
(ii)			
Changes to January at annual rate compared with:			
3 months earlier	9.9	13.3	15.6
6 months earlier	7.9	14.5	16.0
11 months earlier (Feb 1980)	8.4	18.0	15.5
(iii)			

## Monetary Base

Although the major component of the "wide" monetary base (notes and coin held by the public) is published on a seasonally adjusted basis, the other components (bankers' balances and banks' till money) are not currently adjusted and have been extremely volatile. Growth rates of the base over short periods do not therefore provide very meaningful indicators. For the full year Feb 1980 to Jan 1981, the "wide" base grew by 7% over the preceeding year compared with a growth in M1 of 4%.



TABLE 2: PRE-BUDGET FINANCIAL FORECASTS WITH £M3 TARGETS OF 8% AND 7% IN 1981-82 AND 1982-83

	"Wide Monetary Base"	M1	"Adjusted" £M3	PSL2	Effective Exchange Rate (old basis)	Interest Rates	Mortgage Rate
					3 month inter-bank	20-year gilts	
1980-81	(7) *	9	16	13	77	15½	14½
1981-82	11½	13½	8	8½	82	13½	14
1982-83	8	11½	7	7½	78	12½	13½

SECRET

\*Approximation (see section (iii) on Table 1); "quarterly" and "monthly" figures are also computed on different bases

Chart 1

PATH OF £ M3

Log scale:  
Levels of £ M3

Logs of levels of adjusted £ M3

Centre of new target range (8.2% p.a.)

Centre of target range (9.0% p.a.)

Feb 1981

July 1980

Feb 1980

Level in Jan 1981 = £67 billion

Level in Feb 1980 = £58 billion

1983

1982

1981

1980

1979

Based on forecasts.

Out-turns

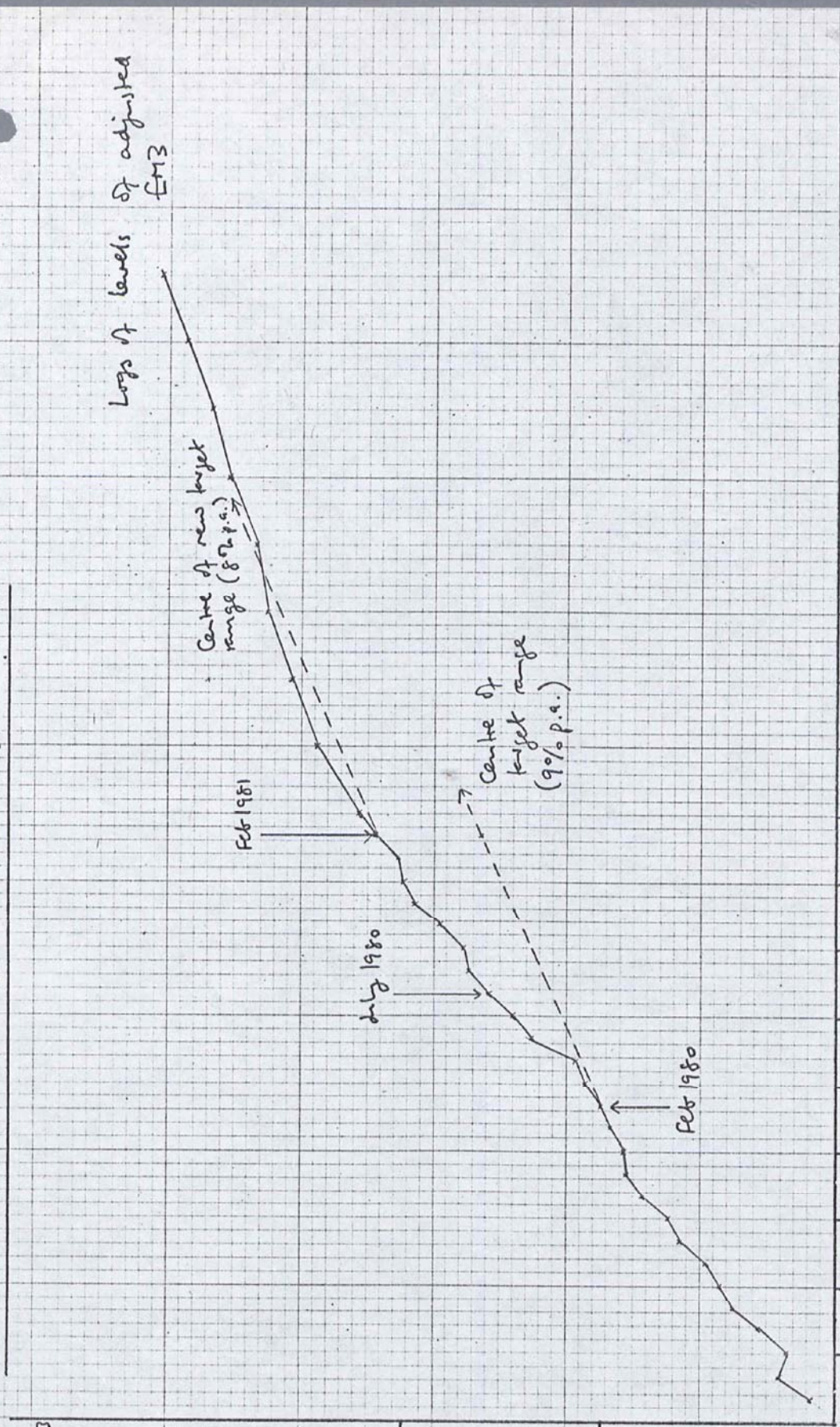


Chart 2. PATH OF M1

Log Scale:  
Levels of M1

Logs of Levels of M1.

Feb 1981

July 1980

Feb 1980

Level at  
Jan 1981  
= £29 billion

Level at  
Feb 1980  
= £27 billion

Growth of 8% p.a.

Growth of  
9% p.a.

1983

1982

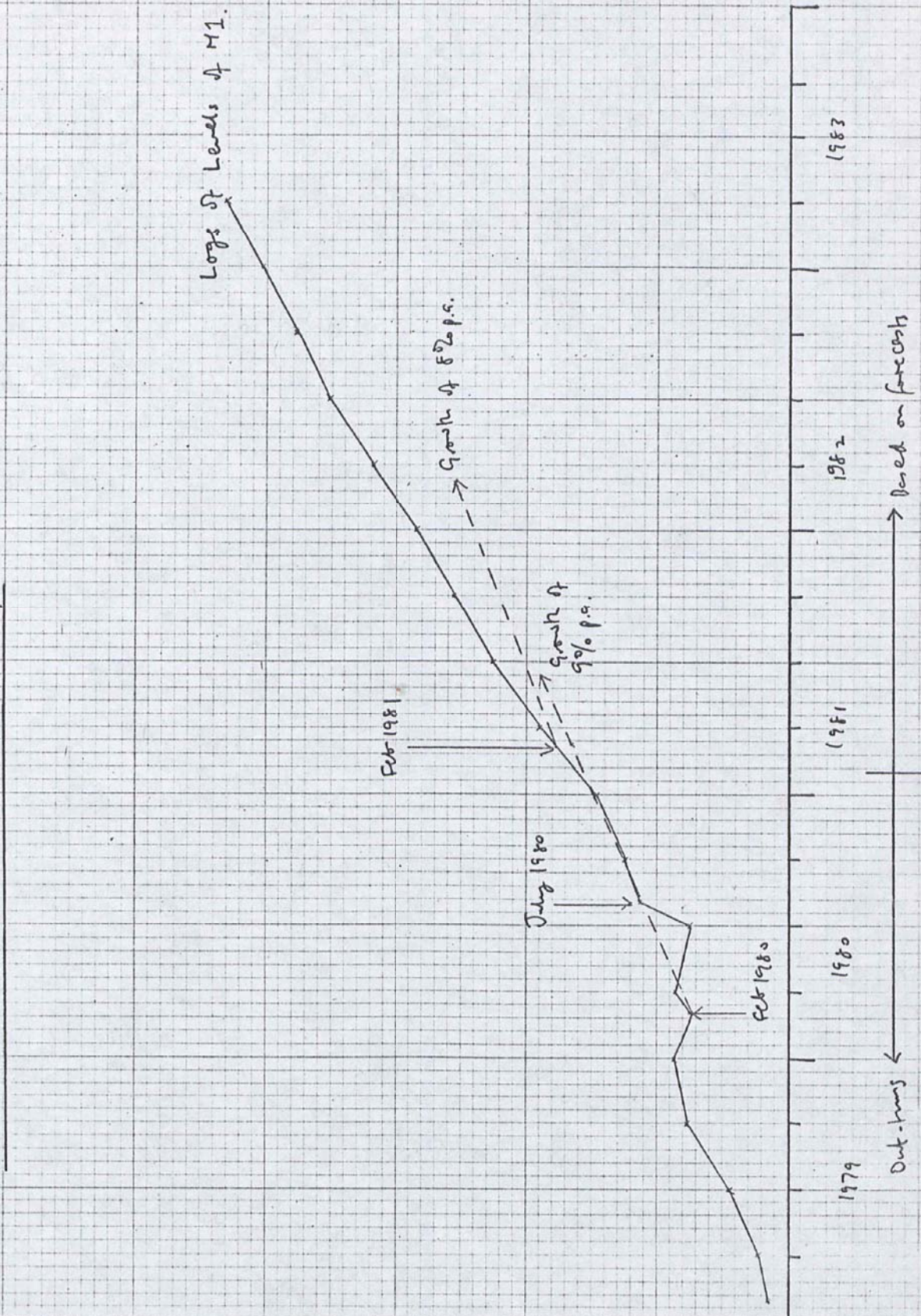
1981

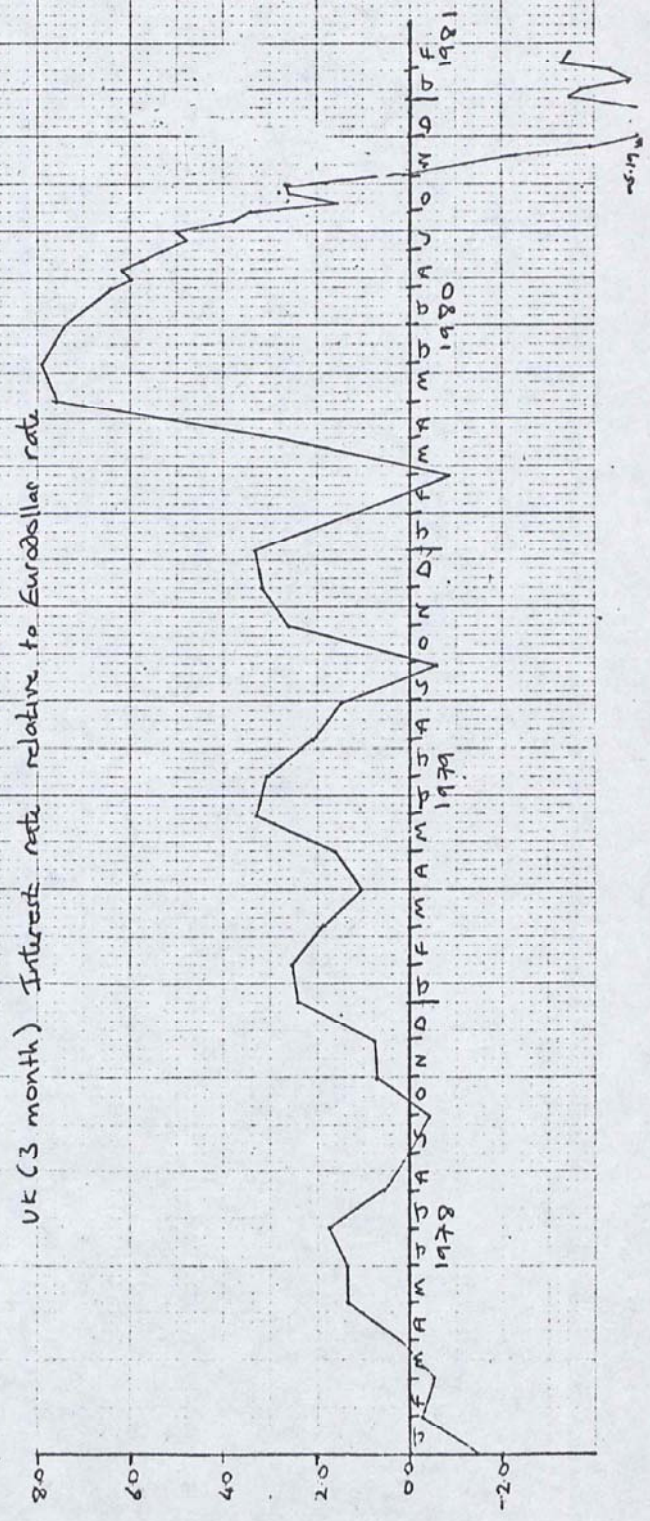
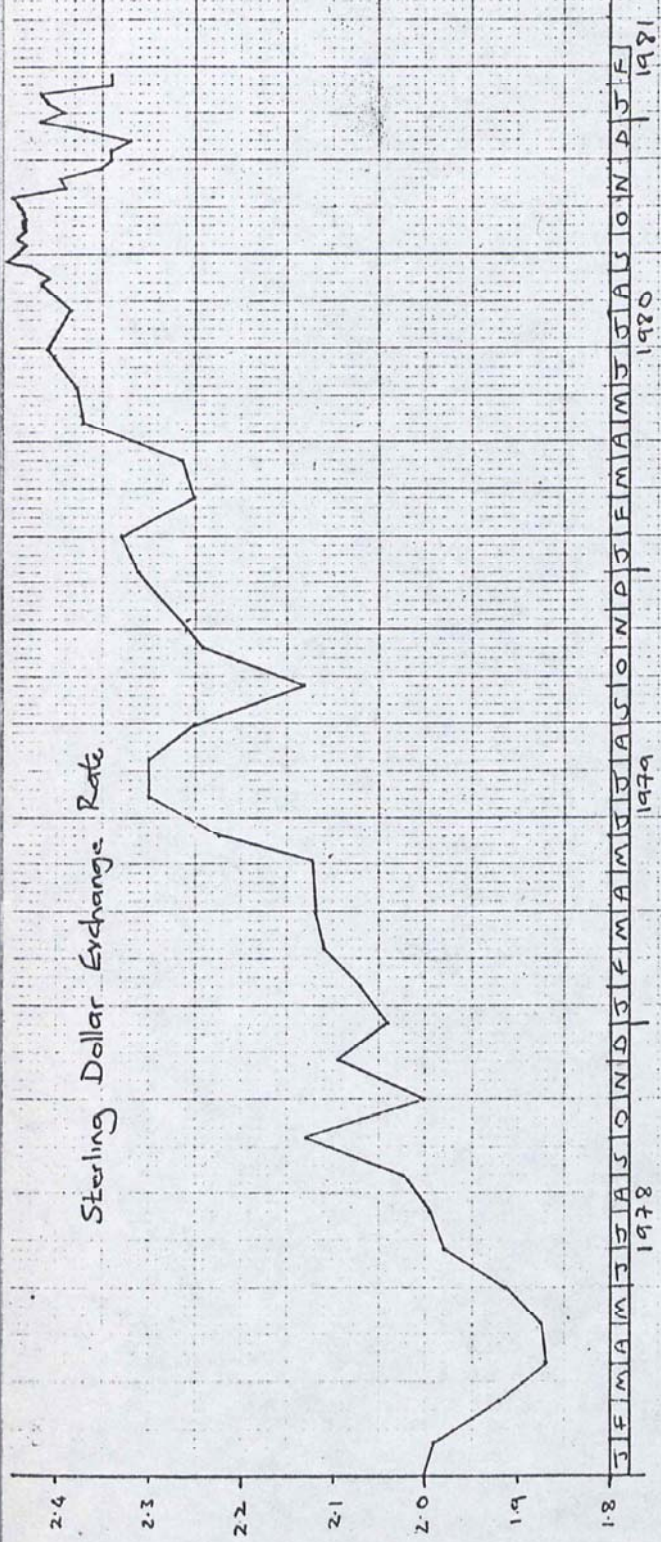
1980

1979

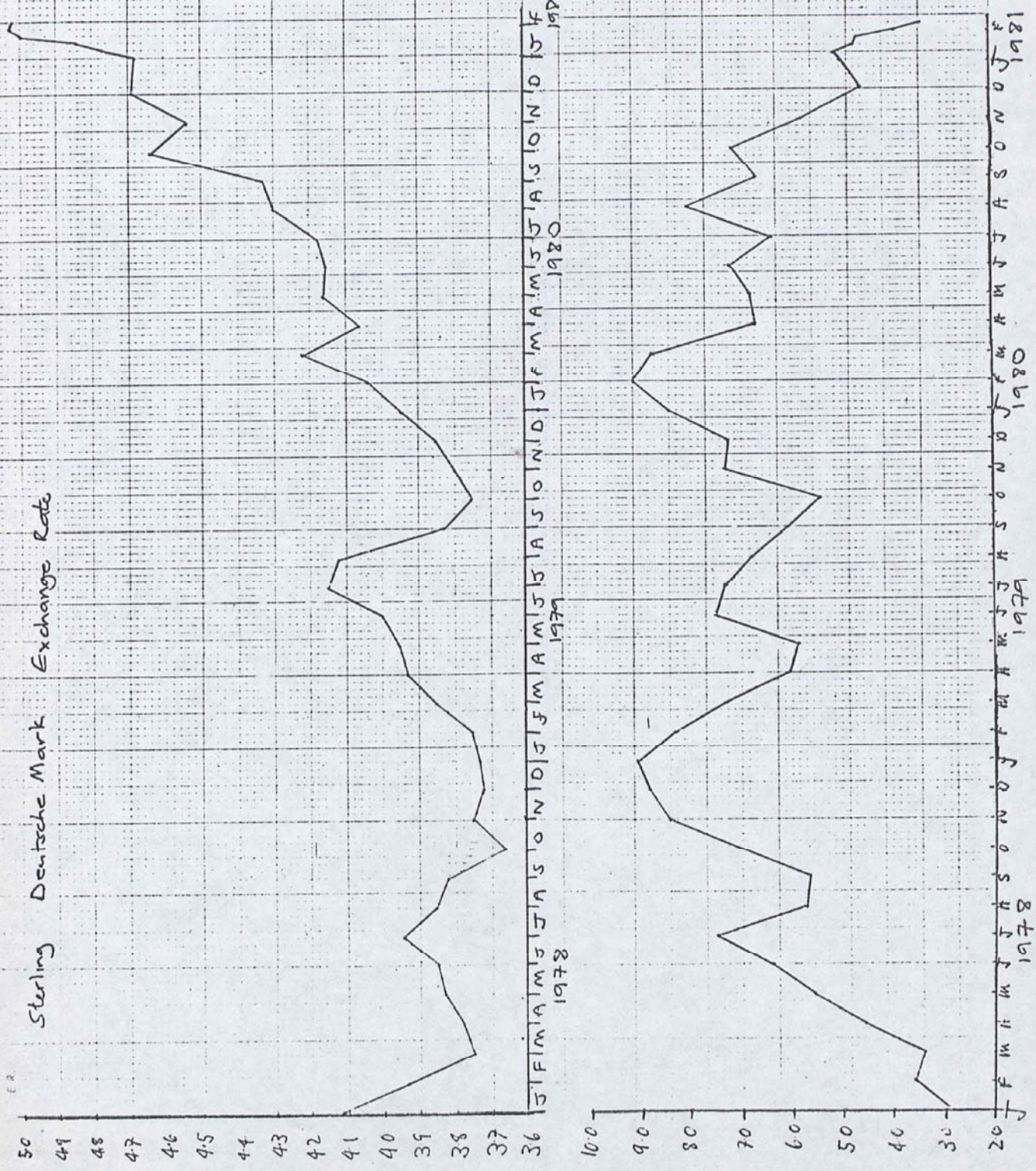
Based on forecast

Out-turns ←





Sterling Deutsche Mark Exchange Rate



## THE MONEY SUPPLY TARGET IN RETROSPECT

1. Between March 1980 and March 1981 we now expect  $\text{£M3}$  to have risen by about 21 per cent\*, compared with a target range of 7-11 per cent annual rate for much the same period. The adjustment to be made for the abolition of the corset is very uncertain, but probably small. The figure for the underlying growth of  $\text{£M3}$  might be about 18 per cent\*. The growth of nominal income (GDP at current prices) over the same period may turn out to be about 10 or 11 per cent.
2. This paper aims to provide some assessment of the significance of these developments. It is strictly too early to conduct a post-mortem examination of 1980-81, but as a background to the Budget judgment and the setting of a monetary target for 1981-82 there are three questions that must be asked:
  - (i) Why did  $\text{£M3}$  rise so fast?
  - (ii) Why did we not stop it? and
  - (iii) What will be the consequences for the future?

The Causes

3. A wide monetary aggregate such as  $\text{£M3}$  does not track nominal income year-by-year at all closely. Over a run of years the velocity of circulation (the ratio of nominal income to the money stock) has been reasonably stable, as we were able to show in the EPR article last July and in evidence to the Treasury Select Committee. For individual years, however, the fit is not at all good.
4. Chart A below shows movements in the velocity of  $\text{£M3}$  since the mid-sixties. The level of the trend line since the aberration of 1972-76 is not easy to establish, but the fluctuations of the last two years do not seem to indicate a break from previous behaviour. During financial years 1977-78 and 1978-79 velocity was little unchanged; the increase in velocity in 1979-80, caused by an acceleration of inflation, is being offset in 1980-81 by an acceleration of monetary growth. Many attempts have been made to estimate stable relationships for the demand for money based on movements in nominal income in the Treasury, the Bank and elsewhere, but they have not produced encouraging results. The recent discrepancy between the growth of  $\text{£M3}$  and nominal income, therefore, is not in itself surprising.

\*Based on the latest monthly forecast. All other figures in this paper are based on the winter quarterly forecast.

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5. There seems to be a rather better relationship between £M3 and the total financial assets of the private sector. When financial wealth increases, the demand for money increases also, in a way which seems, with hindsight, reasonably stable and predictable. Too much should not be claimed for this relationship, which is new and may be controversial, but it does provide a framework within which a quite plausible account can be given of the events of the past year or two. The relevant figures are set out in Tables One and Two below.

Table One: Monetary Aggregates

(Percentage Growth Rates through the Year)

	£M3 (recorded)	£M3 (adjusted)	M1	M0	PSL1	PSL2	GDP at current prices
1978-79	12	13	13	10	14	13	12
1979-80	13	15	7	10	14	12	21
1980-81*	17	15	5	12	14	12	11

\*winter forecast

Table Two: Private Sector Wealth

(Percentage Growth Rates through the Year)

	Private Sector Net Wealth Excluding Revaluations	Private Sector Net Wealth Including Revaluations	Bank Lending	Gross Wealth	Interest Rates (Average Levels Short	Rates Levels Long
1978-79	20	21	20	17	10.7	13.0
1979-80	13	4	24	9	14.9	13.3
1980-81*	18	23	17	17	15.8	13.6

\*winter forecast

6. The total financial assets of the private sector must equal the net financial wealth of the sector plus its borrowing from the public sector, overseas and the banks. During 1980-81 it now seems that the net financial wealth of the private sector, through new savings plus capital gains, may increase by about 20 to 25 per cent. Borrowing from the banks is likely to rise less rapidly, perhaps by 17 per cent and borrowing from overseas may not rise much at all. The total financial assets of the private sector are forecast to rise by about 17 per cent, which is quite fast enough to explain the growth in "adjusted" £M3.

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7. Within this framework, the main cause of the rapid growth of £M3 (and the other wide aggregates) in 1980-81 is a high rate of saving and a low rate of physical investment. The personal sector savings ratio is exceptionally high and is only in small measure offset by the deficit of the company sector, which in the event has not been strikingly large (see Table Three below). Taking the explanation another stage back, the high level of personal savings and the (after all) unspectacular company sector deficit can be seen partly as a response to insecurity, to fear of falls in real income, loss of employment, or, in the case of companies, fear of financial collapse.

Table Three: Net Acquisition of Financial Assets

	Personal Sector	Company Sector	Public Sector	Overseas Sector	(£bn) Residual Error
1978-79	9.7	-1.5	-8.2	-	-
1979-80	10.3	-3.7	-7.7	1.1	-
1980-81*	14.9	-3.1	-9.7	-3.4	-1.3

\*winter forecast

8. To put the situation in perspective, it is necessary to look back to the preceding financial year, 1979-80. In that year the net wealth of the private sector hardly rose - net saving was relatively modest and rising interest rates caused major capital losses. It was also a year of very rapid inflation, so the real value of net financial wealth fell sharply. The real value of the money supply also fell, and velocity rose by about 5 per cent (after adjusting for the corset). This year the private sector has been taking the steps necessary to rebuild its financial position.

9. The counterpart of net saving by the private sector must be a deficit for the public sector (a large PSBR) or for the overseas sector (a surplus on the current account of the balance of payments). This year we have seen both, thanks partly to the recession. The recession itself can be attributed in part to the high level of saving and the low level of investment, especially the running down of stocks. In many circumstances a fall in output will go with a reduction in the money supply. This year, however, the opposite seems to have happened, there has been something of a scramble for liquidity which has deepened the recession whilst adding to £M3.



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10. Further work is in hand to investigate the stability of the private sector's demand for net financial wealth. This includes further study of consumer spending and a special project on company sector behaviour. Meanwhile, the most we can say is that the events of 1980-81 would be consistent with the view that there will be a sharp reaction by the private sector, cutting back its spending whenever its net financial wealth is compressed. If this is correct, the behaviour of the money supply over this period may be seen as part of a pattern affecting financial assets more generally.

