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PREM 19/696

Domestic Monetary Policy

PART 9

ECONOMIC POLICY

PART 1 MAY 1979

PART 9 MARCH 1981

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~9.9.81~~		~~7.1.82~~					
~~15-9-81~~		~~13.1.82~~					
12.9.81		~~26.1.82.~~					
~~2.10.81~~		~~29.1.82~~					
~~8.10.81~~		1.2.82					
~~13.10.81~~		-Pt Ends-					
~~29.10.81~~							
30-10-81							
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~~23.11.81~~							
~~2.12.81~~							
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~~15.12.81~~							

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Dd 533270 5M 2/78 8362633 JET

PART 9 ends:-

ADJ to JC 1/2/82

PART 10 begins:-

Treasury to MCS 1/2/82

10 DOWNING STREET

~~JV~~ → W.R.

OK by me
JV
1/2

You might like to check the pay passage towards the end (we exchanged minutes on Goldsmith's letter earlier).

Pl. return to W.R.

BG.
1/2.

cc PI copy to AW
MCS

SECRET

Prime Minister

I am told that the undisclosed band may well be reduced by ½% on Monday.

MCS 29/1

23

PRIME MINISTER

INTEREST RATES

1. The appreciation of sterling this week suggests that it would be a propitious time to take action to move dealing rates down again. another half a percentage point. Although it looks likely that the percentage increase of M3 during the month will be about 1½%, all the information suggests that the narrow aggregates will be well contained.

2. I have spoken to the Bank (John Fforde) about the need to take every opportunity to reduce interest rates under these favourable circumstances. The Bank were rather hesitant and prefer to wait until next week when new pieces of information, such as the American money supply figures and further information on monetary aggregates will be available. I consulted with Peter Middleton and we are agreed that, provided there are no drastic changes in the environment, next week would be an appropriate time to put some pressure on the dealing rates. I believe that the Chancellor will be writing to you along these lines.

3. I do not think there is any need for your intervention at this stage. If we get into any difficulty next week, then I will come and see you immediately.

29 January 1982

ALAN WALTERS

SECRET

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000 29 January 1982

W Rickett Esq
Private Secretary
No.10 Downing Street
LONDON SW1

Dear Willie,

Your letter of 7 January refers.

I attach a reply for the Prime Minister to send to Mr Goldsmith. The draft reflects discussion at official level with other Departments.

I am copying this letter to Marie Fahey, Department of Employment, Johnathan Rees, Department of Trade, Richard Riley, Department of Industry and Douglas Board, Management and Personnel Office.

Yours sincerely,

Jill Rutter

JILL RUTTER
Private Secretary

DRAFT LETTER TO WALTER GOLDSMITH

Thank you for your letter of 6 January enclosing a copy of your speech outlining proposals for a "workers' charter".

I found many of the proposals interesting and imaginiative. I certainly recognise the importance of the two main themes developed in the speech - the need to provide ways of linking individual employees more closely with the private enterprise system and the relationship between pay and economic performance. Could I offer some comments on both themes and on some of the particular proposals you have in mind?

I share your view that the wider ownership of shares and property is a valuable means of achieving a closer identification of employees' interests with our free enterprise system. Promoting the wider ownership of assets has been a principal strand of Government policies and we have already taken some important steps - the 1980 Finance Act provisions to encourage employee share ownership schemes and the increased sale of council houses are major examples. We will, of course, continue to examine the possibilities of further action. But, as my comments on some of your particular ideas show, neither the progress made so far, nor the difficulties of going further, should be underestimated.

I was particularly interested to see the suggestions for income and capital tax changes in your speech. I believe that you put these forward at the meeting which you had with Geoffrey Howe and Arthur Cockfield before Christmas when the Institute's Budget representations were discussed. I know too that you have had separate talks with Nicholas Ridley and with Inland Revenue officials, about your idea for a new special tax exemption for people moving into self-employment, and I believe you are reflecting further on it. We shall certainly look very carefully at all your ideas. But, as I am sure you understand, I cannot anticipate the Budget.

I also appreciate the importance you attach to tax changes that will encourage profit-sharing and employee shareholding. The numbers participating in such schemes have grown substantially since the 1980 legislation: an independent study estimated recently that companies employing a total of over 1.5 million people now operate employee share schemes. We will, however certainly look further at your proposals to encourage the expansion of such schemes.

/On the

On the nationalised industries, we are as you know concerned to make rapid progress with our policy of reducing the size of the public sector. That being so, I entirely agree with your stress on the need for imaginative thinking on the many opportunities in this area. The role your Institute has played in examining and putting forward new ideas has been particularly welcome. We have in fact looked at one or two schemes on the lines of your proposed free transfer to taxpayers of marketable shares in the assets of certain nationalised industries, but concluded that these were impracticable.

More generally, there are real difficulties in any attempt to spread formal ownership of assets remaining within the control of the public sector, and which will continue to be seen as guaranteed by the Government. You are quite right to emphasise the benefits of wider share ownership; but in the nationalised industries the best way by far to achieve this is through full privatisation. This ensures that responsibility for the assets - as well as ownership - passes to the private sector purchasers. In addition, in each of the major public sector sales so far, we have taken steps to encourage the purchase by employees of shares in the industry concerned. These schemes have all been most successful, with a high proportion of employees taking up their rights under preferential arrangements.

Turning now to your suggestions on Civil Service efficiency and incentives, One of the objectives of the new Management and Personnel Office is to find ways of enabling staff to give of their best, as part of the central aim of promoting efficiency across the Civil Service. Our White Paper "Efficiency in the Civil Service" (July 1981) shows that much has been done. But further concentration on these issues will, I am sure, create a more positive working environment for line managers in the Service.

I agree that staff suggestion schemes can be important motivational instruments in an organisation. The Civil Service has had a variety of such schemes for many years, and has just revised them to stay in line with outside practice. The Government also continues to seek ways of improving incentives in the Civil Service. We have, as you know, appointed an independent Inquiry, chaired by Sir John Megaw to make recommendations on the principles and system for determining pay in the non-industrial Civil Service. Among the issues which we have asked the Megaw Inquiry to look into are the scope for relating pay more closely to performance, whether for individual staff through merit pay schemes or more generally through some form of productivity pay.

I wholly agree with you that we need a better qualified workforce. In education, I believe the right course is to encourage schools to offer a broad curriculum, with scope for development of those personal qualities to which employers rightly attach great importance, and to make as much of the curriculum as possible interesting, relevant and practical. The Government remains committed to the extension of parental choice and involvement in education. Keith Joseph is now seeking to stimulate thinking about education vouchers and I am sure he will be happy to discuss this and the more detailed points on education you make when you meet later this month.

I agree with you that our present training arrangements leave much to be desired, especially in comparison with our major competitors. We recognised in the White Paper on a New Training Initiative that the time had come for the Government to give a lead in securing the necessary reforms. The White Paper sets out a framework within which employers, employees, unions, educationists and the Government can identify the problems more clearly and determine who is primarily responsible for tackling them.

As you say in your speech, the weakness in the current system starts with our provision for young people. The young unemployed clearly deserve the highest priority, but we have to ensure that they are offered more than merely cosmetic opportunities. We are therefore already building towards the new Youth Training Scheme which, from September 1983, will guarantee all 16 year-old school leavers who cannot find a job a year's genuine foundation training. But there is also a need for better training for young people once they have started work. I see this as primarily the responsibility of employers, so I am loth to agree that legislative encouragement is necessary, as I think you suggested in your speech. Instead, I prefer an approach based on what might be called "assisted voluntarism". As part of this, the Government is expanding the scheme of grants to employers who provide integrated vocational training and further education for their young employees.

Finally, I should like to comment on the other main theme of your letter and speech - pay. I certainly agree that achievement needs to be rewarded. But I think that there is a risk of misunderstanding if the case for such rewards is represented as being in conflict with the case for pay restraint. Within the monetary framework which the Government has set, our achievements in terms of increased output depend not least on realistic

/decisions on

decisions on pay by both sides of industry, and in both the public and private sectors. To appear to question the importance of pay restraint and urge rapid movement to higher pay rewards will only impair output and employment prospects if, as I fear, it stimulates pressure for pay increases. Care is also needed in suggesting that improved profits should feed into pay, because the need to rebuild low profit levels can easily be overlooked. As you know the real pre-tax rate of return in manufacturing fell from 13 per cent in 1960 to only 2 per cent in 1980. Better returns are needed to increase both the incentive to invest and the means available to finance it. That, ultimately, is the way to an economy which can provide high rewards, whether through pay or profits.

Thank you for setting out your views so clearly and for the imaginative work which underlies the "Workers Charter". You have already been in touch with some of the Ministers concerned to follow up particular proposals. I am sure that both you and my colleagues will find this helpful in developing ideas in these important areas.

29 JAN 1982

cc Governor's Office 22.

DS

✓cc B Fall (FCO)
AW

10 DOWNING STREET

From the Private Secretary

26 January 1982

BF 9-2-82.

Monetary Policy

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

Bank Lending for Housing

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

BF

Short Term Interest Rates

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

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

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

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

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

Medium Term Financial Strategy

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

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

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

De-restricted Indexed Gilts

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

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

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

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

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

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

Yours sincerely,

Michael Scholar

John Kerr, Esq.,
HM Treasury.