11. The rapid growth of net financial wealth in 1980-81 has been reinforced by a growth in bank lending also well in excess of nominal incomes. This must come as something of a surprise given the sharp rise in interest rates in the latter part of 1979-80. Unlike the growth in net wealth, it cannot be explained by reference to the starting position in the early part of last year. On the contrary, bank lending in 1979-80 actually outstripped the rise in nominal GDP (as it had done also in 1978-79). We have recently developed a new relationship for bank lending to companies in which the sector's requirement for external funds plays a significant role. This can, with hindsight, explain the 16 per cent rise expected this financial year. Personal sector borrowing, including loans to small businesses, seems likely to rise about 20 per cent, which is well in excess of the growth past experience would lead one to predict.

12. The growth of bank lending will owe something to the imbalance between the incomes of the personal and company sectors. It is usual for a recession to hit companies more than in proportion, but this year profits have fallen even in nominal terms whilst interest costs have risen sharply; as a consequence, disposable income is down by about 13 per cent (or £2.5 billion). To illustrate the orders of magnitude involved, a transfer of £2.5 billion from companies to persons is thought to add something like £½-1 billion to total bank lending. Persons borrow more because they buy more consumer durable goods when disposable incomes are raised; companies also borrow more because they need to close a wider financing gap. The effect on £M3 will be smaller than the effect on bank lending however if, as seems likely, a transfer of income from companies to persons means a net addition to total spending, reducing the balance of payments surplus and also the PSBR.

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13. No account of 1980-81 can be complete without reference to the exchange rate. The monetary effects of the strength of sterling are complicated and very difficult to quantify. On balance, it seems that the strength of sterling reduced the growth of £M3. The typical pattern was a movement by non-residents into sterling (which does not add to the money supply) financed by a movement by residents out of sterling - partly because exchange control had recently been abolished - which reduced £M3. Moreover, the appreciation of the pound certainly helped to get the rate of inflation down, which will have reduced net saving and the growth of bank lending.

14. The exchange rate appreciation also contributed to the imbalance between persons and companies. As already suggested, this may have increased total bank lending. Its effect on net saving is much less clear. Normally, one would have said that a transfer of income from the company sector to the personal sector would reduce net saving, but 1980-81 was not a normal year and company spending may have been more sensitive to income (and, therefore, company saving less sensitive to income) than commonly observed relationships suggest.

15. With the benefit of hindsight then, the rapid growth of £M3 and the other wide aggregates is explicable. Over the same period, the narrow aggregates, M1 and the wide base or M0, have been growing much more slowly. The main reason for this divergence must be the rise in interest rates in the latter part of 1979-80. In the case of M1, it may also be important to take the story right back to 1977 and 1978 when velocity was falling sharply (see Chart B below). There are many precedents for M1 and £M3 providing quite different readings (as a glance at Charts A and B confirms). In fact they measure rather different things: the broad aggregates seem to relate to net savings and to bank lending, whilst the narrower aggregates respond to interest rates and perhaps more directly to nominal income or expenditure. The circumstances of 1980-81 produced both a rapid increase in total wealth and a preference for interest-bearing assets within it - a precautionary demand for money rather than a transactions demand.

16. The rapid growth of £M3 may be explicable, but it was not predicted beforehand; and the intention of policy was to prevent the accommodation of inflation that took place. This directs attention to a rather different group of questions.

Control Failure

17. When the Budget decisions for 1980-81 were taken, we believed that the fiscal measures taken were compatible with a growth in £M3 at the centre of the target range and perhaps a slight fall in interest rates. The forecasters put forward this judgment with some hesitation.

"The money supply targets are assumed to be met in the forecast, but they will not be met without difficulty. The problems we have already experienced in holding back the growth of £M3 stem from the strength of the demand for bank credit fed by the plight of the company sector and also the expectation of continuing inflation. This demand will not easily or quickly be cut back, so the banks are likely to face continuing liquidity pressure. They may also come to fear for the solvency of their customers. This points to the continuation of high interest rates, especially at the short end, for some time, despite the recession and despite a gradual improvement in the outlook for inflation."

(Report on the short-term forecast, 13 February 1980)

18. At the time we were conscious of being more pessimistic than most outside forecasters. At a meeting we arranged with five City pundits last March the general view was that 1980-81 would repeat the experience of 1975 with bank lending cut back sharply and companies solving their financial problem by longer-term borrowing. An 8 per cent target was seen as compatible with a substantial fall in interest rates. In the early months of the financial year we were warned by City commentators (Gordon Pepper, for example) to beware of overfunding the PSBR and undershooting the target.

19. An analysis of the forecasts presented a year ago can identify the main reasons for our inadequate pessimism so far as £M3 is concerned.

Forecasts of £M3 and its Counterparts  
(£bn)

<u>1980-81</u>	February 1980	January 1981
PSBR	9.6	12.8
Gilts	5.5	7.8 ←
National Savings	1.8	2.0
Bank Lending	6.3	8.8
Net Externals	-2.3	+ 0.7
£M3	4.4	10.1

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Part of the trouble was the PSBR (where the comparison is complicated by subsequent policy changes). On the other hand, funding has exceeded expectations. The forecasters' hesitations over bank lending seem well justified (by the personal sector component at least). The other major source of error was the net external adjustment, where the error arose from the forecast of £3.8 billion deficit on the current account of the balance of payments: our latest view is that the account will be in surplus by £3.4 billion.

20. These mistakes on the PSBR and the current account go with a serious underestimate of net savings and the growth of financial wealth.

Forecasts of Net Acquisition of Financial Assets  
(£bn)

<u>1980-81</u>	February 1980	January 1981
Public Sector	- 8.5	- 9.7
Personal Sector	15.6	14.9
Company Sector	- 8.6	- 3.1
Overseas Sector	+ 3.8	- 3.4
Residual Error	- 2.3	- 1.3

The net financial wealth of the private sector was expected to rise by 16 per cent (not much faster than the growth of nominal incomes, which we then put at 14½ per cent). Our latest view is that net wealth will grow at over 20 per cent (although the growth of nominal incomes now looks like coming out around 10 or 11 per cent).

We were wrong on the company sector, where we expected a very large deficit indeed, and also on the personal sector where we did not foresee the sharp rise in the savings ratio. (Comparisons are complicated by the revisions to levels of saving and company profits in years prior to 1980.)

21. Financial forecasting has always been a hazardous business. Forecasts of the exchange rate a year hence are now generally greeted (and presented) with robust scepticism. Forecasts of the growth of the money supply a year hence should be regarded as the product of very much the same kind of exercise. Recent experience suggests an average error when forecasting £M3 a year ahead of the order of 5 per cent. That said, the record for 1980-81 on £M3 was rather worse than one could reasonably expect in a typical year. The circumstances of the company sector in particular made forecasting

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exceptionally difficult, as the forecasters acknowledged at the time. We foresaw that achievement of the target figures could precipitate a serious financial crisis for companies, but did not foresee - perhaps because of the assumptions on which the exercise was based - how that crisis would be mitigated.

22. The control of £M3 depends on successful prediction. The actual policy levers have to be determined in advance in such a way as to achieve a pre-calculated effect on the target variable in the future. The main instrument, fiscal policy, can only be brought into action at infrequent intervals. In 1980-81 it was set at the time of the Budget, at what proved to be a level inconsistent with the monetary target, and no subsequent corrections were made. This may reflect in part a reluctance to deflate an economy already in recession, but the instrument most readily available, the indirect tax regulator, is not an appropriate means of reversing a monetary overshoot during the course of the year.

23. Interest rates, which have usually been seen as an alternative instrument for reining back £M3, were not used for that purpose at all after the measures of October 1979. There were strong arguments against raising interest rates in the latter part of 1980, not least the strength of sterling. The consequences for mortgage rates may also have been an inhibition. There was, and is, also considerable doubt whether an increase in interest rates does have a predictable short-run effect on £M3 on which control could be based. In the event, MLR was cut.

24. It is now abundantly clear that forecasts of £M3 a year ahead are not nearly accurate enough for control within a margin of only 2 per cent. The burden placed on forecasting accuracy by such an exercise would be greater than ever contemplated by the enthusiasts for "fine tuning" output and employment. That burden is placed on some of the elements in the forecast (the PSBR, for example, and the balance of payments) which are known to be the least reliable.

25. The overshoot was not corrected then because it was not foreseen in time. That is not to say, however, that it could, or would, have been corrected if in fact it had been foreseen. If the "pre-Budget" PSBR and the current balance had been known in advance, we would probably have had to advise that the £M3 target was unattainable, or attainable only at an unacceptable cost, by pushing the company sector in particular into a financial crisis it could not avoid.

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26. In some respects, the forecasts prepared in February of last year were quite a good indication of subsequent events. They were broadly right on output and employment, on inflation they were not so good (partly because they were wrong on the exchange rate). In the event, the rate of inflation has come out lower than we expected, despite the overshoot on the money supply. It would be easy to conclude from this that the overshoot did not matter very much, but the ultimate consequences are not at all easy to discern.

The Consequences

27. During 1980-81 there has so far been no sign of inflation speeding up so as to bring the growth of nominal income back into line with the growth of the money supply. But a study of the past relationship between money and prices suggests strongly that such a speedy response should not be expected. There is normally an incubation period of about two years before the symptoms come to light.

28. The best fitting relationship between  $\text{£M3}$  and prices, taking account of no other influences at all, has been used to generate an alternative forecast of inflation over the twelve months ahead. This is compared below with the figures actually adopted by the forecasters in the round just completed:

	<u>Retail Prices (change on a year earlier)</u>	
	<u>Money Supply only</u>	<u>Actual Forecast</u>
1981Q4	10½ per cent	11½ per cent
1982Q4	12½ per cent	9½ per cent

The "crude" monetarist forecast is actually rather lower for the present year, but significantly higher in 1982. The contrast is not as extreme as one might have guessed, given the rapid growth in  $\text{£M3}$  over the past year and more. But the "crude" monetarist forecast is sophisticated enough to take account of the starting position. Actual prices in 1979 and 1980 were much higher than the money supply on its own could explain. The relationship, therefore, starts from a position in which prices, even at the end of 1980, are very high in relation to money supply. In its projection, the relationship assumes that this margin of actual over "equilibrium" prices will be gradually reduced to zero. Hence, the inflation rate in 1981 and 1982 is not as high as recent monetary experience on its own would lead one to expect. This is rather like saying that some of the inflation due

to come from the recent growth in the money supply has happened already back in 1979 and early 1980. Indeed, the whole argument of the first section of this paper would suggest it is wrong to see causality as running solely from money to prices. The overshoot was a response to inflation which had already taken place.

29. This is not quite as comforting as it sounds. It remains true (on the basis of this "crude" monetarist relationship at least) that inflation in 1982 would have been much lower if the monetary target for 1980-81 had been achieved. And a forecast inflation rate of 12½ per cent in 1982 is not at all reassuring. If the relationship is right, moreover, it is already getting rather late to do anything much to change the prospect for inflation before 1983.

30. In fact, such a simple relationship between money and prices does not provide a very satisfactory explanation of the past. It rests heavily on the experience of 1972 and 1974 when identifiable special factors, like the world oil price increase, were clearly at work. It does not explain the experience of the late seventies at all well.

31. Since the mid-seventies, M1 seems to have provided a rather better forward indicator of inflation than £M3 (see accompanying paper by Mrs Lomax). The peaks in the growth of M1 in 1975 and 1978, preceded the inflation peaks of 1977 and 1980 with a lag of about two years. On this basis, one might suggest that the exceptionally slow growth of M1 in 1980 pointed to a rapid and continuing slowdown in inflation. Moreover, Chart B suggests that M1 is currently low in relation to nominal income, which could be read as indicating that prices were high in relation to M1 and real GDP. In official forecasting, it is probably fair to say that no weight at all is given to M1 as such, but the factors depressing M1, especially the high level of interest rates, do play a role.

32. The overshoot on the £M3 target has not led to an upward revision of our inflation forecasts. On the contrary, our inflation forecasts have been revised down. At the risk of oversimplifying, this can be explained in terms of the level of the exchange rate and the level of economic activity. We see these as the principal channels by which monetary events are transmitted to prices.

- (i) The exchange rate has remained very strong, despite the overshoot on the money supply target. This itself is a surprise. Before the event we would have said that an overshoot on this scale would have precipitated a substantial depreciation. We saw the high exchange rate as transmitting monetary restraint; it now seems that restraint on output and inflation is being effectively applied by a high exchange rate even if its ultimate origin is not £M3. Indeed, the exchange rate is now about 20 per cent higher than we were expecting a year ago. This must already have reduced the price level by at least 2 per cent, with more to come this year.
- (ii) The level of output has fallen much as foreseen. This has reduced wage settlements (broadly as expected) and has also had a direct effect on prices in the shops (which was not expected at all). Again, the restraint is there, despite the £M3 figures. In this case, however, the explanation could well be in the lagged response of output to financial conditions. The very tight monetary policy of 1979-80 may lie behind the current level of economic activity and the recent success in reducing inflation.

33. These forecasts for prices leave a lot of questions unanswered. Suppose the monetary targets had been achieved, would not that, even in the complicated Treasury model, mean lower inflation in later years? The answer must depend very much on the measures which might have been taken in this hypothetical case to achieve the target. If they had raised the exchange rate yet higher or further depressed output and employment, as in general measures do which reduce £M3, then the prospects for inflation would indeed have been improved - perhaps quite sharply, because the measures needed would, as already indicated, have had to be very tough measures indeed.

### Conclusions

34. Looking back, then, the target set for 1980-81 was a very tough one indeed - tougher than we knew at the time. It should have been seen more than it was in the context of the year before. After a year of very rapid inflation in 1979, the money supply position and the financial position of the private sector generally, was already very tight. Had the pressure been maintained, and indeed increased



as intended, the outcome on inflation might have been very impressive, but the cost in terms of output and employment might not have been acceptable. As it was, we grossly underestimated the extent to which the private sector would react to the threat of financial crisis in ways that relieved the pressure.

35. In explaining the overshoot, we can point to several factors which have added to £M3 but have not led us to raise our forecast of inflation:

- (i) the high level of personal savings;
- (ii) the improvement in the current account (and the destocking which went with it) and
- (iii) the imbalance of income between persons and companies.

We can also point to several factors which have led us to reduce our price forecasts although they did not reduce £M3 (or at least not proportionately):

- (a) the rise in the exchange rate;
- (b) the high level of interest rates; and
- (c) the cut in profit margins.

Both sets of factors change or qualify the relationship between money and prices and may, for that reason, be relevant to setting monetary targets for next year.

Gen Bl  
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10 DOWNING STREET

*From the Private Secretary*

13 February 1981

I enclose my note of the Prime Minister's meeting with the Chancellor and the Governor on Wednesday evening.

I am sending a copy of this letter and enclosure to Tim Allen (Bank of England).

see 11/2/81

J. P. LANKESTER

John Wiggins, Esq.,  
HM Treasury

KRB

SECRET

MR LANKESTER

~~Prime Minister~~  
I don't think this article by Alan Walters (written last November and appears in April) will cause much of a problem. Fortunately, we have managed to stop a v. damaging interview he gave in Decemr.

4

The attached article\* on "Tax Rates, Incentives and Government Revenue", by Alan Walters, is due to appear in the 'Policy Review', published by the Heritage Foundation based in Washington, in April. It was accepted for publication last November.

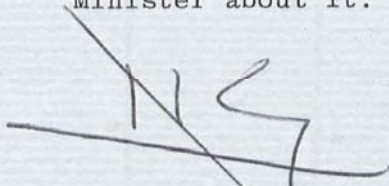
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2. An extract from the article will appear later this month in the newsletter of the International Centre for Economic Policy Studies in New York (in place of an interview which Mr Walters gave to the ICEPS which was loaded with difficulties).
3. The article is historic and analytical. But it contains some some nice potential headlines (though it is by no means as sensitive as the jettisoned interview). It concludes:

"When we advocate tax cuts, we must be prepared to advocate cuts in Government spending at the same time, or else to advocate bigger deficits. Government spending cuts are a better choice. Bigger deficits, if allowed to cumulate, have evil consequences of their own: either more inflation, or more Government borrowing from private lenders ...". (para 28).

4. The article could attract attention when it appears in the shadow of the forthcoming Budget. And whatever extract is used in the ICEPS's newsletter - the editor was not sure which part he would use when I last spoke to him - might also cause interest before the Prime Minister's Washington visit.
5. You might like to have a look at the article, and the jettisoned interview (which I also attach)<sup>+</sup> and alert the Prime Minister about it.



NEVILLE GAFFIN  
17 February, 1981.

\* Flag A  
+ Flag B

SECRET



10 DOWNING STREET

From the Principal Private Secretary

12 February 1981

*Sub*  
*John,*

SHORT-TERM INTEREST RATES

The Prime Minister held a meeting yesterday evening with the Chancellor of the Exchequer and the Financial Secretary to discuss short-term interest rates. Sir Douglas Wass, Mr. Burns, Mr. Middleton, Mr. Walters and Mr. Wolfson were also present.

After discussion it was agreed that there should not be a cut in MLR this week. The possibility of a reduction next week should be left open for the time being. In reaching a decision account would need to be taken of developments between now and next Wednesday and in particular of the market's reactions to the RPI and trade figures to be announced on Friday of this week and Monday of next respectively. It was important, however, that whatever decision was taken then was not reached solely in the light of the immediate situation but within a framework of factors which could be used to determine the management of short-term interest rates in a logical and consistent way over the months ahead. We needed to think through very carefully what our objectives were, what the various factors to be taken into account in deciding interest rates should be and what relative weights to give to those factors. The Chancellor of the Exchequer agreed to circulate such an analysis in time for a further discussion on Wednesday 18 February.

*Yours ever,*

*John Wiggins.*

John Wiggins, Esq.,  
H. M. Treasury.

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*MPAM*

SECRET

cc DE WHITMORE  
DE WOLTON  
DE WALTERS

Subject

Econ PD  
||

NOTE FOR THE RECORD

The Prime Minister met the Chancellor of the Exchequer and the Governor at 1700 hours today to consider whether MLR should be reduced tomorrow.

The Chancellor said that this was a very difficult decision. The Governor had advised that a 1% reduction would be desirable and possible provided we could be satisfied that we could justify it in a credible way. By this he meant -

- (i) Acknowledging that the exchange rate was a factor in the decision;
- (ii) Praying in aid the fall in inflation (the 12 month RPI figure to be announced on Friday will be 13.0%);
- (iii) Acknowledging that M3 is no longer the sole guide to interest rate determination (though in effect we had already done this when we decided to reduce MLR in November);
- (iv) Indicating that from now on we would be looking not only at M3 but at the narrower monetary aggregates in determining interest rates and other policy measures.

The Financial Secretary, Mr. Middleton, Mr. Burns and Sir Douglas Wass were arguing against any reduction. They felt that, if there were to be a reduction, it would be better to do it in the Budget - because it would be possible by then to have worked out a full and credible presentation of the decision based on the four points above. On the other hand, he himself felt that it would be difficult to announce an MLR reduction in the Budget because of the high PSBR forecast for 1981/82 which would emerge in it. He also had an instinctive dislike for announcing MLR changes from the Despatch Box.

The Chancellor went on to say that until yesterday he had been in favour of a reduction tomorrow. However, in the light of today's press - following the banking figures of yesterday - he was inclined to recommend against.

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/ The Governor

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- 2 -

The Governor said that after a very good press last week, this week's press had been disappointing. The story in Monday's papers that an MLR reduction was being ruled out until the Budget had depressed the market and made the reception of the banking figures less good than it might have been. This made it all the more important that, if a decision were taken to reduce MLR tomorrow, it should be justified in a convincing fashion; and this would involve invoking the four points mentioned by the Chancellor. But Ministers had to be clear what they were doing: it would be no good justifying a reduction in MLR in these terms tomorrow, and then telling a different story in the Budget. His own view was that we would have to be focussing more on the aggregates other than M3 from now on in any case: for it was going to be extremely difficult to hit an M3 target of 6-10% at least in the early months of 1981/82, and there was also an intrinsic case for paying more attention to the narrower aggregates. The Governor also mentioned that, in the Bank's view, the recession was likely to be more severe and continue longer than the Treasury forecasters believed. This was another way of saying the exchange rate should be considered as a factor.

The Prime Minister said that the exchange rate and inflation considerations were, in her view, very important; and she wanted to give industry a boost. But she appreciated the Treasury's anxiety. She would want to consider the matter further with Treasury Ministers and officials before taking a final decision.

As the meeting was breaking up, the Governor told the Prime Minister that the Governor of the Swiss Central Bank had told him in Zurich that the UK was faced with a similar situation on the exchange rate front to that <sup>with</sup> which he had been confronted in Switzerland in 1978. In other words, he would put getting the exchange rate down as having immediate priority over money supply considerations. He had also told him that our monetary base had been growing, if anything, too slowly.

TL  
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11 February 1981

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NOTE OF A MEETING HELD IN THE CHANCELLOR OF THE EXCHEQUER'S ROOM,  
H.M. TREASURY ON THURSDAY, 5 FEBRUARY 1981 AT 2.45 P.M.

Present:

Chancellor of the Exchequer (In the Chair)  
Chief Secretary  
Financial Secretary  
Mr Burns  
Sir K Couzens  
Mr Ryrie  
Mr Middleton  
Mr Britton  
Mr Monck  
Mr Unwin  
Mrs Lomax  
Mr Turnbull  
Mr Ridley  
Mr Walters - No.10

B

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MONETARY CONTROL

The 3 February discussion was resumed on the basis of Mr Middleton's submission of 4 February and the paper attached to it. The Chancellor said the question to be settled was whether he should announce in the Budget the possibility of an early move to non-mandatory Monetary Base Control (MBC) as an alternative to the evolution of monetary control arrangements foreshadowed in his 24 November statement.

2. Mr Middleton said that, in further discussion with Mr Walters, the alternative course had now been defined rather more precisely. A broad monetary base ( $M_0$ ) would be targeted over a six month rolling period. Broadly those methods of control which were already being contemplated would be used, with the authorities acting to push interest rates up if  $M_0$  was running above the target range, and reduce interest rates if it was running below the range.

/It seemed likely



It seemed likely that the interest rate bands within which the authorities would be working at any particular time would have to be wider than hitherto contemplated. Under this system £M3 could still be retained as a medium term objective. An announcement in the Budget would be essential, given the substantial changes which the discount market, the banking system and the building societies would have to make in the way they do their business in time for the new system to be introduced before the end of 1981. There was no guarantee that an  $M_0$  objective could be achieved over a six month period; considerable uncertainty remained as to whether the manipulation of interest rates would lead the general public to adjust their holdings of cash to the required extent within the time period. The question thus remained whether some other aggregate might not be preferable to  $M_0$ .

3. The Chancellor noted that an immediate move to MBC required far-reaching decisions to be taken in a very short time. This was in striking contrast with the procedure whereby future arrangements for mortgage tax relief were to be decided over an eighteen month consultative period. He questioned what were the overwhelming advantages of MBC which made it desirable to take decisions within a very few weeks. Mr Walters said that the advantage of MBC was the very much better control over inflation it would make possible; the excellent Swiss record on monetary control and inflation demonstrated the advantage of the system. Moreover MBC was in effect the UK system from 1840 to 1913, a period when there had been no inflation in the UK. The course he had proposed had been specified so as to fit in closely with the existing UK institutional arrangements; he saw no case for a long adaptation period during which a gradual move was made towards MBC - we should learn little about the demand for monetary base if we sought to change the system by evolution.

4. The Financial Secretary said he had much sympathy for Mr Walters'

/proposals;





proposals; but he thought there were serious dangers of damaging side effects in present UK circumstances. He doubted whether the Swiss success could be attributed to MBC alone; Switzerland also had the advantage of a balanced budget, and he thought it would be very unwise in the UK situation to abandon setting the monetary objective in terms of a broad aggregate while the present large public sector financial deficit remained. He did not think MBC on its own would do a trick in the UK, and preferred to follow the course already indicated in the Chancellor's November statement, and in particular to see what could be achieved through more flexible arrangements for short term interest rates.

5. Mr Burns suggested that, before looking at MBC, we should choose between a broad and a narrow aggregate for the specification of the Government's monetary objectives. Were we ready to move from total commitment to a broad aggregate to an exclusive emphasis on a narrow one? (He thought the distinction between  $M_0$  and  $M_1$  should not be exaggerated - both would have to be targeted in much the same way.) He agreed that considerable importance should be attributed to the narrow aggregates, but felt that a good deal of further analysis and experience was required before any far-reaching commitment to a narrow aggregate was entered into. He pointed out that the recent relatively slow growth of the narrow aggregates made it more difficult for the immediate future to specify the target in terms of them; as interest rates fell, their growth would tend to accelerate, and a low target could well require the downward movement in interest rates to be reversed.

6. The question was raised how precise the tracking of a narrow aggregate over a relatively short period should be, or - to put the question another way - how much interest rate variability would be acceptable in practice. The Chancellor said he was anxious to make monetary control more effective, and to give the markets more say

/in determining interest



in determining interest rates. But in present circumstances the credibility of monetary policy was far from firmly established, and he would be very reluctant to give the impression of indecision which would be implied if the Government were now to announce that they were going to follow a course markedly different from that outlined in his 24 November statement. Mr Walters said the extent of the change in direction should not be exaggerated; he accepted that it might still be necessary in effect to aim at a target range for interest rates, at least for a period, although changes in the monetary base would be closely watched. Mr Britton noted that it might not be easy to determine interest rates by reference to the monetary base; the relationship between  $M_0$  and interest rates was uncertain, and  $M_1$  could well prove a better target from this point of view. If a supplementary target to go with a medium term £M3 objective were required,  $M_1$  would in his view be better; insofar as  $M_1$  was open to objections arising from its misuse in 1974, these applied also to  $M_0$ .