SECRET

SECRET

Draft letter to John Kerr, HM Treasury

Monetary Policy

The Prime Minister discussed monetary policy this morning with the Chancellor, the Economic Secretary and the Governor of the Bank of England. Sir Douglas Wass, Mr. Middleton, Mr. Burns, Mr. George and Mr. Walters were also present. The agenda for the meeting was that attached to your letter to me of 12 January.

Bank Lending for Housing

The Prime Minister began by enquiring about the Bank's Notice dated 20 January about lending on mortgage for house purchase. It was explained that the purpose of this guidance was to act on the growth of bank lending to the personal sector for consumer spending which was enjoying the tax relief for house purchase and improvement. The growth of bank lending in recent months had been disturbingly high and a worryingly component had been the strong growth in lending to the personal sector which was a by-product of the increasing competition between banks and building societies. The Prime Minister said that her immediate reaction to the Notice had been that it was designed to stop the kinds of lending which she would like to see encouraged. What was the objection to someone moving houses increasing their mortgage and realising their capital profit in order, say, to

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Short-term Interest Rates

The Governor said that sterling interest rates had fallen each day in the week. The Bank's dealing rate was now 14%. The three month rate on Thursday night was 14¾% - down from 15 and 9/16ths%. The yield curve was now almost wholly flat. These moves had been much assisted by the decisiveness of the miners' ballot, and by what was seen as a concerted drive across Europe to reduce rates. Sterling had remained strong throughout the week. The Governor felt confident that one or other of the clearing banks would be urgently considering a reduction in base rates. (Some moments later a message was brought to the meeting that National Westminster Bank had just brought down its base rate by ½% to 14%.) In discussion,

In discussion, it was agreed that the principle threat to lower European interest rates was the likely movement in the US dollar rates. At the moment they were rising: close on Thursday the three month sterling rate was nearly $^{1}/16$th% above the equivalent Euro dollar rate. Today's money supply figures would be important. Their interpretation might well, again, be enormously different, and it was a matter for regard that the market was subject to destabilising fluctuations once a week as these unprocessed figures were published. There was wide international agreement on the desirability of stabilising financial markets. It was difficult, however, to identify a practical way of making progress. One way forward would be a decision by the American authorities to intervene to smooth out the biggest fluctuations. But, as a matter of doctrine, they were unwilling to do so, although the threat to market stability posed by their stance had become much more than a mere technical problem.

The Chancellor said that, more important even than this was the need to bring home to the administration the damage to the West which would be brought about by an excessive US deficit over the next 12 months. Donald Reagan and Paul Volker were advising that a deficit on the scale currently being envisaged, of $100, or even $150 was far too large. Mr. Burrell Sprinkel, on the other hand believed that markets could be persuaded to accommodate such sums. It would be essential to involve President Reagan; it was encouraging that Mr. Haig now saw the

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

Medium-term Financial Strategy

Mr. Burns said that sterling M3 had for some considerable time been giving misleading signals about the tightness of our monetary stance. M1 had at times been an important indicator, and it was necessary to look at both the wide and the narrow aggregates, together with the exchange rate, particularly when institutional changes in markets were taking place. Sir Douglas Wass said that they were putting a number of options to the Chancellor. One of these was the possibility of an arithmetical formula which gave weight both to sterling M3 and to M1. The Chancellor said that he hesitated to move to a formula. It

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

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

/ De-restricted Indexed Gilts

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

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

/ Summing up

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

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

22 January 1982

CHANCELLOR OF THE EXCHEQUER

CONFIDENTIAL

NOTES ON MEDIUM TERM FINANCIAL STRATEGY

1. The predicted monetary growth that is consistent with forecasts of GNP and interest rates shown in the Burns' draft of the financial strategy average about 13 or 14% over the three years from 1982/83 to 1984/85.

2. This contrasts dramatically with our present M1 trend. Over the past three years it has been about 8%, and has been running at something like 5 or 6% over the last six months or year.

3. It takes a leap of a sophisticated imagination to believe that a move from 8 or 6% to 13% in monetary growth is a counter-inflationary strategy. I suspect this is one of the main reasons why Terry Burns is unhappy with putting the strategy forward in such a form. As we saw last Thursday, thinking around the table, put into more or less precise form by Patrick Minford, was that the M1 growth should be round about 5 or 6% (or say a range from 4-7%). Clearly this very sophisticated group were not thinking in terms of rates which are in the 13-14% range.

4. The 13-14% rate is high mainly because of the predicted effects of falling interest rates. It is worth noting however that a fall in interest rates will have a once and for all effect on the M1 absolute figure. If interest rates then remain where they are, the rate of growth of M1 will resume its trend value with respect to nominal GDP.

5. Thus the high figures for M1 depend critically on first the predicted effect of interest rates on M1, and secondly on the detailed dynamic reaction and time path of the adjustment process. This contrasts with my figures which abstract from this adjustment process; they are so to speak agnostic with respect to the change in interest rates as distinct from their absolute level.

6. My difficulties with the Burns figures arise from a number of considerations. First they hinge critically on (a) a forecast of interest rates in the dynamic context of the next three years, and

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(b) the reaction of M1 balances to these interest rates, and
(c) the adjustment period and process of the adaptation to changed interest rates. I am nervous about making our MTFS hostage to all these dubious predictions. Interest rates have differed very considerably from our forecasts in the past, and there is no reason to suppose that they will be more amenable in the future. Similarly, the reaction of M1 to interest rates may change. (The experience over 1980/81 has shown us that in the short run there was some perversity in the relationship between M3 and interest rates.) Most important, however, is the period of adjustment. We are entering an environment very different from the history of the past decade. It would be dangerous to rely on relationships whichwere derived in the seventies and perhaps sixties in order to predict what will happen in the mid-eighties.

7. The Burns memo raises the prospect that the banks will start paying interest on sight deposits (para 26) and suggests that a low M1 target would be very risky. That indeed makes a point in favour of M1 since the banks argue that the transaction costs of checking accounts are about 9%, so as interest rates fall to 9-10%, the banks will reduce the interest paid on checking accounts to virtually zero thus contracting the M1 figures and not increasing them as interest rates fall.

8. In my view we should be concerned with the trend rates of growth of monetary aggregates and should not publish them for any particular year but only specify them for a period of three years. In broad terms, the numbers should be:

Currency about 3-4%

MO: 4-5%

M1: 5-6%

M3 say 8-10%

PSL2: 8-10%

These are the expected growth rates over a three year period. In any particular year the growth rates may deviate considerably from the three year average.

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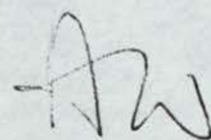
9. These growth rates are roughly for unchanged interest rates. We do not know in detail what interest rates will rule over this period, because of international factors etc, and the growth rate in any particular year, and especially the growth rate of M1, may be much affected by movements in interest rates. It is impossible, however, to predict with any certainty either the changes in interest rate and the effect which those changes are likely to have, transitorily, on the M1 growth rate.

10. Similarly, the figures do not take into account possible institutional changes which may affect the meaning of some magnitudes. These effects will have to be taken into account as they arise.

11. My preferred objective is really to carry on with the original version of the medium term financial strategy, but to remove those elements which gave rise to political criticism, occasionally, misleading monetary policy. In the main, however, I believe that the MTFS was a great success. Except for a brief period in 1980, it delivered very good monetary policy. The problem was that, in terms of the M3 targets, it did not look good. This is the main thing that needs to be revised. I believe the best way to do this is to announce the targets over a three year period and enter, indeed emphasise, the caveats which will allow amendment of the targets, yet be consistent with that steady downward monetary pressure which we all want to see.



25 January 1982

ALAN WALTERS

cc Chief Secretary
Economic Secretary
Financial Secretary
Ministery of State (L)
Minister of State (C)

CONFIDENTIAL

Prime Minister

MLS 25/1

(2)

L. MESSEL & CO.

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21st January, 1982.

Over the last three years bank lending has boomed. Between November 1978 and November 1981 advances and acceptances in all currencies to UK residents jumped from £45.4b. to £77.4b. - or by over 70%. The rise is all the more extraordinary because it has taken place against the background of severe economic recession.

One of the recession's most surprising features is that productivity growth has been very rapid. Normally, productivity declines during economic downturns. But between the third quarters of 1980 and 1981 output per person in manufacturing industries went up by 7.5%. Are the surge in bank lending and the productivity improvement related? In this note, we argue that they are. First, an important element in the lending rise has been the growth of leasing, which is followed by investment in capital assets, higher capital/labour ratios and more output per head. Secondly, there is some evidence that lending to manufacturing has been channelled towards the promising areas (the "sunrise industries", to use the CBI's terminology) and away from industries in decline (e.g. textiles).

The contribution that the banks have made to the productivity gain has been made possible by their freedom from credit restrictions and burdensome reserve requirements. Any return to the lending guidelines and controls of the 1950s and 1960s would therefore be very unfortunate. The remarkably liberal environment in which British financial institutions now work has promoted the efficiency of the "real" economy.

Tim Congdon

Prime Minister

(a) This is a "good news" account of bank lending. It is, I believe, substantially correct and a useful antidote to the fears of credit rationing (see David Blake in Times 25/1/82)

(b) Congdon does not deal with the expansion of bank credit to persons. However I suspect he would point to the fact that it has certainly not been reflected in prices — house prices have been apparently falling, consumer durables are sluggish, and the stock exchange shows no evidence of boom conditions. (cf 1971-2).

AW 25/1

THE BOOM IN BANK LENDING:
IS IT RELATED TO THE SURGE OF PRODUCTIVITY GROWTH?

Several puzzles hinder the interpretation of British economic trends at present. One is the extraordinary strength of bank lending at just that point in the cycle when it should be at its most feeble. Another is the conjunction of economic stagnation and improving productivity. Normally, productivity deteriorates when output declines. Thus, in the last major recession output per person employed dropped 3.3% between 1973 and 1975. By contrast, output per person employed is likely to be higher in 1981 than in 1979, despite production and employment falls far greater than in the mid-1970s recession.

Are these two surprises related? The function of the banking system is to direct loans to the most profitable and productive parts of the economy. It may be that bank lending is buoyant because finance is required for new industries with good productivity performances. The credit they are now receiving will facilitate their future expansion and, hence, general economic growth. The aggregate bank lending numbers will not tell us whether this is happening. Instead, we need to analyse the composition of bank lending. If lending to promising sectors of the economy is increasing more than to the unsuccessful sectors, the banking system is performing its role and aiding efficient resource allocation.

Recent figures from the Bank of England, the quarterly analysis of advances and acceptances to UK residents, published on 31st December provide some evidence on this question. In the following three sections we examine trends in bank lending over three periods - the three years to November 1981; the year to November 1981; and the last quarter.

1. The sectoral composition of bank lending

There is a striking contrast in the sectoral pattern of bank lending. Lending to persons and services has expanded quickly in the last three years, with the rate of growth accelerating in recent quarters; lending to manufacturing and the financial sector has risen more slowly, with a tendency to deceleration. The top half of Table 1 demonstrates the point very effectively. It nevertheless exaggerates the divergence between manufacturing and services because it excludes acceptances and borrowing in foreign currencies. The bottom half of Table 1 refers to "advances and acceptances in all currencies". Lending to persons shows substantial growth, but the disparity between the other four sectors has narrowed greatly. In fact, over the three years to November 1981 lending to manufacturing went up only 10% less than total lending.

2. Bank lending to the services sector

The figures for the services sector give a highly misleading impression of the ultimate destination of bank finance. The reason is that "services" include a category called "professional, scientific and miscellaneous" which is dominated by leasing. Most of the assets acquired by leasing arrangements are for the use of companies in "manufacturing" and "other production". Over the last three years leasing activity has exploded as more companies have become aware of the tax advantages. The point is emphasised in Table 2. Lending to the "professional, scientific and miscellaneous" group soared by almost 150% between November 1978 and November 1981 lending to other "services" groups went up by 40.8%, less than manufacturing. It is a matter of guesswork how much of the "professional, scientific and miscellaneous" lending was, in fact, to acquire leased assets for manufacturing and "other production". If we assume that, without leasing, "professional, scientific and miscellaneous", would have gone up by the same as other services, we can calculate a £3b. figure for leasing over the last three years. Of this £3b., £2b. may have gone to manufacturing, £½b. to other production and another £½b. to retailing etc. (i.e. remaining within the service sector). (The Department of Industry estimates that manufacturing industry leased £1,720m. at 1975 prices from service industries in the three calendar years 1979-81. The numbers are broadly comparable.)

Table 1 The sectoral composition of bank lending

all figs. in £m.	Sterling bank advances to:					
	Manufacturing	Other production	Financial sector	Services	Persons	Total
1978 Nov. 15	8,457	4,061	4,468	8,521	5,838	31,345
1980 Nov. 19	13,004	6,041	5,979	14,420	9,040	48,484
1981 Nov. 18	12,909	6,856	6,899	18,817	12,816	58,297

	% change in sterling advances in:		
	3 years to 18. Nov. 1981	Year to 18 Nov. 1981	Quarter to 18 Nov. 1981
Services	+120.8	+30.5	+9.7
Persons	+119.5	+41.8	+11.0
Other production	+68.8	+13.5	+0.3
Financial	+54.4	+15.4	+2.2
Manufacturing	+52.6	-0.8	-1.1
Total	+86.0	+20.2	+5.4

all figs. in £m.	Advances and acceptances in all currencies to:					
	Manufacturing	Other production	Financial sector	Services	Persons	Total
1978 Nov. 15	11,806	5,120	8,197	14,453	5,848	45,424
1980 Nov. 19	17,583	7,209	10,048	19,678	9,078	63,596
1981 Nov. 18	18,897	8,523	12,656	24,499	12,871	77,446

	% change in advances and acceptances in all currencies to:		
	3 years to 18. Nov. 1981	Year to 18 Nov. 1981	Quarter to 18 Nov. 1981
Persons	+120.1	+41.8	+11.0
Services	+69.5	+24.5	+8.6
Other production	+66.5	+18.2	+3.1
Manufacturing	+60.1	+7.5	+2.4
Financial	+54.4	+26.0	+7.1
Total	+70.5	+21.8	+6.5

Sources: Financial Statistics, Bank of England's quarterly analysis of bank advances.

Table 2 Bank lending to the services sector

	Advances in all currencies to: Professional, scientific and miscellaneous		Other services		Total services
	£m.	%age of total	£m.	%age of total	£m.
1978 Nov. 15	3,601	26.4	10,054	73.6	13,655
1980 Nov. 19	6,343	34.6	12,000	65.4	18,343
1981 Nov. 18	8,982	38.8	14,156	61.2	23,138
%age increase in:					
3 years to 18 Nov. 1981		149.4		40.8	69.5
Year to 18 Nov. 1981		41.6		18.0	26.1
Quarter to 18 Nov. 1981		11.5		6.5	8.4

Source: Financial Statistics, Bank of England's quarterly analysis of bank advances.

Adding in these numbers to each of the main sectors' total borrowing, lending to manufacturing has actually risen rather more than lending to services over the last three years. But there is not a particularly wide dispersion between the growth of the various sectors' borrowing, except for persons.

3. The composition of lending to manufacturing industry

The key question here is "how much of new bank lending is being directed to promising industries (e.g. electronics, offshore equipment) and how much to declining industries (e.g. textiles, metal manufacturing)?" The figures in Table 3 give some of the evidence needed to answer this question.

The most remarkable feature of the table is the spectacular differences between various industries. In general, finance is going to industries with good growth prospects, such as electrical engineering, while the laggards (textiles, shipbuilding) have not been receiving new funds. But there are exceptions, notably the big jump in lending to vehicles, which may be accounted for in large part by government-guaranteed loans to British Leyland. A more emphatic demonstration that bank lending is helping resource reallocation is elusive because we do not know which industries received the £2b. estimated for leasing. But, as most leasing is related to capital investment, it cannot be distress borrowing due to involuntary stockbuilding, inability to cover debt service charges and so on.

A reasonable conclusion is that the banks are directing funds in the "right" direction, away from declining industries and towards promising industries. To recall one of Mr. Healey's pet phrases, it is "picking winners". As that should be in the long-term interests of their shareholders, the banks' behaviour is not surprising.

Conclusion

In terms of absolute amount, the biggest recipient of new bank finance over the three years to November 1981 was the corporate sector, even though lending to persons recorded the highest growth rate. Two conclusions seem justified by our analysis.

Table 3 The composition of lending to industry

all figs. in £m.	Advances in all currencies to: Food, drink and tobacco	Textiles	Electrical engineering	Chemicals	Metal manufacture
1978 Nov. 15	1,771	859	811	2,098	552
1980 Nov. 19	2,666	1,052	1,385	2,347	841
1981 Nov. 18	2,746	991	1,386	2,737	848

	Other engineering and metal	Shipbuilding	Vehicles	Other manufacturing	Manufacturing total
1978 Nov. 15	1,911	556	449	1,657	10,647
1980 Nov. 19	3,022	640	936	2,989	15,968
1981 Nov. 18	3,106	664	905	3,160	16,433

% change in:	3 years to 18. Nov. 1981	Year to 18 Nov. 1981	Quarter to 18 Nov. 1981
Vehicles	+101.6	+3.3	-20.4
Other manufacturing	+90.7	+5.7	-3.3
Electrical engineering	+70.9	+0.1	-7.4
Other engineering	+62.5	+2.8	-4.2
Food, drink and tobacco	+55.1	+3.0	+9.9
Metal manufacture	+53.6	+0.8	+2.3
Chemicals	+30.5	+16.6	+6.0
Shipbuilding	+19.4	+3.8	-3.5
Textiles	+15.4	+5.8	-5.3

Sources: Financial Statistics, Bank of England's quarterly analysis of bank advances.

First, the superficial impression given by the figures is that lending to the service industries has expanded much more rapidly than to manufacturing. This impression is highly misleading. When corrections have been made for lending in foreign currencies and leasing, the rates of growth of lending to services, manufacturing, "other production" and the financial sector do not show major divergences over the last three years. With such a significant part of total new borrowing being performed via leasing, which normally involves the purchase of capital goods, it is quite clear that buoyant bank lending has been instrumental in maintaining high investment. (Total capital expenditure by British industry in the three years 1979-81 was 23% higher than in the previous three years.) The result has been an increased ratio of capital to labour. The associated jump in labour productivity is quite logical. In this respect, it seems that the boom in bank lending and rising labour productivity are related.