7. In further discussion the advantages of evolutionary change were emphasised. There was a risk in the immediate future that we might find relatively rapid growth of both broad and narrow aggregates, associated with upward pressure on the exchange rate. Would we then want to be committed to immediate substantial increases in interest rates? A more gradual movement towards a narrow aggregate would leave us with a safety value in the meanwhile, and would allow the possibility for further study of the performance of alternative definitions of the monetary base as indicators in the meanwhile. There was no question of a move to MBC, and substantial changes in the operations of the financial institutions, being permanently ruled out; but by contrast an early announcement of a move to MBC, even in a longer time scale, would mean an irreversible commitment to institutional change. Under the course already charted the possibility would be

/open to make more



open to make more use of both  $M_0$  and  $M_1$  in the determination of short term interest rates; thus a good part of the changes suggested by Mr Walters could in practice be introduced without any immediate commitment to an eventual move to MBC.

8. Sir Kenneth Couzens emphasised the importance of re-establishing the credibility of monetary policy; in present circumstances it would be undesirable to rush away from £M3 and stake everything on what would be a leap in the dark. It would however be sensible to say now that the authorities would pay more regard to movements in the narrower aggregates; such a step would be credible and evolutionary, and leave adequate room for manoeuvre; such room for manoeuvre could well be required in the light of the Prime Minister's remarks about having regard to the exchange rate in setting interest rates (which would not be possible if interest rates fluctuated markedly according to the requirements of an MBC target). Mr Burns suggested that the authorities might seek to give the £M3 target greater stability by not rolling it forward every six months; at the same time it might be possible to specify ranges for the narrow aggregates which would be consistent with the £M3 target. The Financial Secretary was more doubtful about this; he thought the worst course would be one in which we shifted to a narrow aggregate as the monetary target, and were then obliged by the pressure of events to increase the target. Mr Walters said that he too was worried by the possibility of such pressure; he feared that the £M3 over-run would be monetised - that it would in effect feed into the monetary base. He would himself like to fix a target range of 5-7 per cent for the increase in  $M_0$  over the next year.

9. The Chancellor, summing up the discussion, said that there was still some way to go in getting the necessity of monetary control

/accepted in the

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accepted in the UK, but people were now becoming used to looking at  $M_3$ , which it would be sensible to retain. Nevertheless we should at the same time pay more attention to the narrow aggregates -  $M_0$ ,  $M_1$ , and - when it became available -  $M_2$ . It would be enough for the time being for the system to evolve, without commitment, towards MBC. He envisaged saying in the Budget Speech that more attention would be paid to the monetary base and other narrow aggregates, and that further study would be made of the properties of these aggregates.

JW

A J WIGGINS

6 February 1981

Distribution

Those present  
Sir Douglas Wass

CONFIDENTIAL



Re HS

Econ P. 1.

10 DOWNING STREET

From the Private Secretary

<sup>4</sup>  
3 February 1981

The Prime Minister has read your Secretary of State's minute of 29 January about indexed gilt-edged stock. She has noted that there is still an outstanding issue on the eligibility of the life insurance companies for purchasing this stock. She suggests that this should be resolved by your Secretary of State and the Chancellor.

I am sending copies of this letter to John Wiggins (H.M. Treasury), Ian Ellison (Department of Industry), Terry Matthews (Chief Secretary's Office), Stephen Locke (Financial Secretary's Office, H.M. Treasury), Tim Allen (Office of the Governor of the Bank of England) and Hugh Tyrrell (Board of Inland Revenue).

J. P. LANKESTER

Stuart Hampson, Esq.,  
Department of Trade.

CONFIDENTIAL

NPM



*a/h walking*

*Prime Minister*

*Too late on the principle,  
though I won't tell Trade.  
On the life insurance co's  
point, I really think we*

PRIME MINISTER

*Yes not*

*should leave this to be  
sorted out by the Chancellor.*

INDEXED GILT-EDGED STOCK (IGS)

*Agree? R 29/1*

1 I am sorry that my absence in India has prevented me from commenting earlier on the Financial Secretary's minute dated 13 January on this subject.

2 I have reservations on this further example of indexation which are not removed by the arguments Nigel Lawson has advanced. I will here, however, restrict myself to a point of particular Departmental concern.

3 I am not convinced that pension funds (insured and otherwise) should be the only eligible holders. I should be in favour of allowing the life insurance companies also to buy them for the whole of their business and not merely for the pensions. The life companies hold assets for ordinary life business and pension business in the same fund without hypothecating assets to any particular liabilities. It would require a significant change in their practice to hold IGS only against pension liabilities. I am not sure that they would accept the discrimination against their life policyholders. (Saving through life insurance is very wide-spread: four out of five households have a policy.) Nor do I accept that the amount of indexed stock likely to find its way into the hands of non-residents through United Kingdom life policies would be significant enough to affect the exchange rate. If however we are convinced that the stocks ought to be available only for pensions I consider that I should be authorised to discuss the difficulties with the life companies as soon as possible.



An innovation of this kind is likely to be more successful if we have secured the goodwill of the institutions.

4 I should add that the issue of £2 billion a year of IGS will have only a limited effect towards indexing private sector pensions. The inflow of funds into private sector schemes is likely to be over £10 billion this year.

5 Copies of this minute go to Geoffrey Howe, Keith Joseph, Leon Brittan, Nigel Lawson, Gordon Richardson and Sir Lawrence Airey.

W. J. B.

J. B.

Department of Trade  
1 Victoria Street  
London SW1H 0ET

29 January 1981

SECRET



10 DOWNING STREET

cc. Mast-at aeb.

From the Private Secretary

29 January 1981

As I told you, when the Chancellor of the Exchequer and the Governor called on the Prime Minister yesterday afternoon to discuss the indexed gilt proposal, they also discussed the possibility of a reduction in MLR in the near future. I did not take a detailed note of this part of the discussion; however, you may like to be aware of some of the points that came up.

It was pointed out that the first estimate of the January banking figures would not be available until next Wednesday. But on present information, it looked as if the figures would be relatively good - with M3 growth perhaps about 1%. If the estimate available next Wednesday turned out to be favourable, then a 1% reduction could perhaps be justified on the following day. If, on the other hand, the estimate was less good, and if nonetheless it were considered desirable to reduce MLR, then this would probably have to wait until after the banking figures were announced the following week - i.e. until the following Thursday.

The following arguments were adduced in favour of an early reduction. First, it would improve the funding prospect in the short run and therefore help the February banking figures which were due for announcement on Budget Day. Second, it would provide a useful psychological boost to industry at a time when there was evidence that some manufacturers were beginning to "give up" on their exports. Third, it would help reduce the exchange rate, or at least reduce some of the current upward pressure. Fourth, the real level of interest rates was now substantially positive, and a reduction could be justified and was desirable in its own right.

On the other hand, there were some important arguments against. First, unless the funding programme was going particularly well, a reduction prior to the Budget would look premature. Second, it could make the Chancellor's Budgetary task more difficult insofar as it might increase the pressure on him to restore the credibility of the monetary strategy. Third, there was a risk that a reduction before the Budget would be misunderstood, because this would be in advance of a restatement of the monetary strategy and in particular new targets and the fiscal measures needed to meet them.

/ It was

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BK



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It was agreed that the pros and cons of an early MLR reduction, and its precise timing, would have to be considered further. If it was decided to move, it would be essential to present it in such a way that it was seen as consistent with the Government's future thinking on the monetary strategy; and some indication of the latter might have to be given. In this context it was suggested that the following points might be made: first, that the real extent of monetary pressure had been greater than the M3 figures suggested; second, that this was reflected in the lower figures for some of the other monetary aggregates; third, that the Government would be paying greater attention in future to these other aggregates; and fourth, although this would be a significant change - that the MLR reduction was being done partly to reduce the upward pressure on the exchange rate.

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

I. P. LANKESTER

John Wiggins, Esq.,  
H. M. Treasury.

~~SECRET~~



10 DOWNING STREET

From the Private Secretary

29 January 1981

*subject copy filed on:- Econ Pol: Domestic Monetary Policy: p. 7*

Dear Mr ,

As you know, the Prime Minister met the Chancellor and the Governor yesterday afternoon to discuss the proposal to introduce an indexed gilt.

The Chancellor said that the basic objective was to achieve a more effective marketing of debt. There were two possible approaches - improving the method of marketing, for example by introducing auctions; and improving the instruments, for example by introducing an indexed gilt. His preference would have been to have concentrated at this stage on improving the methods of marketing; but he understood that the Governor felt unable to make any general move in that direction. That being the case, although he continued to have some residual anxieties about the move to indexation, he believed, on balance, that an indexed gilt should now be introduced.

The Governor said that the Bank could change their methods of selling debt. But this would involve considerable market disruption and would thus interrupt the funding programme; and in their view, the proposed changes in method would raise the cost of borrowing. The present methods had worked remarkably well over the last few years. Enormous amounts of debt had been sold and this had been accomplished relatively smoothly and there had been only a very few funding pauses. If the Bank were to go over to an auction system for conventional stocks and this were to be accompanied by forced selling as some had proposed, gilts prices would become more volatile and less attractive to hold and the market would be irrevocably damaged. Therefore, it was not so much a question of the Bank being able to change their methods: they felt it would be undesirable.

The Governor went on to say that the proposal for an indexed gilt raised some very difficult questions. On the one hand, from a marketing point of view any increase in the variety of stock available was desirable. He understood that the Scott Report on public sector pensions was in favour of an indexed gilt; and it was possible that it would reduce the overall cost of borrowing. If there was to be such an issue, now was the time to introduce it - when inflation was coming down. On the other hand, there was

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the broad politico-economic question of whether it was wise to extend indexation in this way when the Government's whole philosophy was to re-establish nominal money as a store of value. He assumed that Ministers had considered this point carefully. Furthermore, there was likely to be criticism from some quarters that the Government had lost confidence in its ability to fund the seemingly out-of-control Government borrowing requirement. There would also be criticism from corporate borrowers who would never be able to compete with the Government and issue their own indexed debentures. But if Ministers were clear that they would like an indexed gilt, the Bank were prepared to issue one; and as would be necessary, to do so by auction - though possibly with a reserve price. They were considering what should be the amount of the issue; it would probably be in the region of £2 billion.

*Handwritten notes in red ink on the left margin:*  
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 10/11/79

*Handwritten notes in red ink on the right margin:*  
 Box  
 1/2  
 Trans. Board 3

The Prime Minister said that she was aware of the arguments against. But she and the Chancellor had concluded that it would be right to announce an indexed gilt - mainly because it would provide some reduction in the cost of borrowing (especially in nominal terms in the early years); and because it would help to fund the borrowing requirement.

Finally, the question of timing was discussed. The Chancellor said that he was not entirely clear how soon an announcement could be made: there was still an outstanding Inland Revenue point to be resolved. On the whole, he felt it would be best to announce it in the Budget, but he did not wish to exclude the possibility of doing so earlier. He would consider this further with the Governor and report back to the Prime Minister.

The Governor emphasised that it was absolutely crucial that the decision to introduce an indexed gilt should not leak: if it did this would immediately cause the market to dry up pending the announcement.

The Prime Minister said that she would be inclined to wait until the Budget, but she would await the Chancellor's further advice.

In view of the Governor's point about the risks of a leak, you will no doubt ensure that knowledge of this decision is kept to as few people as possible.

I am sending a copy of this letter to Tim Allen in the Governor's Office.

*Handwritten flourish or signature mark.*

*Handwritten signature: Tim L...*

A.J. Wiggins, Esq.,  
 H.M. Treasury.

**SECRET**



PRINCIPAL PRIVATE SECRETARY

cc PS/Chief Secretary  
Sir D Wass  
Mr Ryrie  
Mr Burns  
Mr Middleton  
Mr Monck  
Mr Turnbull  
Mr H Davies  
Mr Shields

~~Mr Lankester - No 10~~

INDEXED GILTS

The Financial Secretary has seen Mr Turnbull's minute of 27 January, discussing the possible timing of a new indexed gilt issue.

He is sure we would be ill-advised to delay this until after the Budget.

A handwritten signature in blue ink, appearing to be "S A J".

S A J L

S A J LOCKE  
28 January 1981

Copies attached for:  
Chief Secretary  
Financial Secretary

- 1. SIR DOUGLAS WASS
- 2. CHANCELLOR

cc Mr Ryrie  
Mr Burns  
Mr Middleton  
Mr Monck  
Mr Davies  
Mr Shields

*Ami Amishi*  
*Official Treasury advice*  
*is, on balance, to wait*  
*until the Budget before*  
*announcing the indexed gilt -*

*mt*

INDEXED GILTS

*because the monetary prospect for*  
*February looks narrower (see other note in this folder). I*

If a decision in principle is taken soon to proceed with an indexed gilt, the question of the most appropriate time to launch will need to be settled. One possibility would be to announce it before the Budget, in order to demonstrate that the Government has the instruments in place and operating to achieve the funding necessary to meet the monetary target. The case for this would be sharper if it were thought that the funding programme between now and the Budget was flagging. An alternative would be to launch it in the Budget as part of a comprehensive strategy.

*suggest you*  
*work with*  
*the Chancellor*  
*about this*  
*at the*  
*Treasury*  
*tomorrow.*  
*PL*  
*27/1*

2. There are dangers in creating the impression that the Government is acting out of desperation, that it is seeking solely to fund the PSBR rather than control it. Recent market comment has been very much along these lines. The FT of 24 January, in commenting on the convertible issue, said "When the Bank starts varying the market's diet, it may be a sign that a very large meal is on the way." On 26 January, it said "The Bank of England does not normally introduce innovations except under pressure." It would be unfortunate to launch such a major innovation as an indexed gilt onto a reluctant market.

3. In the Bank's view, there may not be a need for urgent action before the Budget as the prospects for gilt sales over the next two months appear reasonably promising. In addition to the known calls of £350 million, the stocks currently available are:

3% 1985A	£200 million - the low coupon stock
12¼% 1999B	£950 million - the tap stock
12½% 1985	£1000 million - the convertible.

The Bank are hopeful that the convertible, for which tenders will be received tomorrow, will sell well and that the tap stock may soon begin to be taken up. If this were the case, it would be possible to achieve, or perhaps exceed, the £2 billion of gross gilt sales projected over the next two months in the latest assessment of monetary prospects. If the Bank's hopes were disappointed, it would of course be necessary to reconsider the position.

4. Delaying the introduction of indexed gilts until the Budget could also be helpful in allowing time for resolution of the remaining problems on the eligibility criteria. We believe, after taking legal advice, that the Life Offices should be able to sign the statutory declaration envisaged in the prospectus, undertaking to use this only to back their UK pension business. But they will need in some cases to hypothecate assets to sub funds, and the Department of Trade have doubts about their reaction to a requirement of this kind. Advance consultation with the industry could help clear the way to this acceptance of the eligibility criteria, and improve the chances of an enthusiastic market response to the issue.

#### Conclusion

5. Provided this assessment of the prospects for gilt sales proves well founded, there may be no need to press ahead with the launch of an indexed gilt before the Budget, and some danger of appearing to be acting out of desperation in doing so. Delay until the Budget or shortly after also would allow more time to settle the issues of eligibility.

AT

A TURNBULL  
27 January 1981

1. SIR DOUGLAS WASS
2. CHANCELLOR

Copies attached for:

Chief Secretary  
Financial Secretary

cc Mr Ryrie  
Mr Burns  
Mr Middleton  
Mr Monck  
Mr Davies  
Mr Turnbull

### MONETARY PROSPECTS

The prospective outturn for banking January (which ended on 20 January) now looks a little better than it did two weeks ago. The CGBR has come out considerably smaller than expected (a surplus in unadjusted terms of over £800 million) and gilt sales have been stronger (over £1200 million net in total). However, a worse outcome for National Savings and CTDs looks like providing some offset. Overall we would now expect to see £M3 growth in the month (seasonally adjusted) around 1 per cent or just below.

2. There must at this stage however be considerable uncertainty about the final outcome. We have no data yet on the deposit side for the banking month as a whole and for some of the most important counterparts (bank lending and the externals) we have only a few, vague pointers. For banking February, which has only just started, the position is of course even less clear. But on the assumption that about £800 million will be received during the month from sales of one of the current tap stocks, we would expect to see £M3 growth again in the region of 1%. The preliminary figures for February will be announced on Budget day, March 10.
3. By the end of banking February, growth of £M3 over the current target period will probably have amounted to rather more than 20% in recorded terms. Allowing for distortions produced by the "corset" scheme, this would be equivalent to perhaps 18 per cent in adjusted terms compared with the target range of 7-11 per cent p.a.

4. Looking in more detail at banking January, the CGBR in seasonally adjusted terms was around £1200 million, slightly above the average for the financial year but nearly £700 million better than expected. Despite signs of a sizeable shortfall in Inland Revenue receipts at the beginning of the month (within calendar December) the eventual outcome proved to be very strong. No breakdown is yet available on the source of this strength by type of tax.
5. Receipts from National Savings seem to have been disappointing during the month, reflecting mainly the rather poor performance of the latest "granny bond" issue. Large surrenders of Certificates of Tax Deposits further weakened the contribution of non-gilt debt sales to the funding of the PSBR. However, better gilt sales largely compensated for these low receipts, with most of the pre-Christmas "cluster" being sold towards the end of the banking month.
6. January was expected to see a relatively strong growth of bank lending because of the three-monthly pattern of "spikes" recently observed in the figures. Given the profile of the CGBR during the month this now seems more likely, but lending should still have grown considerably less fast than the rate of over £1 billion per month experienced in some periods of 1980.
7. The gilts market turned a little firmer today ahead of the issue of the new Convertible 1985/1992 stock. To realise the scale of gilts receipts assumed in the February forecast, however, requires that substantial sales be made from the combination of this and the current 1999 tap stock.
- 

*Jon Shields*

JON SHIELDS  
27 January 1981



cc Mr. Walters

ECON POL

NOTE FOR THE RECORD

The Prime Minister held a meeting with the Chancellor of the Exchequer, the Financial Secretary and Sir Douglas Wass at 0900 hours today to discuss the proposal for the introduction of a restricted indexed gilt (RIG).

The Chancellor said that the basic objective was to achieve a more effective marketing of debt. There were two possible approaches - improving the method of marketing, for example by introducing auctions; and improving the instruments, for example by introducing an RIG. The Financial Secretary believed we should introduce an RIG straightaway. He himself felt there was a good intellectual case for such a move, but he still had some anxieties about how the markets would react - particularly at a time when we were trying to de-index expenditure. He felt there was a stronger case for concentrating on marketing methods; and if he could be confident that he could get an undertaking from the Governor to pursue improvements in this area, he would be disinclined to introduce an RIG.

Sir Douglas Wass said that an RIG could have the following benefits: it could result in a small real reduction in the cost of borrowing because of the lower risk being borne by the lender and it would involve a lower nominal cost, prior to redemption, because of the low coupon. The Financial Secretary added that there was a third benefit - namely that, assuming inflation turned out to be lower than what the market expected, there would be substantial real savings. Per contra, to continue excessive reliance on conventional funding would, in this situation, make such funding very expensive. Sir Douglas commented that this third benefit was very uncertain; and if inflation turned out to be worse than the market expected, the RIG would be very expensive. He added that, in his own view, the introduction of an RIG could be expected to reduce interest rates generally slightly; but this would be offset by unfavourable effects on equities and the ability of companies to resume rights' issues - this was because private sector companies could not afford to offer indexed debentures themselves.

/The

The Prime Minister said that she was in favour of introducing the RIG (though she did not want it to be known by these initials). In so far as it would help with the funding problem and reduce interest rates, it should be beneficial. She understood that it would be necessary for it to be auctioned, and that the Governor would be prepared to introduce it on this basis if so instructed. It would be right, in her view, to press him to move towards an auction system for conventional stocks at the same time.

Sir Douglas Wass said that a general system of auctioning would involve major institutional changes. In particular, the jobbers would not have the resources to cope with the increased price volatility that would follow from an auction system. A new system of underwriting would have to be devised instead. The Financial Secretary added that such a change would involve a major market upheaval; it would interrupt the funding programme and at least in the short term make funding more expensive.

In conclusion, the Prime Minister said that she and the Chancellor should press the Governor, when they saw him tomorrow, to introduce an RIG by auction; they should also press him on the question of moving to auctions more generally, although she understood that the chances of success on this front for the time being were not great. The question of the timing of the announcement of the RIG should be considered by the Treasury in the course of today; there was the option of either announcing it forthwith, which would help the February banking figures, or announcing it in the Budget which might be more attractive politically.

The Prime Minister also said that she would like the Treasury to provide her with a note on how they saw the prospects for funding in banking February.

TL

27 January 1981

# I N F L A T I O N .

*Econ Pdr  
written by  
Roger Buck  
in 1975*

## Three Fallacies

*SM -*

There are common fallacies about inflation.

Fallacy I that 'money' includes what is called by economists M.1 and M.3". These are :-

*Pa.  
Red.  
19/1/81  
AD*

- M.1 Notes and coins in circulation with the public plus current accounts at Banks held by the private sector only.
- M.3 Notes and coins in circulation with the public together with all deposits to banks whether denominated in sterling or other currencies held by U.K. residents in both public and private sectors.

I submit that to regard M.1 and M.3 as "money" and as part of what is called "The Money Supply" is erroneous, except as to the first two elements in each case, namely treasury notes and coin. The latter of these two is not as relevant as the former, for coin normally has an intrinsic value which approaches its value in exchange. The debasement of coinage by reducing the precious metal content, and the obtaining of filings from original coins (which led to the milling on the edge of some silver coins) is historical and relates really to the days before treasury notes came into use.

"Money" must have two special attributes :

1. It is accepted in general in payment for goods and services in the place where it is proffered, and
2. The payment closes the transaction.

The Treasury note possesses these attributes. Some say it is a store of value, but recent history demonstrates that monetary inflation diminishes the amount of goods and services that the treasury note will buy. It has little or no intrinsic value, for the value of the paper is negligible. But it is more appropriate to our modern society as money than articles of intrinsic value. A nugget of gold proffered in a modern shop would not be acceptable for a bag of flour, a valuable diamond ring would be refused, too, for there is no ability to check values. Where there is no coinage or notes available, some substitute has to be found. For instance, in the gold rush days, gold dust was 'money', the ease of the measurement together with its intrinsic value and arts of recognition leading to acceptability, and the transaction was complete when the exchange had taken place.

Deposits do not qualify as money for the reason that they do not have the two attributes. They are not generally accepted for they are personal to the parties, and the transaction does not finish with the exchange.

The importance of this is intensified when the error is carried into the definition of "money supply" which leads to the untenable assertion that increases in such credits lead to increased "demand" for goods and services.

Wherever there is a credit there is somewhere a corresponding debit. This seems self-evident but is overlooked, with the result that restrictions, statutory and otherwise, have been imposed, distorting business procedures and outlooks and creating intolerable complexities for industry. Let us pursue the thought a little further and look behind a current or deposit account balance. The first thing to notice is far from being evidence of demand, it is evidence of the lack of it, for it is a saving not required for immediate use. One is sometimes misled by the fact that these credits have the quality of liquidity - that is, they can be called up if required on no notice, or short notice. Let us remember too, that

it is generally conceded now, that unbacked treasury notes issued through the Government printing press is at least the main cause of our ills. The notes are placed into circulation and normally find their way to Bank accounts. Exceptions would be of notes kept under the bed, which must surely be rare in these days. Consequently to add credit balances in bank accounts to the note issue and say that that doubles demand is, in itself, seriously to overstate the position, even if the basic premise were true, which it is not.

There is a tendency these days to apply Communist principles to a free society. This is an example of it. All the credits are added up, and it is asserted that these, with treasury notes and coin, are the total demand of the community. But that is not so - one man's demand is another man's lack of demand - and one cancels out the other. If Mr Jones has an account in the Safe and Sure Bank with a credit balance of £10,000 and decides to buy a boat - before the transaction the bank had the obligation to Mr Jones for his credit account balance. After the transaction, when the cheque is paid in, the boat seller's bank has an obligation to the boat seller. Mr Jones' credit balance has disappeared - only to reappear as a credit in the boat seller's account. But communal demand has not changed one whit.

There is, of course, one change which could affect credit balances. This change would be in the value of the balances if inflation - properly so called - had been indulged in - that is that unbacked notes had been placed into circulation diluting the whole. In those circumstances it is perceived that, say, £100 deposit before the dilution would buy 100 units of goods or services; after an inflation of, say, 10% the £100 balance would buy only 90 units of goods or services.

Where the rate of inflation is expressed in M.1 and M.3 terms it overstates real inflation properly so called. This overstatement is detrimental to sterling in the world and is a national disservice.

Fallacy II. That "cost of living" measures inflation.

It has become common recently to enlist another fallacy in stating the rate of inflation. This is when it is stated in terms of increase in prices - or as it is sometimes called, in the cost of living. This could be a fallacy the other way. For instance, there has recently been announced a £1,000 millions subsidy for food. That subsidy will contain or reduce the price of food, but only artificially so. It leads to the untenable conclusion that a subsidy payment of £1,000 millions by the government is anti-inflationary, whereas it is one of the elements of Government over-spending which is the essence of inflation properly so called. Besides this, prices reflect so many other elements, including for instance, the price maintenance arrangements which are sometimes a matter of deliberate policy, especially in the European Economic Community.

Fallacy III. "That increased wages cause inflation".