Secondly, the pattern of bank lending to manufacturing broadly conforms to the relative prosperity of different industries. Because of the importance of leasing, and the difficulty of determining to which particular industry the associated funds are being directed, we cannot be completely confident that new finance is going to the areas which are now regarded as most hopeful for the 1980s. But there is something reassuring about the contrast between the jump in lending to electrical engineering and the much more subdued rise in lending to textiles and shipbuilding. Certainly the figures, with the large divergences between particular industries and the role of leasing, undermine the view that recent bank borrowing has been solely to cover the financial emergency faced by many companies in the last three years. Here, again, it seems that we have found reasons for thinking that the boom in bank lending and rising labour productivity are related.

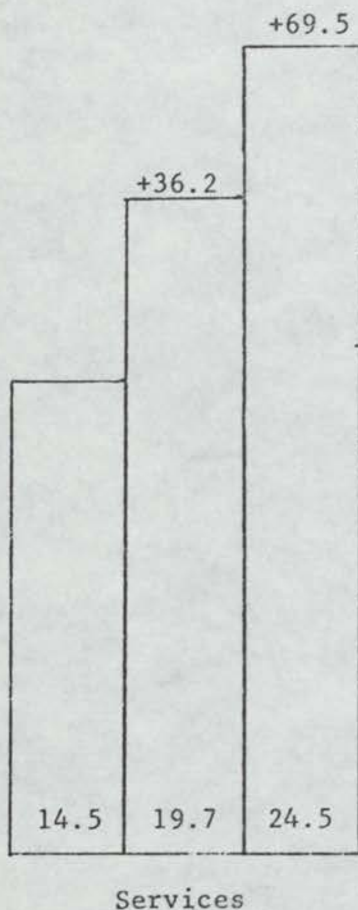
The British banking system is at present one of the freest and least regulated in the world, in sharp contrast to its position in the 1950s and 1960s. It has celebrated its new-found liberty with an explosion of lending to companies and individuals. We have argued here that the corporate lending has contributed to the much improved productivity performance of the last two years. This is, after all, what one would expect. The banks will make most profits if their lending is to industries which have good growth prospects.

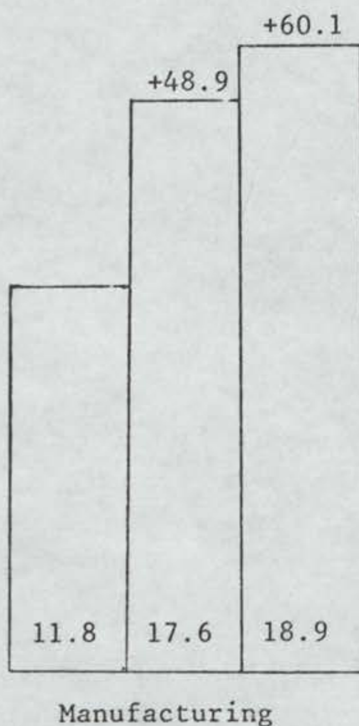
Not much comment has been made here about lending to persons. The increased competitiveness of the banks in this field may in due course result in a rationalisation of the financial system, with building societies and hire purchase companies experiencing a shake-out like manufacturing industry over the last three years. The efficiency gains could be considerable. Unrestricted personal sector credit also enables individuals to time their consumption and saving when they wish, which must be more beneficial to them than if official controls prevent them borrowing.

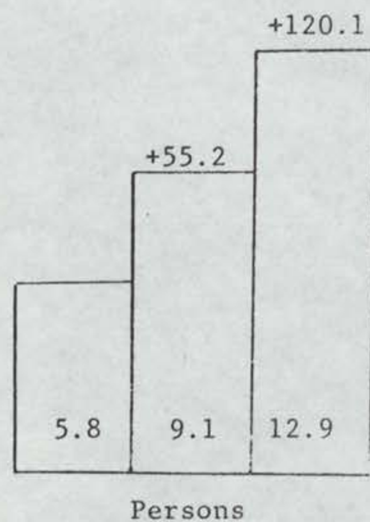
The message is clear-cut. A free financial system promotes economic growth and consumer welfare. Any return to lending restrictions, whether of the crude quantitative form so common in the 1960s or the more discreet qualitative guidelines against personal sector credit enforced in the 1970s, would be retrograde and undesirable.

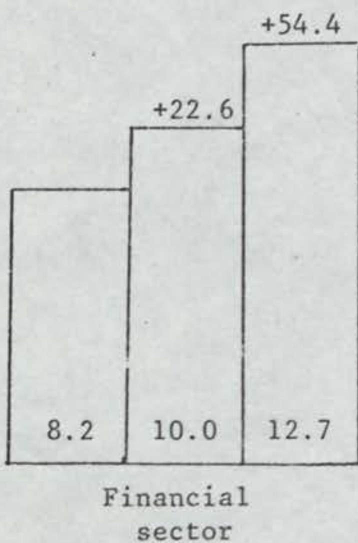
Bank lending to the five major sectors of the economy 1978-81

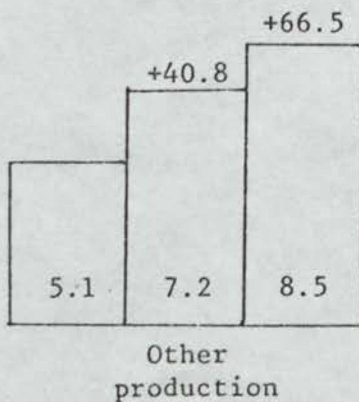
1. Unadjusted, no allowance made for the effect of leasing on the split between services and manufacturing.