It has been said that workpeople through their wages require more than they produce. The first thing to notice is that taken as a community that is not possible. In the absence of monetary inflation there would be a competition for shares of the total produce and one man's increase would be another's deprivation. Escalation of this process to the levels now attained would not be tolerated by the deprived. At present we are going through a phase where labour's demands seem in some cases excessive, but it must be remembered the rate of true inflation is such that the settlements have to include the increase for at least for some time ahead. The truth, of course, is that wages are pursuing cost of living increases which result from government overspending which it meets by printing unbacked money. The consequent fall in the value of the whole currency appears as increased prices, but the process is one and the same. The difficulty employers find in providing cost of living increases, is evidence of this. Unfortunately workpeople sometimes bring themselves under criticism for striking for fanciful and seemingly untenable reasons, but that must not serve to mask the central truth

Let us then recognise the true cause of inflation and deal with it. Flower's Concise English Dictionary defines it as follows :

"Resort to inflation of the currency;  
Raise price artificially; abnormal  
increase of the currency by issue of  
unconvertible legal tender notes".

Governments as well as people must realise that apart from providence itself which gives freely, life does not yield ninepence for fourpence.

Edgar S. Buck, Cardiff  
March 1975.

	Value of Pound 1938 = 100p	Unbacked Money in circulation * December figures £m	Amount of National debt at 31 March each year £m
1939	98	610	7,130.8
1940	85	630	7,899.2
1941	78	780	10,366.4
1942	78	950	13,041.1
1943	78	1,100	15,822.6
1944	77	1,250	18,562.2
1945	77	1,400	21,365.9
1946	76	1,450	23,636.5
1947	76	1,450	25,630.7
1948	71	1,325	25,620.8
1949	69	1,350	25,167.6
1950	67	1,375	25,802.3
1951	62	1,450	25,921.6
1952	56	1,575	25,890.5
1953	55	1,675	26,051.2
1954	54	1,775	26,583.0
1955	51	1,900	26,933.7
1956	49	2,025	27,038.9
1957	47	2,150	27,007.5
1958	46	2,200	27,232.0
1959	45	2,300	27,376.3
1960	45	2,400	27,732.6
1961	43	2,475	28,251.7
1962	42	2,500	28,674.4
1963	41	2,650	29,847.6
1964	40	2,800	30,226.3
1965	38	2,950	30,440.6
1966	36	3,050	31,340.2
1967	36	3,200	31,985.6
1968	34	3,300	34,193.9
1969	32	3,400	33,984.2
1970	30	3,650	33,079.4
1971	28	3,825	33,441.9
1972	26	4,400	35,839.9
1973	24	4,800	36,884.6
1974	20	5,525	40,124.5
1975	16	6,150	45,925.5
1976	14	6,875	56,581.6
1977	12	8,025	66,854.1
1978	11	9,150	79,180.0
1979	10	10,525	86,885.0
1980	9 *		

\*Average for  
seven months

\*Notes in circulation  
plus notes in Bank of  
England banking department



NOTE 1

There are those who promote a modicum of inflation through the printing press "to stimulate demand" in time of industrial depression. History shows that inflation cannot be contained in this way as witness the Fiat money in France and the fate of the German Mark in the 1930's, and look at our own record on the enclosed list. The error is involved in the term "effective demand". This correctly defined is simply offering goods or services in exchange for goods or services with money going in and out amongst the transactions to facilitate them. But in its erroneous form it is obtaining goods and services by means of promissory notes which are never to be repaid and mixing those notes with exactly similar notes which were in fact acquired in exchange for goods and services, devaluing the whole. The rejection of the erroneous leaves true effective demand as essential; for properly viewed demand is supply and supply demand and to interfere with that by way of artificially high interest rates is a serious folly minimising not maximising production and trade.

NOTE 2

Further support for the view expressed under Fallacy one will come from the present promotion of the idea that nearly all wages should be made monthly through a Bank. Lots of money would be deposited in Banks, mostly as new deposits. The aggregate would include these new deposits and be called "money supply" and those in error will call for an increase in MLR. That increase as in other increases under this head would :-

- (a) Gratuitously benefit the Banks at the expense of borrowers the bulk of whom are struggling business people.
- (b) Perhaps, more important, attract to Bank deposits at still higher interest rates resources which would otherwise be invested as risk capital to resuscitate industry and for which it is hungry.



BF for  
mtg on  
28/1  
(1600)

10 DOWNING STREET

CAROLINE

Please could you set up an early meeting - the Prime Minister used the word "urgent"! - with the Chancellor and the Governor to discuss Nigel Lawson's paper on indexed gilt-edged stocks.

TR

19 January 1981

jk Master Set

CONFIDENTIAL

Exam P01

NOTE OF A MEETING BETWEEN THE PRIME MINISTER AND THE CHANCELLOR OF  
THE EXCHEQUER AT 1730 HOURS ON WEDNESDAY 14 JANUARY 1981

The Chancellor referred to the latest very high CGBR figure which - he said - made the monetary prospects for January bleak. The Treasury and the Bank were doing everything they could to sell gilts between now and 21 January - the end of the banking month. He had also decided to strengthen the staffing in the Treasury, the Inland Revenue and Customs and Excise dealing with the accounts so that he would have quicker and better information on the CGBR: for example, in future there would be a weekly CGBR cash flow statement.

The Prime Minister said that she too was most concerned about the immediate monetary prospect. She suggested that the Bank should conduct a gilts auction before 21 January (the Treasury have now said it would be impossible to mount one before then); and also that we should try to arrange a further EEC refund before that date (the Treasury have since said this is impossible as well).

R.

16 January 1981

jk Prof Walters.

CONFIDENTIAL

PRIME MINISTER

*Yes - especially  
The Chancellor & the  
Governor - & we  
will discuss it*

*Prin. Minister*

*You and the Chancellor were, on balance,  
opposed to Nigel Lawson's indexed gilt  
proposal at the November seminar. I think  
we now need a meeting to discuss  
again - with Gordon Richardson of  
course as well. Agree?*

INDEXED GILTS - 13 JANUARY PAPER BY FINANCIAL SECRETARY  
TO TREASURY

*12  
157*

1. I agree with the arguments set out in the Financial Secretary's Paper. One other consideration may be thought to be both relevant and bullish. It is impossible to sell indexed gilts through the present arrangements; they must be sold by tender. This would facilitate more rapid movement towards MBC.

2. The financial implications could be quite dramatic\*. My judgement is that if £10Bn of £20Bn total borrowing were indexed, the real rate of interest on the indexed gilts would be only about 1% - perhaps even negative - but take it at a high 2%. This would remove then the difference between the present 14% and 2%, ie 12% of £10Bn (or £1.2Bn) from the PSBR in the current year. This reduction in the "front end loading" of our present borrowing would be a very useful ally in the difficult months ahead.

\*Ignoring tax payments.

A Walker

15 January 1981



PRIME MINISTER

INDEXED GILT-EDGED STOCKS

At your Monetary Seminar on 18 November you asked me to prepare a paper setting out the pros and cons of issuing index-linked gilts with carefully defined eligibility criteria to ensure that they were not taken up by non-residents. I accordingly attach such a paper.

It has been prepared on the assumption that an issue of the kind described in the earlier paper sent to you by the Chancellor on 14 November is a practical possibility. In other words, that a method of enforcing the proposed restriction to pension funds and life insurance companies (but only in respect of their UK pension business) can be found that would be acceptable to the industry. Officials are currently looking at a slightly revised version of the prospectus which might go some way towards resolving the problems raised in the annex to John Nott's letter of 17 November.

Play A

Essentially, there are four main arguments against indexed debt:

- (a) There could be an adverse effect on expectations if the Government were thought to have abandoned their efforts to curb inflation;
- (b) it would be inconsistent with the Government's attempts to reduce indexation in other areas, such as social security benefits and public sector pay;
- (c) there could be damaging consequences for the finances of the company sector; and
- (d) an issue of restricted stock could have a harmful effect on the funding programme generally if the institutions held off buying conventional gilts in the hope of forcing the Government to extend indexation.

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There are strong counter-arguments, which are set out in more detail in the paper. Very briefly, I believe our monetary policy to be the key influence on inflationary expectations and that indexed debt issued in that context would be seen as a sign of confidence rather than defeatism. Long-term debt issues are quite different from wage or benefit contracts, which cover short periods of around a year, so that the charge of inconsistency is not, in my view, well-founded. Indeed, it is significant that our recent substantial extension of index-linked National Savings Certificates caused no expectational or presentational difficulties whatever - rather the reverse, in fact. In the case of the indexed gilt, the price of the stock would fluctuate with market conditions, and this will determine whether a lender earns a positive or negative real rate of return. As for the effect on the company sector, companies will benefit from the overall reduction in interest rates which we expect. And while there are always risks involved in any change in funding techniques, I have little doubt that the potential benefits far outweigh the dangers. Events since our meeting on 18 November have underlined the urgency of the need for improvements on this front.

I remain convinced, therefore, that indexed gilts would be a valuable addition to our financial armoury. This, for the following main reasons:

(a) Indexed gilts would eliminate the substantial risks incurred with conventional gilts by both investors and the Exchequer owing to the inherent uncertainty about future rates of inflation, and as a result investors should be prepared to accept a lower true rate of interest in return for insurance against inflation. This can be expected to reduce the overall cost of servicing Government debt.

(b) In addition, the risk of HMG having to pay very high interest in real terms as inflation comes down would be effectively eliminated. The opposite argument, to the effect that we have funded the national debt cheaply in recent years and may continue to do so by conventional means, rests on the massive acceleration of inflation in the 'seventies and further depends on the assumption

of continuing high and indeed accelerating inflation in the 'eighties. I am sure we should not base our funding policy on such a proposition, which amounts to little short of a confession of expected failure which markets would be quick to seize on.

(c) There would also be significant improvements in monetary control. Pauses in the funding programme as a result of market expectations of higher inflation could be avoided, since it would then be easier to sell indexed rather than conventional gilts at an acceptable price. The intention is not, of course, to remove conventional gilts from our armoury altogether, but to ensure that both types of stock are on offer. Each will have its market: at some times it will prove easier to sell the one and at other times the other.

(d) The net result is that it should be possible to achieve a given monetary target at lower levels of interest rates, with beneficial effects throughout the economy.

(e) There would also be some gain from a reduction in the PSBR, and this would have obvious presentational advantages. There is no doubt that the gilts market is heavily influenced by PSBR figures, and this would bring a further advantage in terms of monetary control.

Although the above arguments concentrate on the macroeconomic implications, there is also another dimension, raised by the Report of Sir Bernard Scott's enquiry into public sector inflation proofed pensions. The report recommends that the Government give serious consideration to an issue of index-linked bonds to be held by private sector pension funds, thus achieving a greater degree of equity between those who work in the private and public sectors.

I hope this minute, and the attached paper, will provide a basis for a discussion so that we can reach an early decision in principle whether to go ahead with indexed gilts, subject to later decisions on eligibility and timing.

CONFIDENTIAL

I am copying this minute, and the paper, to Geoffrey Howe, Leon Brittan, John Biffen, Keith Joseph, Gordon Richardson and Sir Lawrence Airey.

*NL.*

NIGEL LAWSON

13 January 1981





## INDEXED GILT-EDGED STOCKS

This paper summarises the arguments for and against issuing index-linked gilts for which only pension funds and, in respect of their pension business, life offices would be eligible. The main reasons for considering this are:

- (i) because the risks associated with uncertainty about future inflation would be removed, the cost of Government borrowing by means of index-linked gilts is likely on balance to be less than for conventional gilts, and the risk of HMG having to pay very high interest rates in real terms as inflation comes down would be effectively eliminated;
- (ii) there could be improvements in monetary control because funding pauses associated with worsening inflationary expectations would be less likely;
- (iii) it should be possible to achieve the Government's monetary objectives with a somewhat lower general level of interest rates;
- (iv) the PSBR would be reduced.

The sections which follow consider these, and other relevant issues, in more detail.

### Indexation and Inflation

2. A key issue in the debate about whether to issue index-linked gilts, and about indexation more generally, is the impact on inflation. It can be argued that in issuing indexed gilts the Government would be indicating that they were reconciled to a continued high level of inflation, and had abandoned serious attempts to bring the rate down.

3. On the other hand the key influence on expectations in the medium term is the Government's commitment to control inflation. If this did not change, there is no reason to believe that indexed gilts would affect expectations adversely. Indeed the issue of indexed debt should have a favourable impact, particularly if issued at a time when the inflation rate was falling and a further fall was expected. The authorities could point out that by issuing indexed debt at such a time in addition to conventional gilts the Government were making clear their own belief that inflation would fall, and their commitment to ensuring that it did. Governments which hoped to escape from their obligations through inflation would be the last to issue index-linked debt. Indeed it has frequently been argued that it is sales of conventional gilts which give Governments a vested interest in maintaining a high inflation rate. There is thus no good reason to believe that the issue of indexed gilts would be seen as a weakening of the Government's resolve to pursue policies designed to control inflation.

#### Interest Rates and the PSBR

4. It is argued that in recent years the Government have been able to fund the PSBR at negative real interest rates, resulting in a decline in the real level of the National Debt. If the Government were to issue indexed gilts the chance would be forfeited of very cheap financing in real terms if inflation were unexpectedly high. Throughout the 1970s HMG have been paying interest on low-coupon debt sold in the 1960s. The issue of indexed debt now could necessitate huge repayments at the end of the century if inflation sharply accelerates again.

5. There are two main counter-arguments. In the first place, the reason that fixed interest long-term debt has proved a cheap financing method for the Government in the last decade is that during the 1970s as a whole the average rate of inflation was, contrary to expectations when the debt was issued, considerably higher than it had been in the 1950s and 1960s. We could only expect to make similar savings again if the 1980s prove to be a period during which inflation continues to accelerate - but from a much higher base. This is not an acceptable assumption on which to base funding policy.

6. Secondly, indexed debt can be expected to contribute to a general reduction of interest rates, and thus in the cost of servicing Government debt. In an economy subject to wide variations in the rate of inflation, a fixed nominal yield represents a gamble for both borrowers and lenders. If, by indexing the principal of the loan, the Government removes the element of uncertainty due to inflation, this will benefit both lenders and borrowers and should allow the indexed debt to be sold more cheaply than conventional debt. For a particular issue of indexed stock, who 'gained' or 'lost' in the event would depend on how the rate of inflation compared with expectations at the time the indexed debt was issued. But if there is no systematic market tendency to overestimation or underestimation of inflation, the cost of Government borrowing should be lower than for conventional debt. This argument does not depend on any assumptions about the Government's ability to forecast inflation more accurately than the market or vice versa; it is the overall reduction in uncertainty that is relevant. A further consideration is that the issue of indexed gilts should reduce the demand for money to some extent, and this would allow a lower general level of interest rates consistent with achievement of the Government's monetary targets. This will reduce interest rates on comparable instruments such as corporate debentures.

7. There would, furthermore, be an immediate reduction in the PSBR as, on the basis of existing statistical conventions, only the small real interest coupon would be credited as debt interest payments. Thus if £2 billion were issued in indexed form with a coupon of 2%, as opposed to conventional gilts with a 12% coupon, the saving would be £200 million per annum and with a continuing programme of sales this would build up steadily over time. The reduction would be accompanied by an automatic increase in the value of existing gilt holdings, and hence a reduction in the demand for new stocks. But there would remain a significant presentational gain and for a considerable period, until indexed gilts began to be redeemed, the automatic refinancing of the PSBR would yield benefits in terms of monetary control.

Effects on the Company Sector

8. There is concern about the potential impact of indexed gilts on the company sector. It is possible that the effect would be to increase the cost of capital to industry. Because they both offer compensation for inflation, indexed gilts and equities would be fairly close substitutes, so the institutions could switch out of equities to a significant extent, perhaps leading to some decline in share prices. This would increase the cost of equity finance and further delay the revival of the new issues market with potentially adverse consequences for the money supply. The only way for companies to respond would be to issue indexed debt themselves, but there are problems. In particular, the present tax treatment is not ideal for the issue of indexed bonds, since, in theory at least, only the small real coupon is allowable as interest expense (but see para 10).

9. On the other hand companies would benefit from the general reduction in interest rates which is likely. Both bank borrowing and debenture finance would be cheaper. A revival of the debenture market would take some of the pressure off bank lending, with significant benefit to the money supply and hence possibly still lower interest rates. On balance there may be some changes in relative costs of different types of finance but no overall increase in companies' cost of capital. In the longer term, if indexation were to become more prevalent, there might be changes in the financial structure of companies, but these would be gradual and could be beneficial.

10. It has to be recognised that companies wishing to issue indexed debt do face problems, and none have done so as yet. But of late there have been indications of interest, and the Bank recently let it be known that it was no longer opposed to the idea in principle. On the tax question, Rothschilds have proposed a scheme whereby at maturity the capital uplift on indexed stock would be deemed to be deferred interest and allowable against tax. The Inland Revenue agree that this would be acceptable. The problem remains, however, that companies may have insufficient taxable income in a given year to take advantage of the tax allowance. Treasury, Bank and Inland Revenue officials are looking into ways in which this problem might be eased.

Monetary Control

11. It is argued that criticisms of current gilts marketing techniques are much exaggerated and that innovations are not needed. The system has allowed HMG satisfactorily to fund high levels of PSBR for a number of years. Indexed gilts would be of no help if the market expected an upward movement in nominal interest rates in the absence of any change in inflationary expectations, and in these circumstances there is no guarantee that they would be any easier to sell than conventional gilts. Furthermore, the market, once it had been given a taste of indexation, might hold off purchasing ordinary gilts in the hope of inducing the Government to offer more indexed gilts or to extend eligibility. We might thereby create a funding pause of just the sort that the exercise is designed to prevent.

12. However, the issue of indexed gilts would give the authorities a new instrument which offers the prospect of significant improvements in monetary control. There is little doubt that institutions like pension funds with long-term liabilities related to the general level of earnings would find them attractive. Although in the first instance it would be advisable to issue them at a time when inflation was falling so as to secure a favourable effect on expectations, in terms of monetary control the most important benefits would accrue at times of uncertainty about the prospects for inflation. In those circumstances, conventional gilts would be difficult to sell before an adjustment of yields had taken place. With present techniques, this might require action by the authorities such as a rise in MLR and interest rates generally - the Duke of York technique. And the risk premium which investors would require would further add to the cost of Government borrowing. Indexed gilts, on the other hand, would be easier to sell, partly because it is envisaged they would be sold by tender. Our present difficulties in selling debt by conventional methods on anything like the scale necessary to fund large and foreseen monthly borrowing requirements underline the potential gain to monetary control from an increase in the range of instruments available. Also, as noted above, an issue of indexed gilts would reduce the PSBR, and the funding programme would be somewhat less at risk in the face of fluctuations in market sentiment because a degree of automatic financing would be involved.

### Exchange Rate Effects

13. An unrestricted issue of indexed gilts is open to the objection that it might encourage substantial inflows from non-residents, particularly OPEC investors. There is a risk that inflows of this kind could exert substantial upward pressure on the exchange rate, although analyses by Bank and Treasury economists suggest that on balance and over time the effect on sterling would probably be relatively slight, largely because of the offsetting effect of the reduction in interest rates. However, the risk of a disruptive short-term upward movement, apparently caused by Government action, cannot be ruled out. If, therefore, it were to prove impossible to restrict eligibility to hold the stock in the way we propose we would need to make a choice between confining eligibility to the pension funds and extending it to all life insurance business. In this event, the potential exchange rate consequences of the latter (if foreigners were to buy index-linked UK insurance policies on a lower scale) would need further study. We would then need to weigh the risks of upward pressure on the exchange rate against the disadvantage of the 'pension funds only' course, which would expose us to the charge of discrimination against the self-employed and employees of smaller companies, who are the main pension customers of life offices.

On the other hand, a restricted issue of the kind currently under consideration would not be open to objection on these grounds, since the eligibility criteria are drawn in such a way as to exclude direct overseas purchases and to prevent non-residents' access, while effectively treating all forms of private sector pension provision equally. The restrictions envisaged are not 100 per cent watertight, and the possibility of some 'leakage' overseas cannot be entirely disregarded, but the danger is minimal.

### Presentational Impact on Indexation Policy Elsewhere

14. It is argued that while the Government are attempting to eliminate or modify indexation elsewhere in the economy, indexation of debt would appear inconsistent. Past experience of indexation, whether of wages (threshold agreements) or transfer payments or tax thresholds, has shown that the Government's room for manoeuvre is seriously constrained and unwelcome rigidities in the cost structure of the public

sector are created. Thus in the areas of social security benefits and public sector pay the Government have recently taken steps to weaken the link with inflation increases. It might appear that creditors were being treated differently from benefit recipients or employees.

15. The counter-argument is that the sale of a long-term debt instrument is a quite different transaction from a wage contract or a benefit uprating, so that issuing indexed debt would not be inconsistent with de-indexation elsewhere. Debt contracts are much longer, and hence potential gains and losses through failure to index are much greater than for annual contracts. In any event there would be no question of guaranteeing full compensation for inflation, as is the case with wage, benefit, or pension indexation. The price paid for stock would determine whether investors obtained a positive or negative real return, and they could be sure of this only if they held the stock until maturity. During the life of the stock, its price would fluctuate with market conditions, and investors would still face uncertainty about variations in real interest rates. Direct comparisons between creditors and employers or beneficiaries are therefore not valid. Any presentational problems would of course be easier by the precedent for indexed Government debt already established in the shape of 'Granny' bonds. It is worth noting that the recent extension of these has been favourably interpreted by the market.

#### Benefits for Pensioners

16. The eligibility criteria currently proposed make it very clear that the Government intends the new indexed gilts to be taken up by pension funds and life assurance companies which do pension business. The Wilson Committee argued that the issue of index-linked gilts would be a very significant improvement in the range of assets available for long-term savings institutions and would greatly increase the confidence with which they could issue index-linked liabilities of their own. The Scott Report on the value of public sector pensions recommends that "the Government should now look seriously at the case for issuing indexed bonds to cover pension liabilities". Assuming public sector indexed pensions are to continue, the issue of indexed gilts available to all pension funds could be seen as an attempt to encourage

some equalization of treatment between the public and private sectors.

### International Experience

17. Opponents of indexed gilts argue that other countries' experience of indexed debt has been almost wholly negative. Pressure from OPEC surplus countries for indexed bonds has been generally resisted in OECD. (Since these instruments would not be open to purchase by non-residents, the issues raised there are not relevant.) A number of countries have, nonetheless, experimented with various kinds of indexed bonds - Brazil, Chile, Israel, New Zealand, Finland, France. Some have abandoned the experiment, notably Finland where indexation in the capital market was discontinued along with the indexation of wages at a time when the general indexation in the economy seemed likely to exacerbate inflationary pressures. The French have found bonds linked to the value of gold to be an extremely costly instrument. But a link with gold, or indeed with the price of any specific commodity, is potentially far more dangerous than a link with prices in general, and is not to be recommended. All in all, foreign experience is not necessarily a good guide to the likely effects in the UK now. In many instances indexed debt has been offered as a defensive measure, to maintain capital market facilities for borrowers when inflation was rapid and rising. A restricted issue in the UK by a Government determined to maintain strict monetary control and at a time of falling inflation would be a quite different proposition.

### Conclusion

18. The economic and monetary arguments for indexed gilts are strong. There would be benefits in terms of lower interest rates because of the reduction in uncertainty in the market and, probably, in the demand for money. There would also be a significant gain for monetary control. The presentational problems do not seem insuperable. The key question relates to the effect on expectations. There is no doubt that in some circumstances the impact could be adverse. But at present the decisive influence on expectations should be the Medium Term Financial



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Strategy and the determination of the Government which that Strategy embodies. If a decision to issue indexed gilts were viewed as supporting the implementation of the strategy, as it should be, it would be seen as further evidence of the Government's resolve to defeat inflation.

SECRET

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PRIME MINISTER

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Meeting with the Chancellor: 1730, Wednesday,  
14 January

There are two things which you might like to discuss:-

- I The attached progress report, which you had asked for on monetary control.
- II The Italian scheme of tax relief for non-quoted companies (see Flag A).

The Treasury tell me that they and the Bank are practically "home and dry" on the proposed swap arrangement with the Americans. They have established that there are no bugs in it from our point of view; the only outstanding point as of 7.30 this evening which - amazingly enough - the Americans have not clearly thought about - is whether they have powers to ship the gold to us.. But it is thought that they have.

The Chancellor may also want to have a word about the press treatment of your interview yesterday. I have told him that you were misrepresented, and he accepts this. But I think he will want to suggest that, from now on, we should all go into absolute purdah on the Budget. (He has recently reviewed what happened last year, and has concluded that there should be no attempt this year to anticipate the Budget by any calculated leaks.)

*J.R. Collins*  
for T. Hancock

13 January, 1981.

SECRET

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Treasury Chambers, Parliament Street, SW1P 3AG  
01-233 3000

12 January 1981

*Ye Mr. Tolkiens*

*Am. Tolkiens*

T P Lankester Esq  
Private Secretary  
Prime Minister's Office  
No.10 Downing Street  
LONDON SW1

*This is the  
progress report you  
asked for: we  
will need to keep  
up the pressure.*

*Dear Tim,*

MONETARY CONTROL

In your letter of 22 December you asked for a progress report on developments in the system of monetary control.

*12.  
14.*

... I now attach such a report. It has been agreed with the Bank of England.

*Yours ever,*

*Richard Tolkiens*

R I TOLKIEN  
Private Secretary

## MONETARY CONTROL

1. Following the seminar on 18 November the Chancellor set out the next stages on monetary control in his statement of 24 November. This was accompanied by a background note from the Bank. Copies of the relevant parts of the Chancellor's statement and the note by the Bank are attached. These make clear that although no decision has yet been taken on monetary base control, the changes would be consistent with further moves in that direction. The notes below record the state of play on the main items.

Phasing Out the Reserve Asset Ratio

2. The RAR was reduced to 10% from 5 January. The change was well taken by the markets as being in line with Government policy. There have been no suggestions that it could result in a loss of monetary or prudential control.

3. Final abolition of the RAR depends on making sufficient progress with new arrangements for ensuring adequate liquidity for the banks so that confidence in the banking system is fully maintained. These new arrangements also have to be tied in with the proposed changes in the Bank of England's operating procedures (paragraph 7 below). The Bank are carrying their discussions on this and related technical questions further and are discussing it with the Treasury.

4. We are aiming to carry negotiations with the banking system far enough by the Budget for the RAR to be abolished without raising prudential risks.

The Cash Ratio

5. In order to clear the way for a possible move in the direction of monetary base control, the 1½% cash ratio (which applies only to the London clearing banks) also needs to be removed. This could be done without loss of monetary control but it would deprive the Bank of an important source of income. Discussions are taking place with the Bank about possible supplementary sources of income to replace what would be lost if the

banks held less of their cash reserves with the Bank.

6. It is expected that we shall be able to make recommendations before the Budget. ||

Money Market Management and Lender of Last Resort

7. The Bank has already started to make its operating techniques in the money markets more flexible. Discussions are taking place between the Treasury and the Bank in order to specify more precisely the further changes described in the Bank paper for the Prime Minister's seminar. This includes the introduction of a band in which interest rates might be allowed to fluctuate. It will be important to conduct these operations so that we do gain as much experience as we can about the banks' own requirements for base money.

8. A report will be brought to Ministers so that the new arrangements, along with those already described, could be implemented at Budget time. ||

A New Series for Retail Deposits (M2)

9. The above changes would be enough to move, when sufficient experience has been gained, to a system of monetary base control where the base itself was targeted, and the banks were left to determine their own requirements for cash (a non-mandatory system).

10. In order to ensure that the alternative of moving to a system of monetary base control in which the authorities set the requirement for the base, is also kept open, and because it would be a useful indicator in its own right, work is in hand <sup>to prepare an M2 series</sup>. The next stage is to consult the banks; this is about to take place. There are a number of complications, including the treatment of building society deposits, but it is hoped that the work will be sufficiently advanced to allow progress to be reported at Budget time, with the series introduced later in the year.

Funding

11. There are 3 issues:

a. Funding Techniques for conventional stocks. This is being discussed in a Treasury/Bank group chaired by Sir Douglas Wass. It is taking a very wide look at funding methods.

b. Widening the Market by selling more short term Government debt. Selling more short term debt is a possibility once the RAR is out of the way. The Bank are forming a small advisory group from the market to assess the practical possibilities. This will also be considered in Sir Douglas Wass' group.

c. Indexed Gilts for Pension Funds. The Financial Secretary will shortly be letting the Prime Minister have a paper for further Ministerial discussion. It will take account of the points made in the Scott Report.

General

12. A good deal of progress is being made on the issues raised at the Prime Minister's seminar. The early March Budget date means that time is extremely short, but it should be possible to report to Ministers in good time before the Budget.

R.I.T.

Extracts from Chancellor's Statement  
24. 11. 80

The Treasury and Bank of England have completed the consultations arising from the Green Paper on methods of monetary control published last March. As a result between now and the Budget a number of improvements will be set in hand.

First, detailed consideration of new prudential arrangements for the banks will be brought to a conclusion so that the reserve asset ratio, which has complicated monetary control, can be phased out.

Second, the Bank of England will develop changes in its open market operations and last resort lending - in ways that will allow the market a greater role in the determination of the structure of short-term interest rates. Third, we are considering the future of the clearing banks' cash ratio and also collecting and publishing an additional series for banking retail deposits. These steps are desirable in their own right. They would be consistent with a gradual evolution towards a monetary base system, and will help us to judge how far such a system would contribute towards our medium-term monetary objectives.

BACKGROUND NOTE ON METHODS OF MONETARY CONTROL

1 Since publication of the Green Paper on Monetary Control the Treasury and the Bank have carried out extensive consultations and discussions on proposals for a change to a system of monetary base control and also on possible improvements to operational techniques within the existing framework.

2 From the consultations on MBC, two main types of proposal emerged, with an important distinction drawn between:

- (i) non-mandatory systems in which banks are free to choose the amount of cash balances which they hold at the Bank of England; and
- (ii) mandatory systems in which banks are required to hold a specified proportion of their liabilities as cash balances at the Bank of England.

3 Present arrangements do not allow firm judgments to be made about the desirability of moving to either kind of base control. In the case of a non-mandatory arrangement, it is not known whether the cash which the banks would choose to hold would be stably related to the money supply or to nominal income over an appropriate period. A mandatory system, on the other hand, particularly if related to a broad monetary aggregate, could prove vulnerable to the diversion of monetary flows outside the controlled area. In addition, and before fully moving to either system, time would be needed for adequate information and experience to be gained about the banks' demand for cash.

4 In this context, the Chancellor has announced in the House of Commons this afternoon that a number of improvements to the present system will be set in hand. These are desirable in their own right but they would also enable more to be learnt about the properties of a monetary base system and would be consistent with further evolution in either of the directions set out in paragraph 2 above.



5 The improvements to be set in hand within the existing framework are as follows:-

- (i) Once consultations with the banking system regarding adequate holdings of liquid assets have been completed, and appropriate norms agreed, the Reserve Asset Ratio will be abolished. This was foreshadowed in the Green Paper.
- (ii) Further consideration will be given to the future of the 1½% cash ratio currently applying only to the London Clearing Banks, with a view to establishing arrangements that would be equitable within the banking system, and that could enable the authorities to monitor the development of the functional demand for cash balances at the Bank of England which could ultimately be associated with a non-mandatory system of monetary base control.
- (iii) Discussions will take place with the banks regarding the collection of additional statistics on retail deposits, which would provide further information on monetary conditions and could, if that subsequently seemed appropriate, become the denominator of a cash ratio associated with a mandatory monetary base system.
- (iv) Changes will be developed in the Bank of England's methods of intervention in the money market:
  - (a) It is envisaged that the Bank's intervention will place a greater emphasis on open market operations and less on discount window (lender of last resort) lending. It has been decided that these operations should continue to be conducted in the bill markets rather than through the interbank market, and in large part through the existing intermediaries, members of the LDMA, to whom discount window facilities would remain confined.
  - (b) Initially, the Bank's operational aim would be to keep very short-term interest rates within an unpublished band which would be determined by the authorities with a view to the achievement of their

monetary objectives. The Bank would normally charge a rate on its discount window lending somewhat above comparable market rates but within the unpublished band. At an appropriate stage the Bank might cease to announce a Minimum Lending Rate. These arrangements would allow market factors a greater role in determining the structure of short-term interest rates. It is accepted that this could lead to more flexible, market-related, pricing of overdraft facilities.

- (c) The Bank's operations would be broadly intended to offset daily cash flows between the Bank and the money markets. The present technique of creating initial shortages in the money markets which the Bank then acts to relieve would be abandoned. There would accordingly no longer be a deliberate overissue of Treasury Bills at the weekly Tender.

6 The Bank will discuss the operational details of these changes with those institutions that will be affected as soon as practicable. It is intended that they will be put into effect next Spring.

7 The Bank will also be putting forward proposals for changes in the institutional coverage of credit control and statistical reporting in the light of the Banking Act 1979.

8 Finally, in the light of the above changes, the Bank will examine further the possibilities of broadening the market for short-term central government debt as a means of providing greater flexibility to the government funding programme.

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*Ein Pol  
Downing Street*



*Prime Minister*

*MA 5/1*

Treasury Chambers, Parliament Street, SW1P 3AG  
01-233 3000

5 January 1981

*PM sec.*

T. Lankester, Esq.,  
Private Secretary,  
10, Downing Street.

*Dear Tim,*

DECEMBER MONEY SUPPLY FIGURES

We now have the provisional estimate of money supply growth based on all banks' returns for banking December. £M3 grew by 0.6 per cent bringing the annual rate of growth since mid-February to 22½ per cent or 19¼ per cent when allowance is made for distortions caused by the corset.

....

The counterparts of the growth in £M3 are shown in the attached table. The CGBR at £610 million was fairly low with the modest own-account figure reflecting lower expenditure. On-lending to the rest of the public sector (especially public corporations) was fairly high, but this was offset by the negative direct contribution to DCE by the other public sector (-£140 million), with public corporations particularly repaying market borrowing. Net purchases of central government debt by the non-bank private sector at £760 million were more than sufficient to finance the CGBR, and included £380 million of gilts, £270 million of National Savings following the introduction of the new terms for 'Granny bonds', and £140 million for CTDs.

Bank lending in sterling to the private sector rose by £820 million, somewhat higher than in most recent months. But against this, the 'bill leak' fell by £70 million and bank lending to the private sector in other currencies showed its largest fall in the past year (-£350 million).

Sterling lending to overseas increased by £230 million, with lending to banks abroad again expanding sharply (+£350 million). External and foreign currency finance however was -£260 million, and taken together these factors were a small contractionary influence on money.

*Yours ever,*

*Richard Tolkien*

R.I. TOLKIEN

COUNTERPARTS TO STERLING M3 GROWTH IN BANKING DECEMBER

	<u>£ million</u>	
CGBR: own account	+276	
on-lending to IAs	+ 16	
on-lending to PCs	<u>+318</u>	
		+610
Net purchases of CG debt by non-bank private sector: (incr: -)		
Gilts	-379	
Treasury bills	- 41	
National Savings	-273	
TSB claim on FBS	+ 75	
Certificates of tax deposit	<u>-140</u>	
		-758
Other public sector: Local authorities	+ 53	
Public corporations	<u>-190</u>	
		-137
Sterling lending to the private sector		+816
Sterling lending to overseas sector		<u>+230</u>
DCE		+761
		<u>        </u>
External and foreign currency finance		-261
Non-deposit liabilities (incr: -)		<u>-104</u>
Sterling M3		+396
		<u>        </u>
		+ 0.6%

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Econ PM

10 DOWNING STREET

*From the Private Secretary*

31 December, 1980.

This is to confirm that the Prime Minister is content with the proposed change in the reserve assets ratio which, I understand, is to be announced on Friday. But she has said that it will require very careful briefing if it is not to be misunderstood. You have assured me that considerable attention has been given to the briefing.

I am sending a copy of this letter to Tim Allen at the Bank of England.

L. P. LANKESTER

A. J. Wiggins, Esq.,  
HM Treasury.

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Agreed with ✓  
It will be misunderstood unless very careful wording is given not

Treasury Chambers, Parliament Street, SW1P 3AG abolished at the time

01-233 3000 23 December 1980 of the Budget - it

is the best available  
The purpose is much the same as special Bank assistance - i.e. to prevent a major cash shortage developing when the govt. accounts go into surplus.

T P Lankester Esq  
Private Secretary  
Prime Minister's Office  
No.10 Downing Street  
LONDON SW1

(You will recall that Gordon Peppin accepts that assistance at a time of surplus is correct.) The Banks want

Dear Tim,

THE BANKS' RESERVE ASSETS RATIO

At the Prime Minister's meeting on 18 November, it was agreed that the reserve assets ratio (RAR) could not be abolished until new prudential guidelines had been established, and that this could not be done before the Budget. However, it was also agreed that it would be desirable to consider an interim change to avoid, if possible, the need for special Bank assistance to the market in the first quarter of 1981, when the central government surplus will drain cash out of the system.

to announce on Friday.  
Are you content?

The Chancellor and the Governor have concluded that such a change could indeed be made. A reduction in the ratio from 12½% to 10% of banks' eligible liabilities should just enable the banking system to get through the revenue quarter without further sale and repurchase operations in gilts. It accords with the approach to the new prudential system of recognising that liquid assets are there to be run down at times of pressure. No prudential risks would be created. The reduction would not prejudice decisions on future monetary controls or future prudential guidelines. The Chancellor and the Governor therefore propose to announce the reduction early in January, when the central government goes into surplus.

Since the RA ratio is being phased out anyway next month, reducing it to 10% will be less open to misunderstanding than repeating last year's massive special assistance.

The scale of the problem is as follows. On present projections, the Government surplus is likely to take the cumulative cash shortage in the market from nearly £900 million at the end of banking December to about £3.2 billion by the end of banking April. (The shortage could be smaller if the Government's first quarter surplus falls short of the forecast or larger if sales of Government debt are higher than is projected.) The Bank must meet

/this shortage by



this shortage by converting other assets into cash, unless short term interest rates are to rise in a way entirely inconsistent with the reduction in MLR and unhelpful to monetary control (because the increase in market interest rates would simply encourage round-tripping).

The additional cash shortage in the first quarter will be of roughly the same order of magnitude as in the revenue quarter last year; but the problem of alleviating it will be more difficult for two reasons. First, there are no special deposits to release, as there were in the first quarter of 1981. Second, we start 1981, unlike 1980, with the Bank already providing nearly £900 million of assistance, mainly through purchases of commercial bills. Nonetheless, the problem should be manageable provided the RAR is reduced.

A reduction from 12½% to 10% will release something over £1½ billion of reserves to be converted into cash. The amount by which the Bank's need to buy in commercial bills will be reduced may well be somewhat smaller. It depends how far the banking system is prepared to run down its holdings of reserve asset claims on the public sector (ie Treasury Bills and local authority bills). The Bank judges that the reduction in such assets might not exceed £1 billion, but that it is right to make room for a somewhat larger reduction in case it proves possible.

If the reduction amounts to £1 billion, some £2 billion will remain to be provided by purchase of other assets. The Bank will aim to do so by buying in commercial bills and, to a lesser extent, swapping the banks' foreign currency holdings into sterling. This should be just possible without recourse to special arrangements.

To reduce the RAR below 10% would not reduce the need for the Bank to buy in commercial bills because the ability of the banking system to run down its holdings of reserve asset claims on the public sector would be already exhausted - if not more than exhausted - by the reduction to 10%. Nor would it help to allow more private sector assets to count as reserves, for the same reason. Nor would it help to bring in gilts over one year (the present boundary), because this would make them more attractive to banks, and so could conflict with the objective of broadening the market in central government debt of this maturity.

/The Chancellor and

S E C R E T



The Chancellor and the Governor are satisfied that to reduce the RAR to 10% is the right course to follow in the circumstances. If the Prime Minister is content, the Bank of England will announce the change on or about 5 January.

*Should  
forward to  
Friday.*

I am copying this letter to Tim Allen at the Bank of England.

*TJ  
..*

*yours*

*John*

A J WIGGINS  
Principal Private Secretary

CONQUEROR



ccan Ad

BF 9/1/87

file



10 DOWNING STREET

From the Private Secretary

22 December 1980

Dear Jim.

When the Chancellor and Mr. Middleton called on the Prime Minister with Professor Griffiths this afternoon, they had a word about the follow-up work from the Monetary Seminar on 18 November. The Prime Minister asked if she could have a progress report on all the work that is being done - to reach here please by 9 January.

~ ~

T. L.

A.J. Wiggins, Esq.,  
HM Treasury.

JS

## MONEY AND BANKING FIGURES: 19 NOVEMBER 1980

1 During the five weeks to 19 November, sterling M<sub>3</sub> increased by £1,360 million (2.1%) after seasonal adjustment (Table 11.2). Since mid-February, sterling M<sub>3</sub> has grown at 24½% per annum, but this has been distorted by the removal of the 'Corset' and the underlying growth is somewhat less. M<sub>1</sub> increased by £210 million (0.7%) and has been rising at an annual rate of 8% since mid-February.

2 Domestic credit expanded by £1,480 million, seasonally adjusted (Table 11.3). The most important component was the central government borrowing requirement which, at £1,960 million, was large. Between a quarter and a third of this was on-lent to the rest of the public sector, whose direct contribution to DCE was negative (-£40 million). About half of the borrowing requirement was funded by the non-bank private sector which made net purchases of £930 million of central government debt: net purchases of gilt-edged stocks accounted for £690 million, and certificates of tax deposit for £200 million.

3 The level of sterling lending to the private sector showed a slight fall, of -£20 million after seasonal adjustment, the first monthly fall for nearly four years. Although individual monthly figures can be volatile, this does nevertheless provide further evidence of a slackening in the trend of bank lending. Bank acceptances held outside the banking system (which are not included in DCE), fell by £160 million.

4 Lending in sterling to overseas again rose sharply, by £500 million. Taken together with external and foreign currency finance, which was -£220 million, seasonally adjusted, (and within which there may have been some direct offsets to sterling lending to overseas), there was a net inflow of sterling to the private sector of some £280 million.

5 As already published, the banks' eligible liabilities rose by £726 million (1.1%). Reserve assets rose by £469 million and the reserve ratio rose from 13.0% to 13.6%. Details of the discount market's and banks' balance sheets are shown in Tables 2 and 3.

Estimated seasonal movements - three weeks ended 10 December 1980

The provisional seasonal movements for the three weeks ended 10 December are as follows -

	£ millions
Notes and coin	+280
Private sector sterling sight deposits	+560
M <sub>1</sub>	+840
Other sterling deposits (including CDs)	-260
Sterling M <sub>3</sub>	<u>+580</u>
Bank lending in sterling to the private sector	-710

The seasonally-adjusted change in the money stock is obtained by subtracting (with due regard to sign) the seasonal movement from the unadjusted change.

## Bank of England

## Banking statistics

19 November 1980

## Discount market

£ millions

[Table 2 in the Quarterly Bulletin]

	Liabilities: borrowed funds										
	Sterling							Other currencies			
	Total	of which		Bank of England	Other UK banking sector	Other United Kingdom	Overseas	Total	UK banking sector	Other United Kingdom	Overseas
Call and overnight		Other									
1979 Oct. 17	4,753	4,184	569	—	4,123	575	55	90	55	14	21
Nov. 21	4,574	4,140	434	—	4,219	323	32	93	49	25	19
Dec. 12	4,568	3,736	832	—	4,228	275	65	136	85	19	32
1980 Jan. 16	4,528	3,969	559	95	4,126	255	52	82	41	22	19
Feb. 20	4,521	3,968	553	—	4,148	311	62	77	45	15	17
Mar. 19	4,578	4,009	569	—	4,267	268	43	57	29	18	10
Apr. 16	4,659	4,194	465	174	4,231	224	30	42	19	11	12
May 21	4,580	4,161	419	25	4,295	221	39	103	63	12	28
June 18	4,359	3,675	684	429	3,707	190	33	210	150	20	40
July 16	4,584	4,483	101	—	4,312	248	24	128	79	21	28
Aug. 20	4,669	4,519	150	211	4,206	224	28	120	72	20	28
Sept. 17	4,646	4,415	231	—	4,375	249	22	131	74	21	36
Oct. 15	4,746	4,644	102	21	4,482	222	21	101	56	20	25
Nov. 19	4,904	4,553	351	—	4,625	243	36	42	12	12	18

	Sterling assets													
	Total	UK and Northern Ireland Treasury bills	Other bills			Funds lent					Investments			
			Local authority	Other public sector	Other bills	UK banking sector	Certificates of deposit	UK local authorities	Other United Kingdom	Overseas	Up to 1 year	1 to 5 years	Over 5 years	
1979 Oct. 17	4,951	444	104	89	2,388	25	328	157	53	—	—	—	974	8
Nov. 21	4,792	440	106	81	2,611	19	158	142	52	—	—	—	783	3
Dec. 12	4,778	709	64	78	2,496	14	84	138	44	—	12	—	708	34
1980 Jan. 16	4,720	334	22	133	2,648	47	105	138	53	12	22	—	778	38
Feb. 20	4,774	335	30	112	2,710	21	128	150	52	—	9	—	742	31
Mar. 19	4,758	335	83	104	2,828	13	79	139	52	—	—	—	715	8
Apr. 16	4,830	299	44	105	2,708	31	122	145	50	—	18	—	908	11
May 21	4,782	329	39	128	2,944	12	29	138	45	10	3	—	682	7
June 18	4,580	322	71	120	2,685	24	19	138	65	28	—	—	661	28
July 16	4,784	347	37	117	2,412	88	354	141	37	—	—	—	735	88
Aug. 20	4,836	459	64	118	2,134	124	615	144	35	15	—	—	672	24
Sept. 17	4,787	320	82	127	2,003	144	726	145	38	11	—	—	688	85
Oct. 15	4,869	353	50	127	2,046	106	717	145	38	23	—	—	778	79
Nov. 19	5,026	370	78	140	2,146	37	685	147	54	11	58	—	807	83

	Sterling assets continued			Other currency assets				Undefined assets	
	Investments continued		Other sterling assets	Total	Certificates of deposit	Bills	Other	Total undefined assets	Undefined assets multiple (a)
	Local authorities	Other							
1979 Oct. 17	358	11	12	94	79	12	3	3,096	18.9
Nov. 21	374	11	12	97	77	14	6	3,120	19.1
Dec. 12	373	11	13	131	109	12	10	2,977	18.2
1980 Jan. 16	369	9	12	76	59	13	4	3,201	18.1
Feb. 20	385	10	9	73	58	5	10	3,250	18.4
Mar. 19	384	9	9	65	55	6	4	3,260	18.4
Apr. 16	371	9	9	52	35	14	3	3,187	18.0
May 21	395	11	10	111	67	19	25	3,370	19.0
June 18	398	10	11	209	167	17	25	3,275	18.5
July 16	407	10	11	147	95	28	24	3,332	18.8
Aug. 20	409	12	11	142	100	28	14	3,309	18.6
Sept. 17	397	11	10	177	142	28	7	3,403	19.2
Oct. 15	385	12	10	151	110	24	17	3,373	19.0
Nov. 19	387	12	11	84	55	24	5	3,325	18.7

(a) The undefined assets multiple has been calculated with a capital and resources base of 164 in 1979 and 177 in 1980.

## Banks in the United Kingdom: summary

£ millions

	Notes out-standing	Sterling liabilities											
		Total deposits	Sight deposits				Time deposits				Certificates of deposit	Items in suspense and transmission	Capital and other funds
			UK banking sector	UK public sector	UK private sector	Overseas	UK banking sector	UK public sector	UK private sector	Overseas			
1979 Oct. 17	475	73,685	3,675	676	19,914	2,642	13,755	170	24,924	4,174	3,756	3,307	11,856
Nov. 21	481	75,609	3,572	735	19,533	2,642	14,655	164	25,782	4,608	3,917	3,274	11,777
Dec. 12	498	76,915	3,710	750	19,477	2,498	15,607	163	25,839	4,838	3,833	3,298	11,955
1980 Jan. 16	484	76,886	4,280	823	19,455	2,709	13,893	164	26,689	5,223	3,648	3,794	12,444
Feb. 20	499	77,205	4,389	805	18,427	2,680	14,155	162	27,271	5,373	3,943	3,342	12,263
Mar. 19	511	77,402	4,343	707	18,756	2,931	14,369	158	26,994	5,326	3,817	3,294	12,298
Apr. 16	530	79,011	3,997	639	19,727	2,978	14,423	180	27,250	5,739	4,077	4,066	12,720
May 21	520	80,427	4,305	850	19,266	2,486	14,553	167	28,154	6,146	4,100	3,800	12,697
June 18	526	81,854	4,480	782	19,033	2,813	14,849	195	29,082	6,419	4,201	3,485	13,337
July 16	543	82,491	2,267	780	19,928	2,829	13,470	232	31,074	7,222	4,689	3,595	13,510
Aug. 20(a)	519	84,082	2,437	878	19,743	2,775	13,469	230	32,247	7,249	5,054	3,537	13,279
Sept. 17	525	84,476	2,327	658	19,551	2,827	13,712	250	32,374	7,461	5,316	3,292	13,361
Oct. 15	534	87,084	2,586	704	20,312	2,656	14,193	212	33,236	7,843	5,342	3,392	13,777
Nov. 19	539	89,718	2,603	865	20,268	2,756	15,382	243	34,118	7,909	5,573	3,382	13,610

	Notes and coin	Sterling assets										Special and supplementary deposits
		Total	Balances with Bank of England	Money at call		UK and N.Ireland Treasury bills	Other bills		British government stocks up to 1 year			
				Discount market	Other		Local authority	Commercial				
1979 Oct. 17	1,394	6,750	401	3,508	233	1,124	214	941	329	771		
Nov. 21	1,418	6,888	384	3,782	228	897	148	957	292	797		
Dec. 12	1,489	6,861	449	3,399	230	1,118	152	947	565	797		
1980 Jan. 16	1,386	6,983	611	3,592	271	801	171	956	582	28		
Feb. 20	1,376	6,965	574	3,553	247	905	174	979	532	104		
Mar. 19	1,374	6,908	370	3,707	232	861	241	988	509	132		
Apr. 16	1,551	7,141	416	3,602	266	1,065	300	1,008	483	216		
May 21	1,493	7,232	456	3,641	276	1,083	358	1,021	397	219		
June 18	1,409	7,344	475	3,413	333	1,200	436	1,034	453	242		
July 16	1,522	8,123	357	4,288	299	1,199	390	1,126	464	456		
Aug. 20(a)	1,487	8,317	671	4,157	269	1,110	382	1,153	575	-		
Sept. 17	1,446	8,478	664	4,236	319	1,090	412	1,168	588	-		
Oct. 15	1,463	8,490	495	4,448	361	1,060	452	1,206	467	-		
Nov. 19	1,469	8,959	575	4,341	312	1,301	534	1,210	687	-		

	Sterling assets concluded						Other currency assets				
	Investments			Miscellaneous assets			Miscellaneous assets				
	British government stocks			Other			Miscellaneous assets				
	Over 1 year to 1½ years	Over 1½ years to 5 years	Over 5 years and undated	Public sector	Other	Items in suspense and collections	Assets leased	Other	Items in suspense and collections	Assets leased	Other
1979 Oct. 17	366	1,430	540	377	1,938	5,391	329	2,548	259	14	550
Nov. 21	363	1,488	581	376	1,944	5,573	334	2,593	302	14	599
Dec. 12	210	1,369	593	390	1,957	5,150	336	2,626	266	15	673
1980 Jan. 16	160	1,254	669	358	2,175	6,166	352	2,788	246	15	964
Feb. 20	138	945	514	352	2,139	5,482	372	2,801	241	15	876
Mar. 19	131	985	500	361	2,140	5,378	370	2,835	283	14	765
Apr. 16	78	785	403	348	2,153	6,616	379	2,832	307	15	893
May 21	100	916	368	375	2,141	6,312	391	2,844	327	34	887
June 18	208	1,288	668	394	2,187	5,672	399	2,873	336	33	1,154
July 16	166	713	632	388	2,234	5,867	400	2,857	334	33	1,160
Aug. 20(a)	243	962	769	410	2,198	5,770	402	2,891	302	32	1,372
Sept. 17	284	905	834	447	2,207	5,365	398	2,931	282	13	1,301
Oct. 15	348	1,045	856	456	2,231	5,702	401	2,932	279	13	1,431
Nov. 19	233	1,080	1,045	436	2,283	5,738	397	2,928	331	13	1,503

[a] Three contributors, with assets/liabilities of £167 million, were excluded from the series at end-July 1980. The main net effects are estimated to reduce sterling deposits of the UK banking sector by £79 million; sterling capital and other funds by £88 million; sterling market loans to UK banks by £79 million; and other sterling investments by £48 million. Other net changes were negligible. The changes in Tables 6 and 11 are unaffected by the exclusion of these contributors.