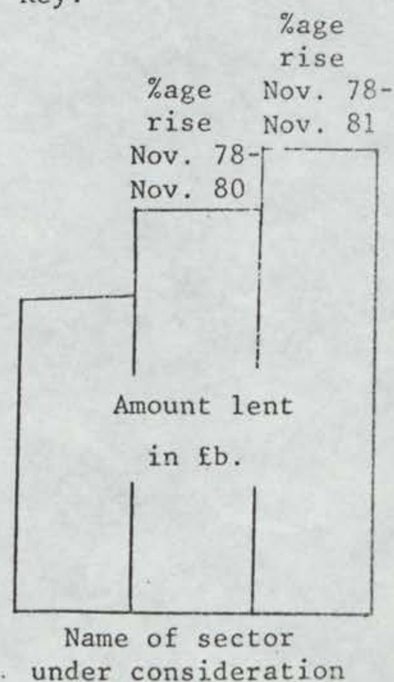




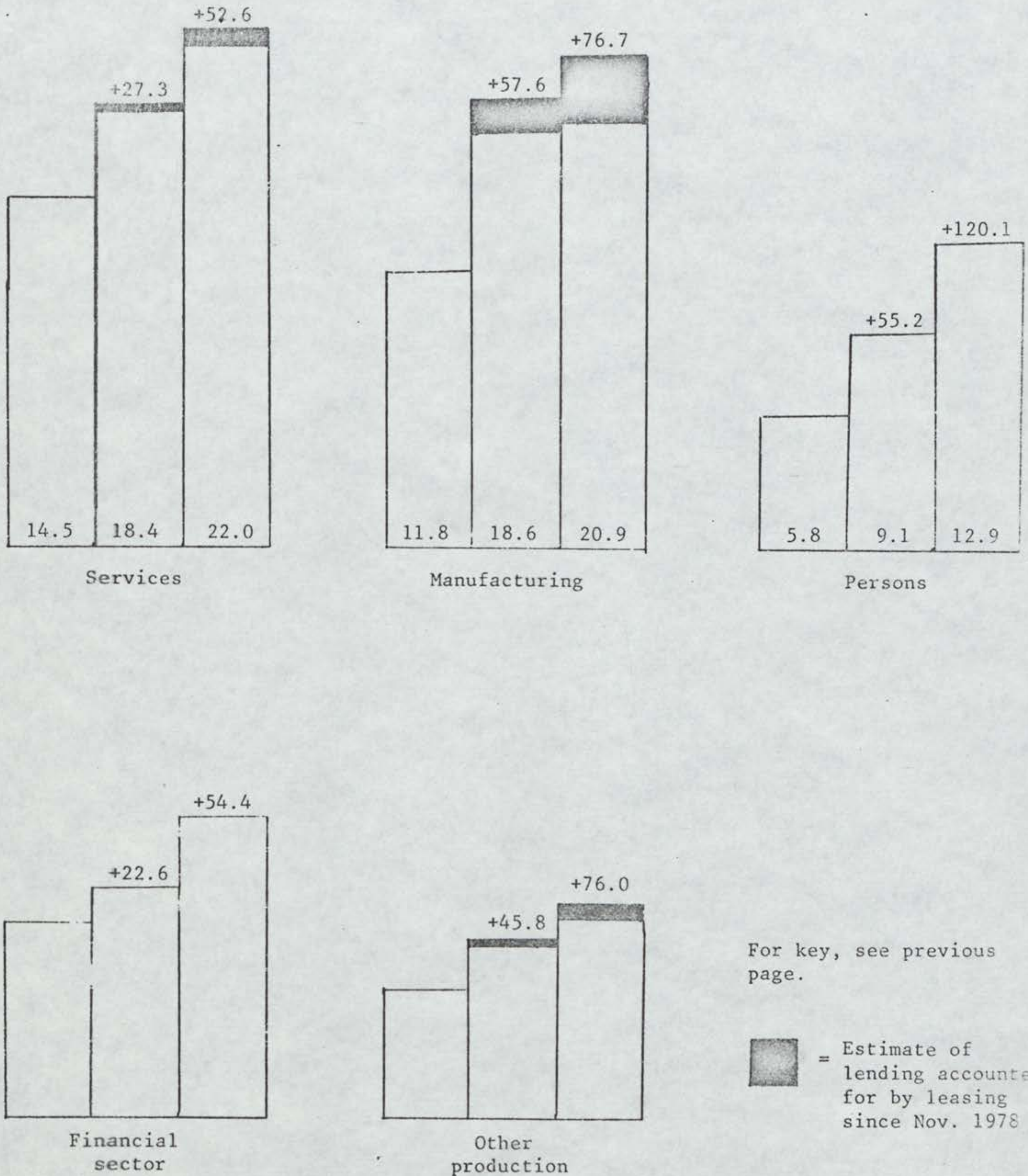








2. Bank lending by sectors, adjusted for effect of leasing on the split between services and manufacturing.



Prime Minister
MCS 29/1

RECORD OF A MEETING IN THE CHANCELLOR'S ROOM, TREASURY CHAMBERS, AT 15.00 ON 21 JANUARY 1982

Present:

Chancellor of the Exchequer	Mr Althaus,	Pember and Boyle
Chief Secretary	Mr Congdon,	Messels
Economic Secretary	Prof. Eltis,	Exeter College
Sir K Couzens	Mr Gilchrist,	Union Discount
Mr Ryrie	Prof. Griffiths,	City University
Mr Burns	Mr Hamilton,	Fielding, Newson, Smith
Mr Middleton		
Mr Ridley	Prof. Minford,	Liverpool University
Mr Kerr	Mr Pepper,	Greenwells
Mr H Davies	Prof. Rose,	Barclays
	Prof. Walters,	10 Downing St.

MONETARY ISSUES

The Chancellor reminded participants that the proceedings were private. Mr Kerr's letter of 18 January had set out a number of questions, which he proposed to take in order.

(a) Current financial conditions - tight or loose?

2. Professor Griffiths said that the broad and narrow aggregates told rather different stories. From the recent behaviour of the monetary base and M1 one might judge that policy had been tight, whereas £M3 and PSL2 (which was more useful in view of the current distortions to £M3) had been growing more rapidly - and of course their record as predictors of inflation was better. But to judge the tightness of policy one needed to make an assumption about objectives. If the aim was to have inflation in single figures in 18 months time the policy was rather loose. If we were focussing on the pace of recovery it was tight. Mr Pepper saw the experience of the last two years as exceptional. The growth rates of £M3 had been badly distorted for a number of reasons. It was dangerous to put too much weight on the narrow aggregates - they had given the wrong signal in 1972/3 - but one should not ignore them in current circumstances. He saw a danger that policy could become too tight and thereby threaten the recovery. The major difficulty we faced was that unless an alternative source

of finance for companies could be found their demand for bank lending would be incompatible with modest growth of broad money. Mr Congdon also thought policy had been quite tight. The recent sharp and unprecedented drop in house prices was a good indicator. PSL2 had grown quite slowly in recent months. But there remained strong demand for credit, particularly in the form of leasing, where the implied interest costs remained low. He agreed with Mr Pepper about bank lending to the private sector. The problem was that in the face of the growth of leasing through bank subsidiaries the debenture market could not get off the ground.

3. Professor Minford saw a number of indications of tightness. M1 and the monetary base were more reliable indicators in current conditions. Developments in the labour market were a good indicator of inflationary expectations, and recent claims had been relatively modest. Real interest rates were exceptionally high. A controlled recovery was in process, but we should not be tempted to loosen policy now. If we held on, £M3 would come back into line. Professor Eltis believed the existing policy stance was about right. PSL2 was the best indicator. We need not be worried by a growth rate of 12 per cent. Professor Rose agreed. £M3 was still growing rapidly, but it had been badly distorted. He thought there had been more round-tripping than was generally recognised. Messrs Gilchrist and Althaus, on the other hand, were more concerned about the excess growth of £M3. They saw a danger of resurgence of inflation, particularly if interest rates were allowed to drop too far.

(b) Influence of International Developments

4. In a brief discussion most participants said they believed that developments in the US would continue to exert a strong influence on the UK, particularly on interest rates. The Americans were still trying to pursue an expansionary fiscal policy alongside a restrictive monetary policy. There were different views about the likely depth of the US recession, but agreement that the net influence of the US in the coming year would be contractionary. The German outlook was more promising, as was the Japanese.

(c) Future Monetary Policy

5. The Chancellor said that his overall objective had been stated, not once, but many times, as maintaining steady but not excessive downward pressure on the monetary aggregates. The aim was to stop inflation rising again and to create the conditions for real growth within the assumed growth of money GDP. He was interested in participants' views on the way the policy should be presented in the Budget.

6. Professor Minford thought that the £M3 targets should be retained, but supplemented with targets for the monetary base and M1, which he thought provided better guidance for short term decisions. Ranges of 3-7 per cent for M1 and 2-6 per cent for Mo should be feasible. It was important to keep the numbers low to consolidate the change in expectations that had already been achieved. The exchange rate had been a useful guide through the fog of the last few months but it should gradually be relinquished. The decline in UK relative labour costs implied an upward movement for sterling, which should not be resisted. On the other hand, a fall should be resisted, with the floor an effective rate of about 90. Professor Eltis disagreed. It was important to recognise the deflationary impact of another year in which the Government aimed at lower monetary growth. The effect of announcing such a low target, and the fiscal stance which could be expected to accompany it, would be to depress activity further. The objective should be to restrict PSL2 to about 10 per cent. He did not think this would cause major problems for sterling. It might drop to $1.70 or so, but would recover. We should not try to stop it falling. As for an M1 target, he thought what Professor Minford proposed was unrealistic. As the recovery gathered steam M1 could be expected to grow more quickly. Professor Rose also opposed an M1 target. M1 was far too sensitive to nominal interest rates. Targeting M1 was indistinguishable from operating a simple interest rate policy.

7. Mr Congdon favoured continuing with a £M3 target with numbers as close as possible to those in the original MTFS. The target should be consistent and simple, and related to an objective for

growth of nominal income. We could clearly not tolerate 15 per cent growth of £M3 for ever, but there was a case for accepting the excess growth that had been observed and simply building it into the base. That should allow us to get back to single figures next year. Prof. Rose saw dangers in this approach. Better pitch the target range higher and stay within it for once. Professor Griffiths thought the designation of the target was not very important. Mr Gilchrist however, believed it was vital for the gilt market. To go explicitly for a higher number next year, or to abandon a target altogether, could create very difficult conditions.

8. Mr Pepper thought that it was the attempt to simplify the presentation of the MTFS that had led us astray. He had recently reread the introduction to the Green Paper on monetary control and found the argument still persuasive. But we had put too much weight on a single £M3 number. He would be alarmed if we now moved to M1 and made the same mistake. It was vital to monitor all the aggregates and reach a considered judgement. We would need to pay some attention to the exchange rate, also. But we should distinguish between a weak pound and a strong dollar. There was a risk of another period of very tight US policy which could push the dollar up. If sterling were reasonably strong against the European currencies we should not respond. Professor Minford said the key was to create a policy environment which influenced expectations. Complexity was not a problem. It had been necessary to analyse policy in spite of £M3. It would be easy to present a network of target bands convincingly. The Fed did.

(d) Indexed Gilts

9. Commenting on the future course of policy Professor Minford said greater emphasis should be placed on index-linked stocks. He was alarmed that there had been no further issues since July. It was foolish to rely on conventional funding at present. But Mr Althaus pointed out that the existing restricted market had been over-supplied early last year. We should widen eligibility. The yield would then fall. Messrs Gilchrist and Congdon agreed. They had never seen the point of the restrictions.

Professor Rose thought IGs could be particularly important as the election approached. They would be an alternative to foreign investments for those concerned about the outcome.

10. Mr Pepper, on the other hand, saw some dangers in unrestricted IGs. They could make it even more difficult for industry to raise equity finance, since the Government would be competing for a limited pool of risk capital. He favoured a short derestricted IG. Mr Hamilton did not think that IGs would in the event reduce the amount of money available for the equity market. Investment managers would not in practice reduce equity holdings to buy them. It was the total quantity of Government borrowing that was important.

(e) Fiscal Policy

11. The Chancellor asked for participants' views on the size of PSBR he should try to achieve in the coming year. Mr Althaus said that if the Government wanted lower interest rates they would need to conduct a responsible fiscal policy. He thought that on unchanged policies the PSBR would be around £8 billion. Anything higher would be a mistake. Mr Congdon thought the exact number chosen was not too important, given the margin of error. He favoured continued restraint, however, and a PSBR no higher than the 81/82 outturn, which he thought would be around £10 billion. The lesson of this year had been that interest rates were the most powerful influence on the economy. In spite of a very brave budget in fiscal terms the interest rate cut had moved the economy more. It would be important to maintain consistency between fiscal and monetary decisions. Professor Rose agreed that the economy was now very sensitive to interest rates. As for the PSBR, he thought a number close to the 81-82 outturn would be satisfactory.

12. Professor Eltis favoured a PSBR roughly the same size as this year. But there was a chance that real growth might be 2% rather than 1%, if the strong export performance was maintained. If so, he would favour another £1 billion of tax cuts to offset the extra revenue that could be expected. Professor Minford said that according to his calculations the cyclically adjusted

PSBR was now lower than for some time at around 2% of GDP. This was good, but we must try to get even lower. In nominal terms a PSBR of £8-9 billion next year would maintain progress. If there were to be any room for manoeuvre we should use it to improve the tax structure. Mr Pepper said the objective should be a Public Sector Financial Deficit no higher than this year.

(f) Monetary Control

13. Professor Griffiths said he had been disappointed by the outcome of the Green Paper exercise. Two years work had come to nothing. The changes were meant to add flexibility to the Bank's operations in the bill markets but in reality little had changed. Our ability to control the money supply had not improved. Mr Congdon agreed there had been no major change. He was glad there hadn't. Mr Gilchrist said that in current circumstances the authorities did not know whether the discount market was bullish or bearish about interest rates. If the market can sell paper at ever higher prices to the Bank it will continue to do so whatever its overall view of the future course of interest rates. If the authorities want rates up they must act dramatically, as they did in September. Once they had given a lead then the market might give an indication of the extent of the rise needed. Mr Middleton agreed that at times when the authorities were operating throughout the yield curve, as at present in conditions of acute shortage, the yield move was not very informative. But in the normal way, when we were influencing only very short rates, we would expect to get information on the market's view from the behaviour of longer rates.

14. The Chancellor thanked the outside participants for their assistance. The meeting ended at 17.00.

H J DAVIES

cc - See attached list

Copies:

Treasury Ministers and officials present
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Mr Monck
Mr Kemp
Mr Britton
Mr Turnbull
Mrs Gilmore
Mrs Lomax

Prof. Walters, 10 Downing Street
Mr Scholar " "

SECRET

Econ Pol 21

PRIME MINISTER

INDEXED GILTS

1. Recent meetings with the Treasury and Bank (Deputy Governor etc) have rehearsed the arguments for indexation of debt and for issuing unrestricted IGs. The net result shows that the Bank now put very little emphasis on the OPEC argument and it is now agreed that there would be probably only a small take-up of unrestricted indexed gilts by foreigners.

2. There is a powerful isomorphism of the OPEC argument which so far has not been put forward and which you may wish to advance at the meeting. A substantial issue of unrestricted index gilts will enable domestic residents who hold sterling to hedge against the risks of a change in Government. As the Election approaches we are more likely to see a run on sterling, just as occurred in France and all the attendant difficulties. If, however, residents can buy unresticted index gilts in any quantity they wish, this will be a very attractive alternative to taking one's money out of the country. As you can see, it is part of your general argument that issuing unresticted index gilts and converting much of the nominal debt to index debt will be a process by which you bind successive governments. At the same time it will serve as a bulwark against a run on sterling over the next two years.

3. The tax argument was also substantially settled. Only the Bank has been vigorous in pursuing the alleged tax disadvantages of unresticted index gilts. But this is an inconsistent position by the Bank because they have always argued that favourable tax treatment of gilts is essential for their marketability. And what is good for conventional gilts is really good also for unrestricted index gilts.

4. My overall impression is that from the Deputy Governor downwards the Bank has no zeal in arguing the case against derestricted index gilts. I believe that the main opposition will come from the Governor himself who will regard this as a matter of face at the various meetings of Central Bank Governors.

21 January 1982

AW

ALAN WALTERS

SECRET

Bank of England

Press Notice

Press Office
Threadneedle Street
London EC2R 8AH
Telephone 01-601 4411

The Bank has sent the following notice to all recognised banks and licensed deposit-taking institutions:

The Bank is concerned to ensure that lending on mortgage for house purchase should in fact be applied to the purchase or improvement of residential property and not to the realisation of capital profits on their houses by the borrowers. To this end recognised banks and licensed deposit-taking institutions are asked to ensure, when making mortgage finance available on exchange of residential property, that, where the borrower is increasing the size of his mortgage and whether the previous mortgage had been provided by themselves or another lender, the bulk of the unencumbered proceeds of the sale are applied to the new acquisition or improvement of the new purchase. Recognised banks and licensed deposit-taking institutions are also asked to ensure that, where a mortgage is transferred to themselves from another lender but there is no exchange of properties, the size of the mortgage is not normally increased unless the property is to be improved.

NOTE TO EDITORS

As the notice explains, the main purpose of this request is to ensure that lending for house purchase is not significantly inflated by borrowers realising housing equity for consumer purposes unrelated to the purchase or improvement of residential property.

The Bank has written to the main Associations of Insurance Companies asking that their members should have regard to this request in so far as it affects their own mortgage lending. The Treasury has made a similar request to the Building Societies Association.

SECRET until publication at 3-30pm

20 January 1982

NOTICE TO RECOGNISED BANKS AND LICENSED DEPOSIT-TAKING INSTITUTIONS

LENDING FOR HOUSE PURCHASE

The Bank is concerned to ensure that lending on mortgage for house purchase should in fact be applied to the purchase or improvement of residential property and not to the realisation of capital profits on their houses by the borrowers. To this end recognised banks and licensed deposit-taking institutions are asked to ensure, when making mortgage finance available on exchange of residential property, that, where the borrower is increasing the size of his mortgage and whether the previous mortgage had been provided by themselves or another lender, the bulk of the unencumbered proceeds of the sale are applied to the new acquisition or improvement of the new purchase. Recognised banks and licensed deposit-taking institutions are also asked to ensure that, where a mortgage is transferred to themselves from another lender but there is no exchange of properties, the size of the mortgage is not normally increased unless the property is to be improved.

Inquiries on the subject of this notice should be addressed to the Money Markets Division of the Bank (telephone 01-601 4307/4327).

BANK OF ENGLAND
20 January 1982

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SUBJECT.

Tile

c A.W

c.c. Master set

10 DOWNING STREET

From the Private Secretary

19 January 1982

Dear John,

The Prime Minister discussed this morning with the Chancellor and with the Governor of the Bank of England developments in the domestic money markets. Mr. Alan Walters, Sir K. Couzens, Mr. Burns and Mr. Middleton were also present.

The Prime Minister said that she had noted that there had been a reduction of 1/16th per cent in several of the Bank's dealing rates yesterday. She was encouraged by this, because she was concerned about the degree of inflexibility which seemed to have beset the authorities' operations in the market. She continued to be much worried about the effect on industry of our high domestic interest rates. She had been pressing since the middle of December for a move which would lead to a reduction of ½ per cent or so in bank base rates. Yet only minute moves had been made.

The Chancellor said that all were agreed on the desirability of a further ½ per cent reduction. The difficulty was in achieving a reduction without causing disturbance in the markets. The Governor said that the Bank's aim was to secure the desired ½ per cent as quickly and as safely as possible. But it was important not to bring about an excessive fall in the exchange rate. It also had to be borne in mind that the decision on the base rates was the banks', not the authorities'. He believed that the next few days should be propitious for engineering such a reduction provided that conditions did not change; but the Bank could not reduce their dealing rates while the exchange rate was falling. The Governor pointed out that, since his discussion with the Prime Minister at the end of the week before last, sterling had been weak, and it had only been on Friday of last week that we had seen a strengthening in the exchange markets. Notwithstanding the awkward US money supply figures at the beginning of this week, the better news on the UK industrial front had had beneficial effects in both the foreign exchange and the domestic money markets. This had enabled yesterday's moves to be made; given the favourable reception they had received, he hoped that some further such move would be made today. It had been possible to present these reductions as a sign of confidence. The Chancellor noted that with an underlying rate of inflation around 12 per cent or more, there was no prospect

/of

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of any substantial reduction in interest rates from their present levels; it was a question of a further reduction of no more than ½ per cent or so. Mr. Burns commented that the monetary aggregates did not suggest that there was scope for a marked loosening of monetary policy. The squeeze which Gordon Pepper's most recent bulletin made much of was exaggerated by the rise in inflation at the end of 1981 which followed the earlier exchange rate depreciation; it would not be right to adjust monetary policy to accommodate this temporary increase in inflation.

The Prime Minister said that it had sometimes appeared to her in recent weeks that our high exchange rate (when it was, say, above $1.90 with an effective rate above, say, 91) was maintained at this level purely by a high interest rate policy. She wanted the desired reduction in rates to take place this week, and she would then wish to consider whether conditions were suitable for a further reduction of the same order.

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

Yours sincerely,

Michael Scholar

John Kerr, Esq.,
HM Treasury.

c A.W.

19

Prime Minister

I think the Treasury are trying to say they're doing their best!