[Table 3.1 in the Quarterly Bulletin]

Total deposits	Other currency liabilities						Total liabilities/assets	of which sterling		
	Sight and time deposits			Certificates of deposit	Items in suspense and transmission	Capital and other funds		Liabilities	Assets	
	UK banking sector	Other UK	Overseas							
164,967	33,527	4,568	107,548	19,324	256	1,345	255,890	89,323	89,473	1979 Oct. 17
169,995	35,873	5,142	109,111	19,870	298	1,396	262,830	91,141	91,637	Nov. 21
169,497	36,737	4,968	108,017	19,775	294	1,386	263,843	92,666	92,423	Dec. 12
167,179	35,352	4,539	108,040	19,249	302	1,315	262,403	93,607	93,248	1980 Jan. 16
169,809	37,097	4,781	107,842	20,088	299	1,292	264,710	93,309	93,540	Feb. 20
183,957	39,557	5,074	117,533	21,793	339	1,362	279,163	93,505	93,531	Mar. 19
185,588	40,507	5,544	117,639	21,897	352	1,374	283,640	96,327	96,291	Apr. 16
182,878	40,073	5,812	115,781	21,212	447	1,378	282,146	97,444	97,276	May 21
183,662	40,296	5,555	116,812	20,999	384	1,369	284,617	99,202	98,787	June 18
181,268	39,576	5,253	115,848	20,591	427	1,287	283,121	100,139	99,453	July 16
183,740	40,194	5,340	117,112	21,093	346	1,477	286,980	101,417	100,800	Aug. 20(a)
182,818	40,350	5,167	117,067	20,233	358	1,488	286,318	101,654	101,418	Sept. 17
185,042	40,747	5,102	119,013	20,181	342	1,416	291,588	104,787	104,207	Oct. 15
189,751	41,857	5,523	121,945	20,425	421	1,401	298,822	107,249	106,714	Nov. 19

*Sterling assets continued*

Total	Banks in UK	Market loans (other than reserve assets)						Bills (other than reserve assets)	Advances				
		Discount market	Certificates of deposit	UK local authorities	UK public corporations	UK private sector	Overseas		Total	UK public sector	UK private sector	Overseas	
24,815	17,241	624	2,549	2,947	215	692	546	501	42,323	1,238	37,046	4,039	1979 Oct. 17
25,751	18,144	378	2,875	2,976	143	569	666	449	43,082	1,398	37,643	4,041	Nov. 21
27,433	19,305	766	2,982	2,922	166	649	644	471	42,743	1,370	37,329	4,044	Dec. 12
25,685	17,985	502	2,806	2,925	180	503	783	445	44,800	1,706	38,984	4,110	1980 Jan. 16
26,543	18,416	589	3,029	3,041	196	456	816	491	45,318	1,666	39,477	4,175	Feb. 20
26,729	18,617	575	2,938	3,162	127	414	896	484	45,203	1,540	39,523	4,140	Mar. 19
26,717	18,357	525	3,102	3,230	118	367	1,018	405	46,664	1,895	40,752	4,018	Apr. 16
27,127	18,814	567	3,079	3,261	88	441	877	440	47,317	1,814	41,472	4,031	May 21
27,670	19,305	268	3,117	3,266	106	485	1,122	468	47,964	1,640	42,102	4,222	June 18
24,390	15,477	34	3,080	3,609	104	481	1,605	518	51,186	1,893	45,161	4,132	July 16
24,878	15,604	80	3,030	3,716	80	463	1,906	530	51,941	1,968	45,621	4,352	Aug. 20(a)
25,495	15,792	169	3,050	3,809	107	591	1,976	575	52,054	1,911	45,691	4,452	Sept. 17
26,172	16,405	37	2,973	3,888	94	564	2,212	399	53,712	2,115	47,163	4,434	Oct. 15
28,541	17,716	294	3,183	3,853	237	806	2,452	453	53,153	2,003	46,481	4,669	Nov. 19

*Other currency assets continued*

Total	of which advances	Market loans and advances						Bills	Investments			Acceptances		
		Banks in UK and discount market	Certificates of deposit	UK public sector	UK private sector	Overseas	Total		UK	Overseas	Sterling	Other currencies		
162,845	39,803	32,783	2,210	2,505	8,271	117,075	406	2,344	118	2,226	5,392	532	1979 Oct. 17	
167,508	39,444	35,055	2,258	2,481	8,133	119,562	409	2,361	121	2,240	5,581	652	Nov. 21	
167,690	39,677	35,826	2,283	2,398	8,069	119,113	415	2,361	120	2,241	5,670	594	Dec. 12	
165,200	40,172	33,968	2,095	2,270	8,205	118,662	404	2,326	126	2,201	5,681	619	1980 Jan. 16	
167,292	40,592	35,897	2,304	2,160	8,463	118,467	383	2,363	115	2,249	6,008	523	Feb. 20	
181,711	42,206	38,247	2,623	2,162	8,602	130,077	390	2,469	130	2,339	6,345	564	Mar. 19	
183,214	43,389	38,971	2,638	2,143	8,738	130,725	382	2,538	137	2,401	6,492	523	Apr. 16	
180,665	42,974	38,474	2,299	2,055	8,787	129,050	355	2,604	128	2,476	6,457	532	May 21	
181,203	44,031	38,858	2,334	2,032	9,121	128,858	393	2,710	134	2,576	6,381	538	June 18	
178,939	44,025	37,845	2,786	2,005	8,971	127,331	391	2,812	132	2,680	5,631	526	July 16	
181,228	44,893	38,149	3,015	1,984	9,057	129,022	381	2,864	149	2,716	5,265	502	Aug. 20(a)	
179,970	44,790	38,781	3,144	1,757	8,959	127,328	493	2,840	148	2,693	4,988	483	Sept. 17	
182,176	44,455	39,641	3,323	1,572	8,871	128,769	515	2,967	141	2,826	4,705	412	Oct. 15	
186,646	45,088	40,910	3,582	1,607	8,926	131,622	541	3,075	151	2,923	4,979	412	Nov. 19	

# Banks in the United Kingdom: detail

[Tables 3.2 to 3.5] the Quarterly Bulletin

£ millions

			Liabilities												
				Sterling deposits						Other currency deposits					
			Notes out-standing	Total	of which sight deposits	UK banking sector	UK public sector	UK private sector	Overseas	Certificates of deposit	Total	UK banking sector	Other UK	Overseas	Certificates of deposit
<b>British banks:</b>															
London clearing banks	1980	Oct. 15	—	41,183	16,544	1,578	473	35,149	2,681	1,302	10,644	1,781	887	7,469	526
		Nov. 19	—	41,689	16,382	1,537	557	35,692	2,625	1,277	11,449	1,778	943	8,114	614
Scottish clearing banks	1980	Oct. 15	483	4,691	1,670	165	80	3,987	115	344	1,315	513	144	569	89
		Nov. 19	487	4,777	1,687	176	107	4,033	111	350	1,423	520	180	594	128
Northern Ireland banks	1980	Oct. 15	51	1,339	463	524	31	708	75	—	13	8	1	4	—
		Nov. 19	52	1,383	484	536	36	733	78	—	13	8	2	3	—
Accepting houses[a]	1980	Oct. 15	—	4,837	953	1,249	42	2,695	647	204	5,983	1,863	459	3,519	142
		Nov. 19	—	5,285	1,135	1,410	47	2,990	603	236	6,602	1,800	733	3,926	142
Other[a]	1980	Oct. 15	—	16,442	3,373	5,572	272	6,885	2,629	1,084	21,441	6,425	709	13,203	1,103
		Nov. 19	—	16,618	3,558	5,684	329	6,821	2,705	1,078	21,868	6,775	697	13,381	1,015
<b>Overseas banks:</b>															
American banks	1980	Oct. 15	—	8,469	1,408	3,156	15	2,257	1,423	1,618	50,505	6,243	1,584	31,420	11,257
		Nov. 19	—	9,161	1,496	3,618	23	2,106	1,606	1,808	49,986	6,119	1,611	30,918	11,337
Japanese banks	1980	Oct. 15	—	824	51	585	—	187	44	7	37,153	10,615	188	22,727	3,623
		Nov. 19	—	1,048	51	764	—	237	41	6	38,012	10,624	202	23,490	3,696
Other	1980	Oct. 15	—	8,249	1,582	3,350	4	1,535	2,616	744	48,441	9,603	1,028	34,587	3,223
		Nov. 19	—	8,655	1,514	3,639	8	1,633	2,591	785	50,562	10,373	1,057	35,881	3,252
<b>Consortium banks</b>	1980	Oct. 15	—	1,050	214	600	—	143	269	38	9,528	3,696	101	5,514	216
		Nov. 19	—	1,102	186	621	2	140	306	33	9,836	3,860	98	5,638	241
<b>Total</b>	1980	Oct. 15	534	87,084	26,257	16,779	917	53,548	10,499	5,342	185,042	40,747	5,102	119,013	20,181
		Nov. 19	539	89,718	26,492	17,985	1,108	54,386	10,665	5,573	189,751	41,857	5,523	121,945	20,425

			Sterling and other currency		Sterling assets									
			Liabilities: items in suspense and transmission; capital, and other funds	Total liabilities/assets	Notes and coin	Reserve assets						Special deposits		
						Total	Balances with Bank of England	Money at call	UK and N. Ireland Treasury bills	Other bills	British government stocks up to 1 year			
<b>British banks:</b>														
London clearing banks	1980	Oct. 15	9,842	61,689	885	4,316	483	2,122	454	1,041	216	—		
		Nov. 19	9,738	62,876	861	4,470	560	2,000	553	1,094	263	—		
Scottish clearing banks	1980	Oct. 15	1,054	7,543	506	522	—	281	79	78	84	—		
		Nov. 19	992	7,678	504	535	1	205	171	78	80	—		
Northern Ireland banks	1980	Oct. 15	201	1,604	28	168	—	85	51	26	6	—		
		Nov. 19	165	1,613	28	169	—	72	65	26	6	—		
Accepting houses[a]	1980	Oct. 15	1,176	11,995	1	416	1	295	40	76	5	—		
		Nov. 19	1,318	13,205	1	454	1	330	19	81	24	—		
Other[a]	1980	Oct. 15	4,335	42,218	30	1,297	8	823	167	239	60	—		
		Nov. 19	4,399	42,886	63	1,365	9	795	187	254	119	—		
<b>Overseas banks:</b>														
American banks	1980	Oct. 15	479	59,453	2	882	1	488	202	127	63	—		
		Nov. 19	416	59,562	2	964	1	484	200	128	151	—		
Japanese banks	1980	Oct. 15	86	38,063	—	81	—	73	6	2	—	—		
		Nov. 19	21	39,081	—	104	—	93	6	5	—	—		
Other	1980	Oct. 15	871	57,561	10	715	2	576	56	62	20	—		
		Nov. 19	865	60,082	10	799	2	610	95	72	20	—		
<b>Consortium banks</b>	1980	Oct. 15	884	11,461	1	92	—	66	5	7	14	—		
		Nov. 19	900	11,839	1	98	—	63	5	6	24	—		
<b>Total</b>	1980	Oct. 15	18,927	291,588	1,463	8,490	495	4,809	1,060	1,658	467	—		
		Nov. 19	18,814	298,822	1,469	8,959	575	4,653	1,301	1,744	687	—		

[a] One contributor was transferred from 'British banks: other' to 'British banks: accepting houses' in November 1980.

		Sterling assets continued											
		Market loans (other than reserve assets)					Bills (other than reserve assets)	Advances			Investments		
		Banks in UK and discount market	Certificates of deposit	UK local authorities	Other UK	Overseas		UK public sector	UK private sector	Overseas	British government stocks over 1 year and undated	Other	
<b>British banks:</b>													
London clearing banks	1980 Oct. 15 Nov. 19	5,179 6,241	511 598	391 371	16 115	89 88	54 68	403 206	26,535 25,405	2,930 2,931	892 1,117	1,683 1,685	
Scottish clearing banks	1980 Oct. 15 Nov. 19	459 547	42 36	28 29	7 6	2 8	4 13	137 108	3,382 3,333	175 193	83 90	54 54	
Northern Ireland banks	1980 Oct. 15 Nov. 19	151 157	19 21	49 50	12 12	63 56	1 1	11 10	850 848	13 13	33 37	14 14	
Accepting houses[a]	1980 Oct. 15 Nov. 19	1,290 1,510	389 460	581 548	102 172	416 341	73 63	195 215	1,554 1,649	141 198	194 232	287 334	
Other[a]	1980 Oct. 15 Nov. 19	4,781 4,701	1,273 1,205	1,394 1,328	258 402	641 780	111 151	132 111	7,325 7,374	419 482	578 508	378 370	
<b>Overseas banks:</b>													
American banks	1980 Oct. 15 Nov. 19	1,289 1,387	426 539	436 436	42 62	397 493	73 67	419 451	4,211 4,359	489 552	288 203	78 77	
Japanese banks	1980 Oct. 15 Nov. 19	188 242	- -	39 55	- -	28 40	1 -	160 189	353 416	15 18	- 1	1 1	
Other	1980 Oct. 15 Nov. 19	2,730 2,792	183 177	790 855	184 229	516 572	73 84	483 534	2,644 2,797	195 229	70 57	145 136	
<b>Consortium banks</b>	1980 Oct. 15 Nov. 19	375 433	130 146	181 181	38 45	59 74	9 6	175 178	309 302	57 52	110 112	46 47	
<b>Total</b>	1980 Oct. 15 Nov. 19	16,442 18,010	2,973 3,183	3,888 3,853	658 1,043	2,212 2,452	399 453	2,115 2,003	47,163 46,481	4,434 4,669	2,249 2,357	2,686 2,718	

		Other currency assets										
		Market loans and advances						Bills	Investments	Sterling and other currencies	Acceptances	
		Total	of which advances	Banks in UK and discount market	Certificates of deposit	UK public sector	UK private sector					Overseas
<b>British banks:</b>												
London clearing banks	1980 Oct. 15 Nov. 19	10,613 11,366	2,906 3,081	4,097 4,324	40 44	400 405	728 822	5,347 5,770	22 22	496 499	6,675 6,833	504 550
Scottish clearing banks	1980 Oct. 15 Nov. 19	1,332 1,434	606 616	336 378	8 8	61 61	170 172	758 815	1 1	35 40	774 747	114 113
Northern Ireland banks	1980 Oct. 15 Nov. 19	14 13	1 1	8 2	- -	- -	1 1	5 10	- -	15 15	163 171	3 3
Accepting houses[a]	1980 Oct. 15 Nov. 19	5,200 5,865	1,855 1,914	1,346 1,669	143 128	28 24	515 510	3,268 3,534	12 12	204 210	838 939	1,836 1,977
Other[a]	1980 Oct. 15 Nov. 19	21,223 21,656	7,687 7,592	3,684 4,134	137 162	365 368	1,918 1,896	15,119 15,096	23 34	855 883	1,499 1,475	606 642
<b>Overseas banks:</b>												
American banks	1980 Oct. 15 Nov. 19	49,743 49,257	10,877 10,850	8,309 7,976	1,082 1,097	175 180	2,476 2,478	37,701 37,525	52 61	298 301	328 351	682 659
Japanese banks	1980 Oct. 15 Nov. 19	36,504 37,332	6,148 6,440	8,711 8,983	211 227	262 264	1,024 998	26,296 26,860	69 65	539 605	85 12	117 117
Other	1980 Oct. 15 Nov. 19	47,815 49,808	9,959 10,019	11,956 12,212	1,557 1,734	198 210	1,853 1,858	32,251 33,794	320 329	363 361	124 312	1,158 1,226
<b>Consortium banks</b>	1980 Oct. 15 Nov. 19	9,632 9,917	4,417 4,569	1,193 1,231	145 181	83 94	186 192	8,024 8,218	16 17	161 160	72 69	97 104
<b>Total</b>	1980 Oct. 15 Nov. 19	182,176 186,646	44,455 45,088	39,641 40,910	3,323 3,582	1,572 1,607	8,871 8,926	128,769 131,622	515 541	2,967 3,075	10,758 10,909	5,117 5,391

### UK banking sector: transactions in liabilities and assets<sup>(a)</sup>

£ millions

Month ended	Liabilities												
	Total	Domestic deposits								Overseas sector deposits		Non-deposit liabilities (net)	
		Total		Public sector				Private sector		Sterling	Other currencies		
		Un-adjusted	Seasonally adjusted	Sterling		Other currencies		Un-adjusted	Seasonally adjusted				
Un-adjusted	Seasonally adjusted	Un-adjusted	Seasonally adjusted	Un-adjusted	Seasonally adjusted	Un-adjusted	Seasonally adjusted	Sterling	Other currencies				
1979 Nov. 21	+ 4,693	+ 905	+ 1,267	+ 118	- 71	+ 10	+ 54	+ 605	+ 723	+ 395	+ 3,475	- 82	
Dec. 12	- 78	- 173	- 242	- 100	+ 119	- 3	+ 188	- 100	- 258	+ 342	- 318	+ 71	
1980 Jan. 16	+ 4,969	+ 283	+ 89	+ 166	+ 144	+ 10	+ 391	+ 219	- 284	+ 402	+ 4,095	+ 189	
Feb. 20	+ 857	+ 65	+ 513	+ 88	- 139	- 4	- 278	+ 397	+ 259	+ 127	+ 929	- 264	
Mar. 19	+ 7,952	+ 10	+ 348	- 240	+ 2	- 20	+ 159	+ 255	+ 111	+ 204	+ 7,662	+ 76	
Apr. 16	+ 3,247	+ 1,449	+ 745	- 47	- 103	+ 26	+ 940	+ 292	+ 530	+ 376	+ 1,075	+ 347	
May 21	+ 6,250	+ 1,500	+ 1,929	+ 247	- 21	- 2	+ 555	+ 1,252	+ 700	+ 394	+ 4,308	+ 48	
June 18	+ 1,456	+ 580	+ 113	- 110	+ 4	+ 14	+ 947	+ 366	- 271	+ 144	+ 338	+ 394	
July 16	+ 4,634	+ 2,882	+ 2,780	+ 78	+ 192	+ 1	+ 3,098	+ 2,882	- 295	+ 769	+ 678	+ 305	
Aug. 20	+ 3,517	+ 1,446	+ 1,788	+ 248	+ 160	+ 13	+ 1,072	+ 1,502	+ 113	- 3	+ 2,078	- 4	
Sept. 17	- 549	- 365	+ 41	- 407	- 232	+ 15	+ 275	+ 506	- 248	+ 276	- 427	- 33	
Oct. 15	+ 5,116	+ 1,486	+ 1,183	+ 43	+ 221	+ 12	+ 1,477	+ 996	- 46	+ 327	+ 2,766	+ 537	
Nov. 19	+ 3,529	+ 1,417	+ 1,727	+ 218	- 34	- 12	+ 862	+ 1,424	+ 349	+ 185	+ 2,088	- 161	

Month ended	Assets											
	Total	Lending to public sector					Lending to private sector				Lending to overseas sector	
		Total	Sterling			Other currencies	Sterling		Other currencies	Sterling	Other currencies	
			Un-adjusted	Seasonally adjusted	Central government		Other	Un-adjusted				Seasonally adjusted
Un-adjusted	Seasonally adjusted	Un-adjusted	Seasonally adjusted	Un-adjusted	Seasonally adjusted	Un-adjusted	Seasonally adjusted	Un-adjusted	Seasonally adjusted			
1979 Nov. 21	+ 4,693	- 13	+ 366	- 102	+ 89	+ 12	+ 699	+ 678	- 6	+ 103	+ 3,898	
Dec. 12	- 78	+ 241	- 373	+ 411	- 170	- 60	- 469	+ 171	- 32	- 7	+ 249	
1980 Jan. 16	+ 4,969	- 1,216	- 697	- 1,545	+ 329	- 48	+ 2,082	+ 1,385	+ 372	+ 175	+ 3,604	
Feb. 20	+ 857	- 399	+ 214	- 503	+ 104	- 113	+ 570	+ 493	+ 306	+ 89	+ 404	
Mar. 19	+ 7,952	- 209	- 126	- 229	+ 20	- 76	- 31	+ 403	- 132	+ 101	+ 8,299	
Apr. 16	+ 3,247	+ 547	- 309	+ 96	+ 451	- 2	+ 916	+ 987	+ 199	+ 222	+ 1,365	
May 21	+ 6,250	+ 149	+ 732	+ 107	+ 42	+ 18	+ 1,080	+ 972	+ 481	- 181	+ 4,703	
June 18	+ 1,456	+ 545	- 398	+ 560	- 15	- 18	+ 382	+ 457	+ 335	+ 425	- 63	
July 16	+ 4,634	+ 475	+ 1,219	- 41	+ 516	+ 17	+ 3,063	+ 2,106	+ 12	+ 428	+ 639	
Aug. 20	+ 3,517	+ 331	+ 223	+ 157	+ 174	- 23	+ 249	+ 664	+ 80	+ 588	+ 2,292	
Sept. 17	- 549	+ 122	+ 265	- 85	+ 207	- 219	+ 271	+ 651	- 19	+ 84	- 788	
Oct. 15	+ 5,116	+ 323	+ 5	+ 51	+ 272	- 181	+ 1,531	+ 1,235	+ 1	+ 235	+ 3,207	
Nov. 19	+ 3,529	+ 765	+ 992	+ 731	+ 34	+ 10	- 205	- 91	- 19	+ 501	+ 2,477	

[a] The banking sector comprises all banks included in Table 3 together with the discount market and the Banking Department of the Bank of England. Inter-bank items are excluded and adjustments made to allow for transit items (see additional notes to Table 6 in the Quarterly Bulletin).

### Components of private sector liquidity<sup>(a)</sup>

[Summary of Table 12 in the September Quarterly Bulletin]

£ millions

Month ended	'Money'		Other money-market instruments		Savings deposits and securities				Certificates of tax deposit		PSL <sub>1</sub> <sup>(b)</sup>	PSL <sub>2</sub> <sup>(c)</sup>
	Unadjusted	Seasonally adjusted	Total (net)	of which bank bills	Total (gross)	of which shares and deposits with building societies	Total (net)		Seasonally adjusted			
							Unadjusted	Seasonally adjusted	Gross	Net		
	1	2	3	4	5	6	7	8	9	10	11	12
1979 Nov. 21	53,207	53,644	6,088	1,922	47,215	36,265	44,761	45,198	992	757	60,724	105,687
Dec. 12	53,745	53,555	6,143	2,026	47,501	36,660	45,020	45,020	941	703	60,639	105,421
1980 Jan. 16	53,769	53,891	6,088	2,047	47,970	37,141	45,517	45,412	862	632	60,841	106,023
Feb. 20	53,530	54,346	6,074	2,005	48,161	37,289	45,770	45,896	728	590	61,148	106,906
Mar. 19	53,781	54,630	6,402	2,164	48,480	37,579	46,116	46,316	662	562	61,694	107,910
Apr. 16	54,795	54,897	6,715	2,184	48,780	37,823	46,284	46,601	609	529	62,221	108,742
May 21	55,482	56,139	7,323	2,483	48,994	38,002	46,275	46,797	634	556	64,096	110,815
June 18	56,442	56,584	7,439	2,664	49,778	38,787	46,922	46,945	604	527	64,627	111,495
July 16	59,828	59,372	6,101	1,666	50,348	39,333	47,453	47,308	634	551	66,107	113,332
Aug. 20	60,950	61,089	5,608	1,315	50,664	39,629	47,797	47,889	858	753	67,555	115,339
Sept. 17	61,115	61,613	5,514	1,058	51,283	40,183	48,411	48,524	625	540	67,752	116,191
Oct. 15	62,606	62,606	5,486	1,010	51,957	40,857	49,079	49,342	818	708	68,910	118,142
Nov. 19	63,502	63,992	5,258	838	52,483	41,382	49,605	50,088	1,080	950	70,330	120,288

[a] An article introducing and explaining the full table of the components of private sector liquidity appeared in the September 1979 Quarterly Bulletin; see also additional notes to subsequent issues.