MCS 18/1

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

18 January 1982

Michael Scholar, Esq.,
No.10 Downing Street

Dear Michael,

INTEREST RATES

In his minute on 8 January to the Prime Minister about discussions with the Bank of England on interest rates, the Chancellor reported that there was general agreement on the objective of trying to secure an early further reduction in bank base rates of about ½ per cent. It was also agreed that the Bank would direct its money market operations to this end, but without giving a dramatic signal which might lead the market to think we were prepared to see the exchange rate fall sharply. You might like a report on developments and progress over the past week.

On Friday, 8 January, the prospects for achieving some reduction in interest rates looked reasonably good. The effective exchange rate was at 91.8, the dollar rate at 1.92. Interest rates, e.g. the 3 month interbank rate and the Treasury Bill tender, had fallen slightly. The Bank's aim during the subsequent week was, as a preliminary to a fall in base rates, to induce some easing of interbank rates by "overdoing the help" i.e. tending to provide slightly more assistance than was strictly indicated by the market shortages.

In the event US developments were adverse. The US weekly money supply figure announced on 8 January fell less than the market had expected, and the figure announced on 15 January showed an exceptionally large increase. Whatever the reasons for this, the market reacted with a sharp rise in Eurodollar rates. They rose from 13½ per cent on 8 January to nearly 14½ per cent at one point on 13 January. The 3 month rate is now 14 7/16ths. In consequence the dollar strengthened markedly and the dollar/sterling rate fell to below 1.86 by Thursday. The effective rate was 90.1. The pound weakened only slightly against European currencies. In the domestic markets the climate of expectations was poor, influenced by the miners' ballot and the train strike.

/Although the

Although the Bank gave substantial assistance, buying gross £1.8 billion of bills, it was not, in these circumstances, possible to make much headway in reducing rates. To have acted aggressively could have had a very adverse effect in the foreign exchange markets.

By Friday 15 January the 7 day and 3 month interbank rates were still more or less where they had been a week earlier. The Bank's dealing rate was unchanged in Bands 1 and 2. It was however lowered by 1/16 in Bands 3 and 4. This signal - quite important in the move to get base rates down - was noticed by the professionals in the market, and the Treasury bill rate was slightly down on a week earlier.

The gilts market was also depressed. Prices were marginally down over the week; sales were very small and yields are in the 16-16½ range.

The position on the exchange rate is now rather better. The dollar rate is not much changed at 1.87½ but our effective rate is 90.8 tonight. The exchange rate is still affected by higher Eurodollar rates but is beginning to benefit from a more hopeful view of the miners' ballot. This is also affecting the money markets, and the Bank managed to reduce their dealing rate by 1/16 in Bands 1 and 2, and by a further 1/16 in Band 4, today.

The pace of further progress, towards the Government's agreed aim, will be influenced by developments on the foreign exchange and labour fronts.

Yours ever,

John Kerr.

J.O. KERR

Interest rate - holding up exchange rate.

18

SECRET

12 January 1982

ALAN WALTERS

PRIME MINISTER

MEETING ON WEDNESDAY, 13 JANUARY 1982 AT 3.30PM

1. The attached note summarises what are likely to be the broad conclusions from the meeting. I have privately agreed this note with Peter Middleton, and I understand that Terry Burns is also in substantive agreement.

2. As far as I can see, the only main omission from it is that we have not discussed monetary base control. All the measures discussed, however, are consistent with a move to monetary base control in the future. I am certain, however, that at present neither the Bank nor the Treasury are willing to move quickly to a monetary base control system. Unfortunately over the last three months or so we have in fact moved away from it: our interest rates have been stuck and have not responded to market movements. But, as you know, we hope this will be changed in the near future.

3. I doubt if any progress will be made by raising the issue of monetary base control at this meeting. We have first to re-establish the interest rate flexibility before we can take the next steps.

AW

12 January 1982

ALAN WALTERS

SECRET

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AGENDA FOR MEETING TO BE HELD AT 3.30PM
ON WEDNESDAY, 13 JANUARY 1982

I MONETARY AGGREGATES AND INTEREST RATES

A. Operating Policies

a. Interest Rates and Monetary Aggregates

The main conclusion we should reach is that we must shift from the primus status of £M3 to the narrow aggregates. Although, de facto, we have paid little attention to £M3 movements in recent months (although partly this neglect may be alleged to be due to the strike) £M3 is still formally the most important aggregate for interest rate policy.

Because (i) £M3 is insensitive to changes in interest rates whereas M1, MO etc are not,

(ii) £M3 is very much influenced by structural and other changes in credit markets, and

(iii) we have not (rightly) been motivated in practice by £M3 for many months,

we should place greatest emphasis on MO, M1 and retail M1. £M3 should be demoted as an aggregate "taken into account".

Alternatively we could devise a weighted average target such as $W = \frac{2}{3}M1 + \frac{1}{3}M3$. I believe there are more advantages in the loose specification however.

b. The Exchange Rate and Interest Rates

The main role of the change in the exchange rate should be as a subsidiary indicator of changing monetary conditions. We used it as a main signal in the absence of reliable aggregates during the strike, but it should now be relegated to its subsidiary role as correlative evidence. Changes in the exchange rate often are not due to UK monetary changes (eg political factors, changes in monetary policy of the USA, Germany etc,

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real effects, such as oil prices, etc) and need very careful interpretation. There is a crucial distinction between on the one hand using the exchange rate as an indicator and, on the other, embracing a published fixed exchange rate. This, if credible, involves potentially massive intervention with all the attendant effects.
[This is related to the EMS question which is a subject for later discussion.]

B. Strategic Decisions

a. Targets

We should consider replacing £M3 by a target which we can achieve such as M1 and M0. We should express our targets as percentage increases only over 3-year periods and with many caveats about revision for possible "structural changes". [For example we may provide that if interest rates fall dramatically then we should be prepared to tolerate a higher growth for M1 during the fairly short adjustment period.]
Further work is needed to give a 3-year target for M1, but I should have thought that about 6% [in principle starting at 8%, as now and declining to 4%, the average value in the 1960s, is appropriate] over the 3-year period.

The other aggregate Ms, £M3, M3, PSL1 and PSL2, should be used to shed light on monetary, and particularly credit conditions and may be used to modify the long run targets.

The exchange rate has no role for long run strategy: the value of sterling will, in the long run, be determined by our moentary/fiscal policy and the real performance of the economy, relative to those of our competitors.

b. Money GNP as "target"

This has been suggested as an alternative to the monetary aggregates [by Sam Brittan, James Meade, et al]. Although it is easily understood and interpreted the

main disadvantage is that it treats increases in real output in the same way as increases in inflation. Even among Treasury Ministers and officials, this causes confusion.

I cannot see that a statement of intentions in terms of money GNP is superior to a general statement in terms of a projected target rate of inflation.

II FUNDING

i. Overfunding

This is the standard technique for attempting to reduce the £M3 figures when there is a boom in bank lending to the private sector and the PSBR is well contained. But if we overborrow long we have to lend more at the short end and increase the Bank's portfolio of bills.

I believe that we should only fund the PSBR and not try to offset fluctuations in private sector borrowing.

ii. Instruments

a. Indexed Debt

It is essential that we do not issue conventional long term debt at 16 or even 17 per cent, if our long term inflation is expected to be less than 10 per cent.

Issues of indexed debt are restricted - and so the secondary market is also restricted.

There is a powerful case for issuing unrestricted indexed gilts and making these instruments widely marketable. The objections, apart from some tax arrangements, are that the debt will be bought by foreigners (OPEC) and that this would violate our (informal) agreement with other industrialised countries.

As a counter argument it seems unlikely that any substantial amount of debt (at say 2-2½% real yield) would be bought by foreigners when they can get 16% or so tax free.

b. Auctioning Debt

The Bank would prefer to return to the conventional methods. We have agreed, however, to auction the next issue of restricted debt. [I believe that the auction method has been successful and we should be looking towards an expansion of auction and tender methods.]

III EMS

The main questions are:

i. Would exchange rate be more stable?

Answer:

There would be more short run stability, but not in the long run; the exchange rate would move in jumps, on realignment, rather than smoothly.

[Note: Short run stability can be bought anyway on the forward markets.]

We would also need on average more reserves for intervention. In general the EMS calls for considerably more intervention with attendant monetary effects which depend on how the purchase/sales are financed.

ii. Would EMS "discipline" substitute for or reinforce our counter-inflationary operations?

Answer:

EMS would not substitute for our strategy (both Germany and France have money supply targets). The evidence, quoted in Bundesbank Bulletin October 1981, is that economies

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in EMS have diverged not converged since 1979, so it is unlikely that joining EMS will do anything to reinforce our counter-inflationary strategy. On the contrary it may stymie our strategy: consider if we had joined EMS in 1979, we would have intervened and increased the monetary aggregates to keep the rate from appreciating in 1980.

iii. Is the EMS a step towards a true Central Bank of Europe?

Answer:

If the EMS were a stepping stone to a true Central Bank of Europe and an integrated currency, there would be a good case for getting in now, but it is virtually certain that no such result is even remotely possible, especially in view of the increasing divergence of France and Germany. This divergence will cause increasing strain in the EMS which may lead to a breakdown. In general the EMS involves an increase in the politicisation of exchange rate changes, particularly on realignment meetings. Our objectives have been to restore free prices, rather than controlled prices, to markets and to eliminate, or at least reduce, political influence.