[b] PSL<sub>1</sub> equals columns 2 + 3 + 9.

[c] PSL<sub>2</sub> equals columns 2 + 3 + 8 + 10.



## Money stock: amounts outstanding

£ millions

[Table 11.1 in the Quarterly Bulletin]

Month ended	Notes and coin in circulation with public	UK private sector sterling sight deposits		Money stock M <sub>1</sub> [b]		UK private sector sterling time deposits [c]	UK public sector sterling deposits	Money stock Sterling M <sub>3</sub> [b]		UK residents' deposits in other currencies [c]	Money stock M <sub>3</sub> [b]	
		Non-interest-bearing [a]	Interest-bearing	Unadjusted	Seasonally adjusted			Unadjusted	Seasonally adjusted		Unadjusted	Seasonally adjusted
1979 Oct. 17	9,267	15,143	4,038	28,448	28,190	25,747	978	55,173	55,160	4,915	60,088	60,070
Nov. 21	9,307	14,777	3,588	27,672	27,760	26,617	1,096	55,385	55,700	5,571	60,956	61,270
Dec. 12	9,675	15,064	3,540	28,279	27,660	26,566	996	55,841	55,750	5,279	61,120	61,030
1980 Jan. 16	9,319	14,379	3,798	27,496	27,690	27,384	1,162	56,042	56,240	4,874	60,916	61,120
Feb. 20	9,372	13,815	3,473	26,660	27,280	27,995	1,250	55,905	56,580	5,090	60,995	61,670
Mar. 19	9,467	14,185	3,505	27,157	27,570	27,752	1,010	55,919	56,860	5,327	61,246	62,190
Apr. 16	9,566	14,655	3,675	27,896	27,450	28,052	963	56,911	57,050	5,831	62,742	62,880
May 21	9,706	14,271	3,601	27,578	27,550	29,065	1,210	57,853	58,280	6,240	64,093	64,520
June 18	9,707	14,290	3,566	27,563	27,240	30,028	1,100	58,691	58,720	5,991	64,682	64,710
July 16	9,963	14,355	4,359	28,677	28,220	32,268	1,178	62,123	61,670	5,600	67,723	67,270
Aug. 20	9,940	14,062	4,388	28,390	28,290	33,613	1,426	63,429	63,500 [d]	5,729	69,158	69,220 [d]
Sept. 17	9,858	14,338	4,168	28,364	28,550	33,832	1,019	63,215	63,850	5,453	68,668	69,300
Oct. 15	9,842	14,629	4,434	28,905	28,650	34,752	1,062	64,719	65,080	5,366	70,085	70,440
Nov. 19	9,824	14,586	4,415	28,825	28,840	35,676	1,280	65,781	66,410	5,744	71,525	72,160

[a] After deducting 60% of transit items (see additional notes to Table 6 of the Quarterly Bulletin).

[b] M<sub>1</sub> equals columns 1 + 2 + 3. Sterling M<sub>3</sub> equals M<sub>1</sub> + columns 5 + 6. M<sub>3</sub> equals sterling M<sub>3</sub> + column 8.

[c] Including UK residents' holdings of certificates of deposit.

[d] The changes in these items for the five weeks ended 20 August given in Tables 11.2 and 11.3 do not equal the differences between the amounts outstanding. See the footnote on page 2 and additional notes to Table 11 of the Quarterly Bulletin.

## Money stock: changes<sup>(a)</sup>

£ millions: percentages in italics

[Table 11.2 in the Quarterly Bulletin]

Month ended (unadjusted)	Notes and coin in circulation with public	UK private sector sterling sight deposits		Money stock M <sub>1</sub> [c]	UK private sector sterling time deposits [d]	UK public sector sterling deposits	Money stock Sterling M <sub>3</sub> [c]	UK residents' deposits in other currencies [d]		Money stock M <sub>3</sub> [c]		
		Non-interest-bearing [b]	Interest-bearing					Transactions	Valuation changes [e]			
											1	2
1979 Nov. 21	+ 40	- 366	- 450	- 776	+ 870	+ 118	+ 212	+ 733	- 77	+ 868		
Dec. 12	+ 368	+ 287	- 48	+ 607	- 51	- 100	+ 456	- 261	- 31	+ 164		
1980 Jan. 16	- 356	- 685	+ 258	- 783	+ 818	+ 166	+ 201	- 274	- 131	- 204		
Feb. 20	+ 53	- 564	- 325	- 836	+ 611	+ 88	- 137	+ 255	- 39	+ 79		
Mar. 19	+ 95	+ 370	+ 32	+ 497	- 243	- 240	+ 14	+ 91	+ 146	+ 251		
Apr. 16	+ 99	+ 470	+ 170	+ 739	+ 300	- 47	+ 992	+ 556	- 52	+ 1,496		
May 21	+ 140	- 384	- 74	- 318	+ 1,013	+ 247	+ 942	+ 698	- 289	+ 1,351		
June 18	+ 1	+ 19	- 35	- 15	+ 963	- 110	+ 838	- 257	+ 8	+ 589		
July 16	+ 256	+ 65	+ 793	+ 1,114	+ 2,240	+ 78	+ 3,432	- 294	- 97	+ 3,041		
Aug. 20	- 23	- 294	+ 29	- 288	+ 1,337	+ 248	+ 1,297	+ 126	+ 2	+ 1,425		
Sept. 17	- 82	+ 276	- 220	- 26	+ 219	- 407	- 214	- 233	- 43	- 490		
Oct. 15	- 16	+ 291	+ 266	+ 541	+ 920	+ 43	+ 1,504	- 34	- 53	+ 1,417		
Nov. 19	- 18	- 43	- 19	- 80	+ 924	+ 218	+ 1,062	+ 337	+ 41	+ 1,440		
Month ended (seasonally adjusted)												
1979 Nov. 21	+ 13	+ 18	- 450	- 419	- 1.5	+ 1,037	- 71	+ 547 + 1.0	+ 733	- 77	+ 1,203	+ 2.0
Dec. 12	+ 23	- 73	- 48	- 98	- 0.4	+ 21	+ 119	+ 42 + 0.1	- 261	- 31	- 250	- 0.4
1980 Jan. 16	+ 122	- 331	+ 258	+ 49	+ 0.2	+ 292	+ 144	+ 485 + 0.9	- 274	- 131	+ 80	+ 0.1
Feb. 20	+ 72	- 158	- 325	- 411	- 1.5	+ 880	- 139	+ 330 + 0.6	+ 255	- 39	+ 546	+ 0.9
Mar. 19	+ 45	+ 227	+ 32	+ 304	+ 1.1	- 4	+ 2	+ 302 + 0.5	+ 91	+ 146	+ 539	+ 0.9
Apr. 16	+ 27	- 302	+ 170	- 105	- 0.4	+ 424	- 103	+ 216 + 0.4	+ 556	- 52	+ 720	+ 1.2
May 21	+ 18	+ 171	- 74	+ 115	+ 0.4	+ 1,155	- 21	+ 1,249 + 2.2	+ 698	- 289	+ 1,638	+ 2.0
June 18	+ 77	- 339	- 35	- 297	- 1.1	+ 740	+ 4	+ 447 + 0.8	- 257	+ 8	+ 198	+ 0.3
July 16	- 120	+ 303	+ 793	+ 976	+ 3.6	+ 1,786	+ 192	+ 2,954 + 5.0	- 294	- 97	+ 2,563	+ 4.0
Aug. 20	+ 164	- 129	+ 29	+ 64	+ 0.2	+ 1,602	+ 160	+ 1,826 + 3.0	+ 126	+ 2	+ 1,954	+ 2.9
Sept. 17	+ 116	+ 377	- 220	+ 273	+ 1.0	+ 349	- 232	+ 390 + 0.6	- 233	- 43	+ 114	+ 0.2
Oct. 15	+ 51	- 205	+ 266	+ 112	+ 0.4	+ 935	+ 221	+ 1,268 + 2.0	- 34	- 53	+ 1,181	+ 1.7
Nov. 19	- 26	+ 251	- 19	+ 206	+ 0.7	+ 1,192	- 34	+ 1,364 + 2.1	+ 337	+ 41	+ 1,742	+ 2.5

[a] Changes in the money stock may differ from those which can be calculated by reference to amounts outstanding (see additional notes to Table 11 of the Quarterly Bulletin).

[b] After deducting 60% of transit items (see additional notes to Table 6 of the Quarterly Bulletin).

[c] M<sub>1</sub> equals columns 1 + 2 + 3. Sterling M<sub>3</sub> equals M<sub>1</sub> + columns 5 + 6. M<sub>3</sub> equals sterling M<sub>3</sub> + columns 8 + 9.

[d] Including certificates of deposit.

[e] See additional notes to Tables 6 and 11 of the Quarterly Bulletin.

## Public sector borrowing requirement, domestic credit expansion and changes in money stock

£ millions

Month ended (unadjusted)	Public sector borrowing requirement (surplus -)		Purchases (-) of public sector debt by UK private sector (other than banks)		Sterling lending to UK private sector (b)	Sterling lending to overseas sector (c)	Domestic credit expansion (d)	External and foreign currency finance (increase -)			Net non-deposit liabilities (increase -) (e)	Money stock sterling M <sub>3</sub> (g)	
	Central government borrowing requirement	Other public sector contribution	Other public sector debt	Central government debt (a)				Public sector	Overseas sector sterling deposits (e)	Banks' foreign currency deposit liabilities (net) (f)			
										1			2
1979 Nov. 21	+ 458	+ 52	- 458	+ 719	+ 103	+ 874	- 45	- 395	- 304	+ 82	+ 212		
Dec. 12	+ 2,351	- 256	- 1,209	- 470	- 7	+ 409	- 276	- 342	+ 736	- 71	+ 456		
1980 Jan. 16	- 856	+ 433	- 1,365	+ 2,081	+ 175	+ 468	+ 217	- 402	+ 107	- 189	+ 201		
Feb. 20	- 790	- 18	- 152	+ 580	+ 89	- 291	+ 604	- 127	- 587	+ 264	- 137		
Mar. 19	+ 532	- 91	- 297	- 1	+ 101	+ 244	- 288	- 204	+ 338	- 76	+ 14		
Apr. 16	+ 479	+ 275	- 869	+ 1,473	+ 222	+ 1,580	+ 204	- 376	- 69	- 347	+ 992		
May 21	+ 1,170	- 132	- 544	+ 478	- 181	+ 791	+ 397	- 394	+ 196	- 48	+ 942		
June 18	+ 2,532	- 101	- 913	+ 363	+ 275	+ 2,156	- 953	- 144	+ 173	- 394	+ 838		
July 16	+ 110	+ 512	- 572	+ 3,335	+ 666	+ 4,051	+ 171	- 769	+ 284	- 305	+ 3,432		
Aug. 20	+ 1,859	+ 57	- 1,211	+ 456	+ 350	+ 1,511	- 366	+ 3	+ 145	+ 4	+ 1,297		
Sept. 17	+ 744	+ 66	- 798	+ 145	+ 84	+ 241	+ 154	- 276	- 366	+ 33	- 214		
Oct. 15	+ 615	+ 402	- 1,055	+ 1,426	+ 235	+ 1,623	+ 450	- 327	+ 295	- 537	+ 1,504		
Nov. 19	+ 1,690	+ 11	- 934	- 129	+ 501	+ 1,139	- 96	- 185	+ 42	+ 161	+ 1,062		
Month ended (seasonally adjusted)													
1979 Nov. 21	+ 901	- 5	- 486	+ 698	+ 103	+ 1,211	- 727	- 109	- 104	+ 63	+ 547		
Dec. 12	+ 1,355	- 213	- 1,209	+ 170	- 7	+ 96	+ 109	- 104	- 104	- 163	+ 42		
1980 Jan. 16	+ 126	+ 483	- 1,430	+ 1,384	+ 175	+ 738	- 104	- 104	- 104	- 149	+ 485		
Feb. 20	+ 228	- 71	- 479	+ 503	+ 89	+ 270	- 58	- 58	- 58	+ 118	+ 330		
Mar. 19	+ 578	- 142	- 253	+ 433	+ 101	+ 717	- 229	- 229	- 229	- 186	+ 302		
Apr. 16	- 582	+ 275	- 758	+ 1,544	+ 222	+ 701	- 343	- 343	- 343	- 142	+ 216		
May 21	+ 1,493	- 29	- 504	+ 370	- 181	+ 1,149	+ 248	+ 248	+ 248	- 148	+ 1,249		
June 18	+ 1,409	+ 137	- 890	+ 438	+ 275	+ 1,369	- 843	- 843	- 843	- 79	+ 447		
July 16	+ 399	+ 560	- 536	+ 2,378	+ 666	+ 3,467	- 207	- 207	- 207	- 306	+ 2,954		
Aug. 20	+ 2,044	- 63	- 1,192	+ 871	+ 350	+ 2,010	- 120	- 120	- 120	- 64	+ 1,826		
Sept. 17	+ 1,139	- 45	- 736	+ 525	+ 84	+ 967	- 578	- 578	- 578	+ 1	+ 390		
Oct. 15	+ 404	+ 325	- 1,013	+ 1,130	+ 235	+ 1,081	+ 314	+ 314	+ 314	- 127	+ 1,268		
Nov. 19	+ 1,961	- 43	- 927	- 15	+ 501	+ 1,477	- 220	- 220	- 220	+ 107	+ 1,364		

[a] Purchases (-) of central government debt by the UK private sector (other than banks) can be analysed by instrument as follows:

Month ended	Marketable debt		National savings		Tax instruments		Other (h)	Total (column 4 above)	
	Stocks	Treasury bills	Unadjusted	Seasonally adjusted	Unadjusted	Seasonally adjusted		Unadjusted	Seasonally adjusted
1979 Nov. 21	- 987	+ 75	- 47	- 63	+ 333	+ 321	+ 168	- 458	- 486
Dec. 12	- 1,133	- 51	- 56	- 85	+ 20	+ 49	+ 11	- 1,209	- 1,209
1980 Jan. 16	- 1,388	+ 33	- 136	- 132	+ 125	+ 56	+ 1	- 1,365	- 1,430
Feb. 20	- 428	+ 21	- 205	- 207	+ 457	+ 132	+ 3	- 152	- 479
Mar. 19	- 166	+ 2	- 167	- 167	+ 21	+ 65	+ 13	- 297	- 253
Apr. 16	- 775	+ 3	- 72	- 14	- 3	+ 50	- 22	- 869	- 758
May 21	- 409	- 110	- 57	- 48	- 58	- 27	+ 90	- 544	- 504
June 18	- 846	- 4	- 64	- 76	- 5	+ 30	+ 6	- 913	- 890
July 16	- 541	+ 97	- 31	- 41	- 75	- 29	- 22	- 572	- 536
Aug. 20	- 961	+ 80	- 118	- 120	- 233	- 212	+ 21	- 1,211	- 1,192
Sept. 17	- 892	- 29	- 72	- 67	+ 197	+ 254	- 2	- 798	- 736
Oct. 15	- 819	+ 12	- 30	- 35	- 219	- 172	+ 1	- 1,055	- 1,013
Nov. 19	- 688	- 12	+ 2	- 14	- 221	- 198	- 15	- 934	- 927

[b] Bank lending in sterling to the UK private sector (see page 6) plus Issue Department's holdings of commercial bills.

[c] Bank lending in sterling to overseas sector (see page 6) plus Issue Department's holdings of ECGD-backed promissory notes acquired as part of money-market smoothing operations.

[d] Domestic credit expansion equals the sum of columns 1 to 6.

[e] See page 6.

[f] Banks' foreign currency deposits from, less foreign currency lending to, UK and overseas residents (see page 6).

[g] Sterling M<sub>3</sub> equals domestic credit expansion plus columns 8 + 9 + 10 + 11 (see also page 7).

[h] Includes repayments (+) by the Fund for Banks for Savings (a central government fund) to the trustee savings banks.

## Symbols and conventions

.. not available.

- nil or less than £½ million.

Owing to rounding of figures, the sum of the separate items will sometimes differ from the total shown.

Further notes and definitions on these tables are given in the *Quarterly Bulletin*.

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PERSONAL AND CONFIDENTIAL



H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-233 3000

Direct Dialling 01-233 .....

A N Ridley  
Special Adviser

CF  
M.  
Dec 17<sup>th</sup>

Dear Tim,

<sup>R</sup>  
<sup>15/12</sup>  
You might like to see, and show  
the PM, the attached conclusions  
of an early draft of the Treasury  
Select Committee Report which were  
not, in the end accepted. It is, I  
suspect, largely the work of Jeremy  
Bray.

It shows two things: the radical  
hostility to Govt. policies of many  
members of the committee (I have  
no reason to believe it reflects Bray's



H. M. Treasury

Parliament Street London SW1P 3AG

Switchboard 01 233 3000

Direct Dialling 01 233

views alone); and the fact that there  
is some effective opposition to  
the more extreme ways in  
which such criticisms can be  
expressed. I believe the final  
report will be short of any  
explicit concluding para which  
the CFI goes round today

Yours

Adam

at end insert

Conclusions

1. The fact that the government has not been able to achieve its target for EM3 or its expectations for PSBR casts doubt on their practicality, given the state of the economy when they were announced in March 1980.
  
2. The effort to achieve the targets has resulted in severely deflationary policies, directly through high interest rates and cuts in public investment, and indirectly through reductions in stocks and the effect of the exchange rate on exports.
  
3. The effect of the deflation of demand has been to squeeze profits and reduce inflation.
  
4. The contribution of the exchange rate to reducing inflation will be unwound if a decline in the pound restores a greater degree of competitiveness to manufacturing industry.
  
5. With no controls on capital movements, inwards or outwards, the Committee appreciates the difficulty in judging the timing and magnitude of the effect on expectations, capital movements, and the exchange rate of any action on the part of the authorities. Continuing doubt about the basis and direction of the government's monetary policy does not however make it any easier for the market to form equilibrating expectations.

6. The government has set other considerations above the achievement of its monetary targets in the short term.
7. The action of the authorities should continue to be based on an assessment of their effect not only on monetary targets, but also on competitiveness, investment, output, inflation and employment, in the shorter and longer term.
8. On balance the Committee believes that the continuation of such tight monetary policies will do more to cut output, investment, and exports than it will to cut inflation, in both the shorter and the longer term. The Committee agrees with the Chancellor that the rates of growth of M3 and PSBR are likely to be substantially lower in the second half of the financial year 1980/81 than they were in the first.
9. In the further relaxation of monetary policies the priorities should be:
- (i) a reduction in interest rates;
  - (ii) any measures to reduce the exchange rate below its level in November 1980;
  - (iii) measures to ease the liquidity pressures on private <sup>manufacturing</sup> industry including Bank of England intermediation for medium term loans to industry;
  - (iv) maintenance of investment in the public sector.
10. The effects of specific fiscal measures should be judged by their effects on the final objectives of output, employment, and inflation, and on money supply, and not just on the PSBR, which is not an adequate proxy for the other variables.

11. Pay restraint in the public and private sector in the shorter and the longer term would make it possible for the government to pursue less tight monetary policies than would otherwise be necessary.

12. The government should not ignore the short term social distress and the possibility of long term damage to industrial relations from a high level of unemployment.

13. A fresh basis for the medium term financial strategy and its implementation is needed to maintain the necessary monetary discipline while allowing the economy to recover from the present severe recession.

RESTRICTED

→ AD, AW, → Jaki



E.10

R

15/12

CHANCELLOR

1. ~~M. Hatters~~ *clm*

cc Chief Secretary  
Financial Secretary  
Sir Douglas Wass  
Mr Ryrie  
Mr Burns  
Mr Middleton

~~L. M. Hatters~~

3. CF

*Linka. to Central Bank*

A VIEW FROM THE MONEY MARKETS

The attached note from a well-informed source may be of some interest.

*AM*

ADAM RIDLEY

12 December 1980

*UK R.*

I think it would be advisable to consider the general strategy of stressing that the MTS is medium term (i.e. in Treasury balance longer than a year). M<sub>3</sub> was meant to be on target over something like a two year period (i.e. almost half a cycle).

*R*

RESTRICTED



THE MOOD OF THE MARKETS - 12 DECEMBER

There is enormous confusion over the reports of what the Chief Secretary said to the backbench Finance Committee and of various interpretations which can be put on those reports. One school of thought think that what is signalled is a greatly relaxed attitude to the movement of sterling  $M_3$  and the PSBR, which will be justified on the basis of the degree of recession. Another interpretation is that the Government is not relaxing, and indeed recognises the need to raise taxes; but equally recognises that what happens to the PSBR this year is effectively water under the bridge. A good deal of effort has been expended on analysis of the articles in the Guardian by Ian Aitken and Hamish McCrae (12 December). What this means is that there is a far wider concern than hitherto about the possible abandonment of the MTFPS, a larger PSBR and massive demands on the gilts market. This has undoubtedly been a significant influence in recent days, though precisely how much is difficult to make out given the concomitant movement of American interest rates. Though there may be attempted <sup>Gilts</sup> rallies, such as the one today (Friday 12 December), inferences about the future are rather gloomy.

2. At another level it is increasingly being argued that "simple-minded" monetarism has proved to be unviable. By that is meant the policy in which the authorities simply seek to control  $M_3$  by putting interest rates at a suitably high level and do not bother too much with the PSBR. The problem is that, with this doctrine moving out of fashion, people are increasingly unclear about the principles on which the Government will be operating henceforward, and they are in need of a clear steer from the Government. Amidst the hubbub, it is not surprising that many gilt brokers will be defending a set of policies which will ensure a high level of gilt sales. But then they would, wouldn't they.

3. While there is no imperative need to clear up matters before Christmas, it would help a great deal if something could be done. However it would be wrong to wait beyond the first or second week of the New Year and the approach of the next set of monetary statistics.

4. Looking ahead a number of important considerations suggest themselves:

(a) If gilts are flogged hard in the last quarter of the financial year while the PSBR is in surplus, then money market overnight rates will get extremely tight. Even if the Bank pursued the policy of not selling gilts while not continuing with the "repos", <sup>prospect</sup> /overnight rates will still be tight. This will have an unsettling effect on long markets.

(b) The attraction of leaving money short to exploit the high overnight rates will necessarily mean a diversion of interest from the longer gilts. If, moreover, it appears likely that there will be a large PSBR in the following financial year, then long rates must tend to drift upwards, and when funding begins again it will be that much more expensive.

(c) The position is made no easier by understandable uncertainty about how the new system of monetary control will operate as the Bank begins to conduct more aggressive open market operations through the discount houses.

9 December 1980

Policy Unit

*TKM*

PRIME MINISTER

*Original returned to Policy Unit*

MONETARY BASE CONTROL

About a week ago; I heard from Alan Walters that a young research economist called David Howard at the Federal Reserve had done some research on the UK monetary system and was coming over here with the resulting paper which he expects to publish in a few months' time.

Alfred and I had dinner with Howard yesterday. He has found that there is a stable trend relationship between the monetary base in the UK and the money supply. This appears to dispose of one important objection by the Bank. The Bank may well respond, Alan thinks, by saying that the relationship may be stable historically, but that the stability will disappear if the base itself is used for monetary control. However, Alan argues that the Swiss and German evidence disproves that.

David Howard has had a session with Goodhart at the Bank, he is talking to the Treasury today (someone called Riley who I assume works for Peter Middleton) and to Brian Griffiths and his people on Thursday.

Things therefore seem to be moving in the right direction in the MBC area.



JOHN HOSKYNS

1. MR RILEY *CSR*
2. MR SPRINGTHORPE

17

## MONEY SUPPLY IN NOVEMBER

The Bank of England's press release on the banks' eligible liabilities is due to be published today at 2.30 pm. The Bank will publish with them the preliminary indication of money supply growth in banking November. The Prime Minister may wish to have the attached note before question time.

*Tina Lennon.*

T LENNON

9 December 1980

## BACKGROUND NOTE

The banking figures for banking November are to be published at 2.30 pm today. Banks' eligible liabilities rose by 1.1%; sterling M3 rose by more, at 2.1%, and the Bank following normal practice will indicate to the market that the rise was "about 2%" (full money supply figures are to be published on 18 December). This brings the annualised rate of growth since February to 24 $\frac{1}{4}$ % (or about 20% if allowance is made for corset distortions).

The London clearing banks' press release, published at the same time, will indicate that their sterling advances to the private sector fell by just over £1 billion. Their advances to the public sector also fell by about £200 million. To a large extent this reflects a substantial switch of borrowing from overdraft finance to market sources because of the sharp drop in market interest rates. It nevertheless confirms the marked slowdown in private sector borrowing evident in recent months.

This month's money supply figure is likely to disappoint the market which had been predicting an increase of around 1%. It will be evident from the fall in the clearers' bank lending figure that the high PSBR (the calendar November CGBR of £2.7 billion will also be announced today) and positive external factors reflecting the strong current account are pushing up the money supply.

Line to Take / Section G of the Weekly Brief provides a number of defensive supplementaries. Some further supplementaries are attached.7

(i) The money supply figure reflects high Central Government borrowing, but this was expected and is broadly consistent with the Industry Act forecast.

(ii) There are signs that the growth in bank lending to the private sector has turned down, and this should augur well for the rest of the target period.

SECRET

(iii) The Government has always recognised that the slowdown in monetary growth would occur in the New Year as the public sector moved into surplus and substantial sales of the new issue of National Savings Certificates augmented the slowdown in bank lending.

- 2 -

SECRET

## SUPPLEMENTARIES

### Further proof that Government strategy not working

No. Our strategy is to bring down inflation and to create the conditions for sustainable economic growth. This is what we ~~have~~ <sup>are now</sup> achieving. Inflation is falling rapidly and will continue to fall!

### Monetary policy off course

No. The signs are that private sector borrowing has now turned down. The clearing banks' advances to the private sector actually fell by over £1 billion last month. Public sector borrowing is still high but we expect this to moderate substantially in the New Year.

### Monetary growth now twice the target

Monetary growth has been higher than we want and is likely to exceed the target. But the fact that private sector borrowing appears to be moderating, that public sector borrowing will be much reduced in the New Year and that National Savings will be making an increased contribution, all mean that the excess over the target will be much less than now appears.

### Cut in MLR not justified

With inflation falling rapidly and the corporate sector bearing more than its fair share of the burden, the MLR cut was certainly fully justified.

PRESS ANNOUNCEMENT

ELIGIBLE LIABILITIES AND PROVISIONAL MONEY SUPPLY:  
19 NOVEMBER 1980

During the five weeks to 19 November, eligible liabilities of banks in the UK rose by £726 million (1.1 per cent) to stand at £66,001 million. Reserve assets increased by £469 million to £8,959 million and the reserve ratio rose sharply from 13.0 per cent to 13.6 per cent.

Preliminary information suggests that sterling M<sub>3</sub> may have grown by about 2 per cent during the month, after seasonal adjustment. This figure may of course need to be revised in the light of subsequent information. Full money and banking figures will be published on 18 December.

BANK OF ENGLAND  
9 December 1980



SECRET

2



*M m*

Treasury Chambers, Parliament Street, SW1P 3AG  
01-233 3000

8 December 1980

Tim Lankester Esq  
Private Secretary  
Prime Minister's Office  
No.10 Downing Street  
LONDON SW1

*n*

*9/12*

*Dear Tim,*

NOVEMBER MONEY SUPPLY FIGURES

*U*  
The provisional estimate of money supply growth based on all banks' returns for banking November is now available.  $\pounds$ M3 grew by 2.1 per cent, bringing the annual rate of growth since mid February to 24 per cent before allowing for corset distortions, or about 20 per cent after such distortions are allowed for.

... The counterparts to the growth in  $\pounds$ M3 are shown in the attached table. Overwhelmingly the largest is the CGBR, which at almost  $\pounds$ 2 billion, was very high. On-lending to the rest of the public sector accounted for about  $\pounds$ 570 million of this, with a small part of this being offset by a reduction in bank lending to local authorities and public corporations. Private sector purchases of central government debt were  $\pounds$ 870 million, with sales of gilts accounting for about  $\frac{1}{2}$  of this. New investment in national savings was very small ahead of the new issue of Granny Bonds on 17 November.

Bank lending in sterling to the private sector fell slightly, and if allowance is made for a fall of  $\pounds$ 160 million in the outstanding "Bill leak" the underlying reduction seems to have been appreciably larger. But there was substantial sterling lending to overseas of nearly  $\pounds$ 500 million, which appreciably outweighed the negative external adjustment; thus the net effect of external transactions was expansionary, probably reflecting the strong current account.

/The financial markets

*Current etc  
also copies this*

SECRET



The financial markets may be rather disappointed by the figures, whose impact will be reinforced by the very high CGBR figure for calendar November (£2.7 billion) which will also be published tomorrow. There are nonetheless some helpful points which can be made in background briefing:-

- i. The money supply figure reflects high Central Government borrowing, but this was expected and is broadly consistent with the Industry Act forecast.
- ii. There are signs that the growth of bank lending to the private sector has turned down, and this should augur well for the rest of the target period. (The clearing bank figures would point to a rather larger fall in bank lending - the discrepancy results from the fact that market interest rates were somewhat lower than the banks' base rates over the November make-up day.)
- iii. We have always recognised that the slow down in monetary growth depended on the movement of the public sector into surplus after the beginning of the new year and on substantial sales of the new Granny Bond issue, which would only begin to come through in banking December.

*Yours*

*John*

A J WIGGINS  
Principal Private Secretary

Banking November  
 £m seasonally adjusted

CGBR		+ 1961
Purchase of central government debt by the non-bank private sector (increase = -)		- 869
of which:		
gilts	- 665	
Treasury bills	+ 23	
National Savings	- 14	
Other	- 213	
Net other public sector		- 43
Sterling bank lending to the private sector		- 10
Sterling bank lending to overseas		+ 492
DCE		+ 1531
External and foreign currency finance adjustment		- 278
Net non-deposit liabilities		+ 104
£M3		+ 1357



Treasury Chambers, Parliament Street, SW1P 3AG  
01-233 3000

*Am. Sh. to the*  
This is in response  
to your concern about  
the swap operation  
last week.

*and* *12*  
*9/12*

PRIME MINISTER

I understand you are concerned about the scale of assistance given by the Bank of England to the money markets last week in the form of forward foreign currency swaps, which will have the effect of avoiding problems in the money markets over the banking December make-up day on 10 December.

2. These operations are designed to relieve pressures in the money markets which would otherwise lead to upward pressure on both short term interest rates and the exchange rate. I believe that neither of these is desirable in current circumstances and as you know the Bank, with my approval, has in recent months been providing assistance to the markets on a substantial scale.

3. Much of the assistance this year has been in the form of purely domestic operations, as you know from our exchanges about gilt sale and repurchase agreements, and relatively little in the form of foreign currency swaps. All the methods of giving assistance have the effect of providing the banks with additional reserve assets to enable them to meet their required ratio, and we think that there is little difference in their monetary impact. In practice

/it is likely that



it is likely that failure to provide assistance would actually add to the money supply in the short run rather than reduce it. This is partly because banks would have to bid for funds in the market if the authorities were unwilling to lend, and partly because a sharp rise in short term interest rates would enable operators in the markets to draw on unused overdraft facilities and reinvest the proceeds in the money markets. So I believe that our policy of providing assistance is quite consistent with the need for monetary restraint.

4. All forms of market assistance by the Bank are undertaken on the basis of guidelines which I have laid down. Major tranches of assistance such as the gilt sale and repurchase facilities are subject to explicit approval in advance. The current procedure for foreign currency swaps is that the Bank inform the Treasury as such assistance is being given, but not in advance. Given the operating guidelines which the Bank works to, the precise amount of assistance in this form which is required in any given month is very much a matter of judgement which only those closely involved in the markets are in a position to make. I believe it would be impracticable to require advance notification in each case.

5. The need for market assistance is, of course, very much the result of the operation of the present reserve asset system. In order to avoid the hindrance to monetary control which it entails, we have agreed to phase out this system as soon as adequate prudential arrangements for the banks can be drawn up, and I hope this will be before the Budget.

G.H.

(G.H.)

8 December 1980

CONFIDENTIAL

FILE



10 DOWNING STREET

From the Private Secretary

8 December 1980

Dean Rd.

MS

As I told you on the telephone, the Prime Minister has been most concerned to read that the Bank last week swapped substantial amounts of dollars across the banking month to ease liquidity pressures over make-up day. Her impression is that this must have inflated the money supply for the current month, just as the earlier assistance to the clearers in the summer did so. She hopes that the Treasury were aware of what the Bank were doing before they took this latest action.

I would be grateful if you could let me have as soon as possible a note setting out the reasons for this latest action, and indicating whether or not the Treasury were aware of it in advance.

T. P. LANKESTER

A. J. Wiggins, Esq.,  
H.M. Treasury.

SECRET

MM  
(Turbo)



## CABINET OFFICE

With the compliments of  
Sir Robert Armstrong KCB, CVO  
*Secretary of the Cabinet*

T. P. Lankester, Esq.

70 Whitehall, London SW1A 2AS  
Telephone: 01-233 8319



CABINET OFFICE

70 Whitehall London SW1A 2AS Telephone 01 233 8319

From the Secretary of the Cabinet: Sir Robert Armstrong KCB CVO

MBM (discussed <sup>with</sup> and  
reviewed <sup>me</sup>)  
R approved in  
minutes  
17/12 by 15 PM

5th December, 1980

Ref. A03764

You sent me a copy of your minute of 5th December to Douglas Wass about the Chancellor's proposed article in the Sunday Times.

I made a number of minor suggestions on the text, but the main point which I discussed with you related to paragraph 7 of the draft, in which the Chancellor proposes to refer to the Cabinet discussion and endorsement of the Medium Term Financial Strategy before his Budget last March.

What is proposed is technically, I think, a breach of the confidentiality of Cabinet proceedings. But, as I told the Chancellor yesterday, I would not wish to stand on that: he has been publicly accused of not consulting his Cabinet colleagues on this, and I think that he must be entitled to say that he did consult them. On the other hand I think that it would be preferable for him not to refer specifically to "a document": such a reference could provoke Parliamentary demands to see it, or even attempts to get hold of a copy by unauthorised methods. I therefore suggested that the paragraph should be recast to read:

"I was determined that this framework should have the full authority of the Government. So I discussed it with my colleagues in the Cabinet before my Budget last March, and they explicitly endorsed the Medium Term Financial Strategy which was subsequently set out in the Financial Statement and Budget Report. The suggestion in last week's Sunday Times that the Cabinet did not know about it and had not approved it before the Budget is quite without foundation."

Since I spoke to you I have once again refreshed my memory of the Cabinet minutes of the discussion in question. The text I have proposed seems to me to be entirely consistent with the minutes.

I am sending a copy of this letter to Tim Lankester.

A.J. Wiggins, Esq.





cc: Mr. Burns  
 Mr. Ryrie  
 Mr. Middleton  
 Mr. Unwin  
 Mrs. Gilmore  
 Mr. Aaronson  
 Mr. Ridley  
 Mr. T. Lankester - No.10  
 Mr. D. Wright - Cab. Office

(R)

SIR DOUGLAS WASS

M. S. W.

par 7

CHANCELLOR'S ARTICLE IN SUNDAY TIMES

..... I attach a further draft of the article, in which I have  
 tried to take account of the Chancellor's comments, and  
 those of Mr. Burns. Could copy recipients please give  
 me suggestions for simplification, shortening etc. as  
 soon as possible.

R

5/12

(par 7)

h.t. for,  
 (A.J. WIGGINS)  
 5 December 1980

DRAFT SUNDAY TIMES ARTICLE

Since I made my Commons Statement on 24 November, I have been more than ever impressed by people's readiness to exaggerate the power of the Government in economic affairs and the speed at which economic change can be brought about. I therefore particularly welcomed the Editor's invitation to explain how I see the Government's role, and to set out the main lines of the Government's economic strategy.

2. It is especially foolish to exaggerate the Government's economic power in the present state of the world economy. The latest round of oil price increases sparked off high inflation and rising unemployment practically throughout the world. In all the Western industrial countries, economic growth has been halted. Now the Gulf War threatens new disruptions. No Government has been able to shield its country's economy from these adverse developments.

3. The post-war history of the British economy only confirms how unrealistic it is to expect rapid solutions to profoundly deep-seated problems. Britain suffers from a sort of economic arthritis, which is all too deeply rooted in our national life: an instinct to resist change and to protect established interests, despite the cost in terms of lost opportunities for development and growth. Governments have repeatedly tried to remedy this essentially supply-side weakness by fiddling about with aggregate demand. But - as the experience of 1978-79 showed with uncomfortable clarity - the economy has shown itself steadily less able to respond to this treatment, and the result has been higher inflation not higher output.

4. So this is why I make no apology for insisting on the need for a long-term approach. Our 1979 Election Manifesto emphasised the severity of Britain's economic difficulties and the length of time it would take to remedy them. We saw the Government's main contribution to be the fostering of a more stable economic climate, with as few sudden changes as possible, and particularly with high and variable inflation eradicated through firm control of the growth of the money

supply. This would give people taking business decisions, including decisions in the field of pay bargaining, a firm framework as a background to those decisions. The point was well put in the policy document "The Right Approach to the Economy" prepared in Opposition in October 1977 by Jim Prior, Keith Joseph, David Howell and myself.

5. We argued there that such a framework, in which monetary targets would be clearly set out and explained, could play a vital role in reducing inflationary expectations. If it is to do this, it is essential that the Government's firmness of purpose should be clearly recognised and understood. For then individuals will know what they have to do to move together towards the achievement of a common purpose - "Democracy is Government by explanation".

6. This is the approach the Government are now carrying forward. Inflation remains the first enemy: getting inflation down is the key to the creation of the stable economic climate on which real progress depends. In my Budget last spring I set out the crucial financial framework without which we cannot hope to succeed - a policy for monetary growth expressed in quantitative terms over a five year period. A commitment of this sort was, of course, implicit in each of the policy documents considered and endorsed by the Conservative Party in Opposition. But it had never before been set out so explicitly and in such detail. And of course it carried with it important implications for the whole conduct of the Government's economic policy including public expenditure and taxation.

7. I was determined that this framework should be specifically reaffirmed with the full authority of the Government. ~~That is why I circulated a document to the Cabinet early in March, which set out the gist of the Medium Term Financial Strategy subsequently published in the Financial Statement and Budget Report.~~ That strategy was, at my request, explicitly endorsed by Cabinet. ~~The suggestion to the contrary in last week's Sunday Times is quite without foundation.~~

rather explicitly done.

8. I realise that setting up this sort of monetary framework ~~has itself no particular attractions, and~~ may seem very arid. It is because I think it so important for Government s not to arouse expectations they cannot satisfy that I have been at pains to reaffirm the validity and relevance of this framework. People should know that over the period of this Parliament the growth of the money supply will be on a firmly declining trend. Over the medium term, money will not be available to finance inflationary pay settlements or price movements. At the same time the monetary framework provides an assurance that as inflation comes down, the money supply will grow at a rate consistent with a reasonable expansion of economic activity. This is what the Government is doing: but in a democracy the Government cannot control people's response to its policies - that has to be up to them.

9. Now how is all this relevant to our present situation, and what had my 24 November statement got to do with it? A medium term approach necessarily abstracts from the various pressures which affect the economy from month to month and year to year. The fact that the Government are pursuing a medium term policy does not mean that current developments should be ignored, or that no adjustments to the balance of policy should be contemplated in the shorter run. We have to find a way to preserve the broad medium term direction of our policy, while at the same time responding sensibly to urgent problems.

10. It is fundamental to the medium term framework that the Government's claims on resources should be cut back. Only if this is done will it be possible to get interest rates down and so give a major stimulus to the development of the productive sector of our economy. Meanwhile, however, the unforeseen depth of the recession adds to the costs of social security benefits, reduces the cash flow of the nationalised industries and calls for a response from the Government in

terms of higher spending on short-term employment support programmes, particularly to help the young unemployed. It is against this background that the Cabinet's recent, and in some ways painful, decisions in the field of public expenditure have to be seen. In broad terms the Government, while maintaining the medium-term objective of reducing the burden of public spending, has accepted that the rate at which reductions in the total can be achieved is bound to be affected by the short-term difficulties we are now facing.

11. But, of course, the problems of the recession affect the rest of the economy as well, and interact with the deep-seated weaknesses I described at the beginning of this article. British industry is now suffering from a double squeeze: that resulting from prolonged failure to control its costs, and that resulting from the impact on the exchange rate of North Sea oil. Meanwhile we have all benefitted as consumers from the higher value of the £ sterling and from the necessity British manufacturers have faced to cut their prices to the bone. Hence the present situation which people who have been able to keep their jobs have generally enjoyed substantial improvements in real living standards, while companies' ability to sustain investment, employment and output has been steadily eroded. One of my main objectives in the decisions announced on 24 November was to do something to redress this financial imbalance; while I could not afford - consistently with the medium term framework - net reductions in Government revenue, those decisions will result in those parts of our economy which are better placed to do so carrying a relatively larger share of the burden. And the recently announced change in arrangements for stock relief will give substantial help to manufacturing industry, on which the pressures are strongest.

12. Of course, we still face major problems and difficulties. Cyclical movements in the economy are bound to make it impossible for us to keep to the exact path set out for the medium term. There is no denying that the money supply has recently been

growing faster than I would wish, or that public sector borrowing has been higher than expected. Nevertheless there are clear signs of underlying improvement: bank lending to industry is likely to fall back as companies adjust the scale of their operations to recessionary conditions, while the Government can look forward to a sharp turnaround in its cash flow, with substantial revenue due early in the New Year. These factors, and the heartening progress in reducing inflation in recent months - with prices increasing during the last six months at an annual rate of less than 10 per cent - made possible last week's 2 per cent reduction in the Minimum Lending Rate.

13. Last week's decisions will have relatively little effect on public sector borrowing during the current financial year. Whether they will achieve the appropriate fiscal balance for next year is something I shall review in my Budget. It may well be that no further adjustment is called for, but I cannot yet commit myself to this. But I am reasonably confident that it will now be possible for the broad path of the money supply needed to realise our medium term plans to be achieved with somewhat lower interest rates than we have had over the past year.

14. This is one of the factors which will help the economy to come out of recession. Provided pay and other cost increases fall in line with the slowdown in inflation, we can look forward to falling interest rates together with improved confidence and competitiveness, and the economy will be able to begin to grow steadily. Sensible monetary discipline is not the enemy of growth, it is a pre-condition for the sort of growth that can be sustained. But we have to be patient: we have to see inflation coming down, and so making more room for expansion within the established monetary framework. Then we can have higher output without the Government rushing into "reflationary" packages which would just rob us of our one hope of future prosperity.

PRIME MINISTER

You asked about the statements in the last two Market Reports that the Bank had "swapped" substantial amounts of dollars into this banking month from the next to ease domestic monetary conditions. As I mentioned to you this morning, this is another way in which the Bank ease the liquidity of the banks from time to time. They take in dollars from the banks and give them sterling in exchange; and the transaction is reversed next month. The Bank's defence is that they had to do this, as in the past with the other measures of liquidity assistance, to prevent large increases in their short-term interest rates; and they did this on this occasion because they were afraid that the interest rate would be pushed up sharply.

sterling

~~sterling~~

If they did it on account of the exchange rate, I must say that I have some sympathy with what they have done. I have been unable to find out how much this latest assistance is likely to add to the money supply; as long as the effect is not too great, I believe we must take some risks in order to hold the exchange rate down. Unfortunately, with the increase in the Fed. discount rate, there may be less upward pressure on sterling in the next few weeks.

?

Duty Clerk  
PP TL

I think that  
the Treasury knew  
before the Bank  
took this action  
cannot be  
surprised. It seems  
that the Treasury  
are aware of  
the need to  
keep up with  
putting up the  
money supply  
not

5 December 1980

1) J  
2) Pm

SECRET

COPY NO

Date

FOREIGN EXCHANGE MARKETS - EVENING REPORT

FRIDAY 5 DECEMBER 1980

International Markets	Yesterday	Today	
	Closing	Opening	Closing
£ Effective Rate	77.20	77.34	77.28
Spot against US \$:			
Sterling	2.3470	2.3403	2.3400
Deutschemark	1.9427	1.9589	1.9587
Swiss Franc	1.7510	1.7665	1.7670
Yen	211.00	212.52	211.22
Gold price	631½	618	617

European Monetary System			Spread	
Divergency Indicators* (%)	Yesterday	Today		
Deutschemark	-54	-58	Top Guilder	3 13/16%
French Franc	+50	+55	Bottom Belgian franc	5 11/16%
Lira	-51	-50	EMS Intervention	
Irish Punt	-14	-25	France +75 (DM)	
*75% = Divergency Threshold			Germany -130 (dollars)	which -105 for Fed
			Denmark +40 (dollars)	
			Ireland -13 (dollars)	

3 month margins and interest rates					
	Yesterday	Today		Yesterday	Today
1 Forward premium/discount	+3 7/16	+4 3/16	4 UK Interbank £	14 5/8	14 7/16
2 Covered margin	-5 1/16	-3 1/8	5 Euro-dollars	18 1/2	19 1/4
3 Uncovered margin	-3 7/8	-4 9/16			

EEA transactions	Today \$m		This Month \$m	
	Spot	Forward	Spot	Forward
a) Intervention :				
i) Market.....	-7		+14	
ii) Government expenditure (inc EEC).....			-18	
iii) Bank customers.....	+48		+85	
iv) Net interest payments.....			+27	
v) Maturities and swaps.....	+39	-38	+33	-32
b) Total Intervention	+80	-38	+141	-32
c) External public sector borrowing (net)			-271	
d) Change in reserves	+80	-38	-130	-32

Reserves:		Spot	Forward
a) Level of reserves at beginning of month.....	\$m	28,189	1,627
b) Level of reserves tonight.....	\$m	28,059	1,595
c) Forecast end-month level.....	\$m	27,635	1,125
d) Forecast end-month total intervention.....	\$m	+358	-502

General Comments: The Fed raised the discount rate by 1% to 13% at the end of trading yesterday and increased the reserve rate for restricted borrowers at the discount window by 1% to 3%. Euro dollar rates have risen in consequence but the markets remain remarkably calm.

M. O'Hara



## DAILY DOMESTIC MARKET REPORT

Friday, 5th December 1980

GILT EDGED MARKET: SUMMARY

	<u>Prices</u>	<u>Yields</u>
Short	$-\frac{1}{8}$ to n/c	+0.14 to n/c
Medium	$-\frac{1}{4}$ to n/c	+0.05 to n/c
Long	$-\frac{1}{4}$ to n/c	+0.04 to n/c
Undated	$-\frac{1}{8}$ to n/c	+0.08 to n/c

FT Government Security Index

70.06(-0.33)

Authorities bought/sold £ 95.9

Million net

EQUITY MARKET

FT Industrial Ordinary Index

470.2 (-8.0)

MONEY MARKETS

	<u>7 days</u>	<u>1 month</u>	<u>3 months</u>	<u>12 months</u>
Interbank	$14\frac{7}{16} (-)$	$14\frac{3}{8} (-\frac{1}{16})$	$14\frac{11}{16} (+\frac{1}{16})$	$13\frac{15}{16} (+\frac{1}{8})$
Treasury bill [Av. tender rate = 12.9977	of 12.9502 on 28/11]			
Local authority			$12\frac{3}{32} (-)$	
£. CDs			$14\frac{3}{4} (+\frac{1}{16})$	
Eurosterling			$14\frac{9}{16} (+\frac{1}{16})$	
Eurodollar	$19\frac{1}{2} (+\frac{1}{4})$	$20\frac{15}{16} (+2)$	$15\frac{1}{16} (+\frac{1}{8})$	$19\frac{1}{4} (+\frac{3}{4})$
Uncovered differential (in favour of £ = +)			$16\frac{1}{16} (+\frac{9}{16})$	
Covered differential (in favour of £ = +)			$-4\frac{9}{16} (-\frac{11}{16})$	
			$-\frac{3}{8} (-\frac{1}{16})$	

FOREIGN EXCHANGE MARKET

% Effective Rate

77.28(+0.08)

£ Rate

2.3400(-0.0070)

Dins Leman.

5th December 1980

SECRET

The gilt market was slightly easier at the opening. Business was on a fairly small scale. The main feature was the large amount of next maturity which was bought in. The market ended the week fairly steady.

## SECRET

## GILT-EDGED OPERATIONS

(Transactions - cash values)

£ million (sales +, purchases -)

	Today	December Banking month
ISSUE DEPARTMENT, BANK OF ENGLAND		
1. Next maturities (up to 12 months)	-92.9	-178.9
2. Variable Rate Stocks	-	-
3. Other short dated (up to 5 years)	-	-3.5
4. Sub-total	-92.9	-182.4
5. Medium dated (5-15 years)	-	+91.6
6. Other dated (over 15 years) and undated	-	-
7. Part payments on gilts sold earlier	-	+377.0
8. Total transactions by Issue Department	-92.9	+286.2
9. TRANSACTIONS BY CRND	+0.8	+13.6
10. CASH REDEMPTIONS	-3.8	-257.3
11. GRAND TOTAL	-95.9	+37.5

## PRICES/YIELDS OF SELECTED STOCKS

Representative Stocks	Price	Yield
12% Exchequer 1984	$97\frac{1}{4}$ ( $+\frac{1}{16}$ )	12.91 (+0.02)
13% Treasury 1990	$102\frac{7}{8}$ ( $-\frac{1}{8}$ )	13.43 (+0.03)
12 $\frac{1}{4}$ % Exchequer 1999	$94\frac{3}{4}$ ( $-\frac{1}{8}$ )	13.39 (+0.03)

Tap (and recently issued) stocks	Outstanding: Dept. Holdings	Issue	Price of Issue or Last Sale
----------------------------------	-----------------------------	-------	-----------------------------

11 $\frac{1}{2}$ Treasury 1989	£995m	$29\frac{3}{8}$ ( $-\frac{1}{8}$ )	13.27 (+0.03)	30
Known Future Transactions		Part payments (+) due on stocks already sold		Redemptions (-) of stock outside Issue Department
(£ million)				
Dec. banking month		-		-
Jan. banking month		+490		-580
Feb. banking month		-		-

Yield Curve Rates	5 years	10 years	20 years
at close	13.11	13.47	13.37

SECRET



*Grant pd*

Treasury Chambers, Parliament Street, SW1P 3AG

*12*  
1 December 1980

*FL*  
T P Lankester Esq.  
Private Secretary  
10 Downing Street  
LONDON  
SW1

*n/w*

*Dear Tim,*

STATEMENT ON MONETARY POLICY BY PAUL VOLCKER

I understand that the Financial Secretary mentioned to the Prime Minister on Friday morning a speech given by Paul Volcker, Chairman of the Federal Reserve Board, and that the Prime Minister expressed some interest in seeing this.

I thus enclose a copy of Mr Volcker's statement which you might like to show the Prime Minister. The side-linings and underlinings are the Financial Secretary's own.

*Yours ever,  
Stephen*

S A J LOCKE  
Private Secretary

PART 6 ends:-

CSD to HMT 26.11.80

PART 7 begins:-

FST Office to TL 1.12.80