AW

12 January 1982

ALAN WALTERS

SECRET

CONFIDENTIAL

A

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

12 January 1982

M. Scholar, Esq.,
Private Secretary,
10, Downing Street

Dear Michael,

MONETARY MATTERS

We spoke about papers for the Prime Minister's meeting tomorrow afternoon. I now attach a draft annotated agenda, together with copies of the three annexes (B, C and E) which you have not previously seen.

'EMS File

A copy of this letter, and its enclosures, goes to Tim Allen at the Bank. We agreed that you would separately inform the FCO about the handling of item 3 (i.e. EMS).

Yours ever,

John.

J.O. KERR

AGENDA FOR THE PRIME MINISTER'S ~~SEMINAR~~ MEETING ON 13 JANUARY at 3.30 pm

I. MONETARY POLICY: IMMEDIATE OPERATIONAL DECISIONS

a. Short Term Interest Rates

Papers

1. Annex A - Monetary Policy and the Exchange Rate (paper attached to Mr Jenkins' letter of 14 December to Mr Scholar). The main points in this note are still relevant, though the numbers are superseded by those below which contain later information.

2. Annex B - Statistical Material

This is attached and comprises the following tables and charts:

a. Table 1 - Summary of Domestic Interest Rate Changes

b. Tables 2-4 - UK and Overseas Interest Rates, Inflation Rates and Exchange Rates

c. Table 5 - Recent Growth Rates of Monetary Aggregates

d. Note 6 - Prospects for £M3

e. Chart 1 - Past Movement of Monetary Aggregates

Points for Discussion

1. Interest rate decisions are currently taken with a view to maintaining steady but not excessive downward pressure on the monetary variables. (Chancellor's Mansion House Speech). The emphasis placed at particular times to the various factors determining short term interest rates depends on judgement. There is room for disagreement about whether monetary conditions are currently slightly tight or slightly loose. This depends in part on the weight to be given to the narrow rather than the wider measures of money after allowing for the distortions to all the aggregates from the abolition of the corset and the civil service dispute. It also depends on the interpretation of past movements in the monetary aggregates and the exchange rate.

2. This is the subject matter of Annexes A and B which we might discuss in order to establish:

M, M. ~

a. whether excessive weight is currently being given to £M3

Is the extent of recent increases in bank lending a worrying factor; and has enough account been taken of structural changes in banking eg competition of banks and the building societies.

b. It is agreed (as set out in the Chancellor's minute of 8 January to the Prime Minister) that we should try to secure an early reduction in bank base rates of around ½%. What the scope is for further reductions in short term interest rates in the near future?

- a key factor is the Government's attitude to the exchange rate which is down from its peak, but still high in real terms compared with the past. With inflation tending to rise the consequences for prices of a large depreciation could be serious. The markets currently react as though they believe the exchange rate has a large weight to day to day interest rate decisions.

c. If the exchange rate is to be a factor, are we right in using as our guide, not an absolute exchange rate target which would involve intervention to defend the rate, but a judgement about the effect of market interest rates on both the level and rate of change of the effective exchange rate in the turbulent markets we have seen since the summer.

- this question links in later questions on the EMS, but at this stage could be treated as one of the factors - along with money in its various forms - determining interest rates.

b. Funding

Papers

3. Annex C - Pros and Cons of Derestricting Indexed Gilts

This is a distillation of a much longer and detailed analysis.

Points for Discussion

Funding is another immediate issue. There are two considerations:

a. Policy: how much funding should we do. The question

here is whether we fund more than the PSBR or not in the interests of getting closer to the £M3 target. This is a complex subject. However as the intention is to do no more than just fund the PSBR this year, we might stick to questions of:

b. Techniques and Instruments.

i. should the indexed gilt be derestricted. The pros and cons are in Annex C.

ii. If so should there be a conversion issue for conventional debt - also see Annex C.

iii. Should the Government continue to auction the restricted indexed gilt. The Bank would like to return to a conventional method of issue but have agreed that the next issue (an imminent possibility) should be sold in the same way as the previous two.

iv. There are no suggestions of moving to auctions for conventional stock though the Treasury would like to explore with the Bank the implications for present methods of changes which might take place in the securities markets.

II MONETARY POLICY: DECISIONS ABOUT THE LONGER TERM

Subject: Monetary Targets and the MTFS

Points for Discussion

1. As policy is currently stated, the Government could change its interest rate policy by giving different emphasis to the various factors which it takes into account. It does not have to change the target variable; the extent to which the target might be missed is one factor to be taken into consideration.

2. The Chancellor is considering how the annual targets and the medium term strategy should be expressed in the Budget. The present formulation is in terms of £M3 which is:

a. assumed to be within the power of the monetary authorities to control

b. have a close and known relationship with money incomes and inflation in the longer term.

3. We now doubt both these propositions. £M3 has not been controlled very well as the table below shows:

	Target range for growth of £M3 (ar)	Growth of £M3 (ar) actual	Adjusted
April 76 to April 77	9-13	8.1	8.1
April 77 to April 78	9-13	15.6	15.1
April 78 to April 79	8-12	11.3	12.2
October 78 to Oct 79	8-12	13.6	15.3
June 79 to April 80	7-11	10.8	14.2
June 79 to October 80	7-11	17.1	16.7
February 80 to April 81	7-11	18.6	15.2

A further overshoot is expected this year.

4. It would therefore be helpful to consider the following alternative approaches to the present £M3 numbers for MTFS and target purposes.

(i) Use a Narrow Aggregate

The papers submitted for the Prime Minister's seminar last July analysed the properties of the narrow aggregates in some depth and concluded that:

a. the narrow aggregates are not demonstrably better or worse than £M3 in predicting long run trends in inflation but like all aggregates, however, they show large and erratic short run variations. If, as is possible, banks begin to pay interest on current accounts, M1 could suffer similar structural distortions to those affecting £M3.

b. M1 should be easier to influence by changes in the level of interest rates than £M3, but it does not have the same links with fiscal policy.

c. In the event of the narrow aggregates deviating from target the presumption would be - much more clearly than with £M3 - that the initial response should be a change in the level of short term interest rates.

d. If nominal interest rates are allowed to fall as monetary growth and inflation decline, the growth of M1 could be more rapid than for the wider aggregates. This raises problems of presentation in setting targets which might need to be oncomfortably high.

e. Mo, the monetary base, would be more difficult to control by changing the level of interest rates than M1 (and possibly than £M3).

(ii) Use the Exchange Rate

The exchange rate plays an important part in operational decisions on interest rates. It would be a major change in policy to move to a published exchange rate target in place of the monetary aggregates. And it would be difficult to have an independent exchange rate target outside the EMS, which is to be discussed later.

(iii) Stick to £M3 and Accept an Overrun

Given the presentational difficulties of changing the published figures, another approach would be to leave the targets as they are but accept that they may be overrun as was implied by the Budget presentation. This would be the result of looking at other monetary indicators and the exchange rate in particular years.

(iv) Raise the £M3 Targets, but Keep the Framework Otherwise Unchanged

This would be done in line with the Government's inflation objectives, making a crude allowance for structural changes in the financial system such as the banks' move into lending for house purchase. But we would be left with the main thrust of policy on an aggregate whose behaviour we do not understand well, and which to date we have not been able to control effectively. A similar result could be achieved by switching to PSL2 which includes building society deposits.

(v) Treat £M3 as One Nominal Magnitude Amongst Many

The presentation of policy would be based on figures for the movement of a set of nominal magnitudes - £M3, narrow aggregates and perhaps the exchange rate. Alternatively the various monetary aggregates could be weighted together as a single composite aggregate indicating the thrust of policy for the purposes of published guidelines.

III THE EUROPEAN MONETARY SYSTEM (with the Foreign and Commonwealth Secretary)

Papers

4. Annex D - The Chancellor's minute to the Prime Minister of 18 Sept

5. Annex E - The Governor's letter of 13 November

The Treasury recently put in a paper to the Treasury Select Committee of a purely neutral kind, but the above are the best basis for discussion.

Points for Discussion

The order of discussion might follow the structure of the Chancellor's minute. This asked two general questions:

a. would membership keep sterling stronger and the exchange rate more stable.

b. could it be operated and presented as a continuation of our present counter inflation policies.

Specifically the seminar might discuss:

i. would there be a benefit, in the short or longer term, to the exchange rate from the simple fact of belonging to the system.

ii. do we favour relating our exchange rate to the DM? Would it be right ~~to join~~ at the existing pattern of exchange rates?

iii. would we wish to combine membership with a monetary aggregate policy - or as a means of replacing these policies.

iv. what would be the implications of membership for interest rate and fiscal policy? How far would we wish to use intervention to achieve our exchange rate obligations or monetary objectives?

v. would membership of the EMS make it easier to take and present decisions to increase interest rates, cut expenditure or increase taxes if these were necessary for counter inflationary reasons.

vi. would joining gain us any advantages in the community budget discussions.

ANNEX B

ANNEX B

TABLE 1

CHRONOLOGY OF MONEY MARKET OPERATIONS

Date	Rate at which Bank intervened in money markets %	Clearer's Base Rates %	Interbank Rates: 7 day %	Interbank Rates: 3 months %	20 year gilt (par yield curve) %	Exchange Rates: $: £	Exchange Rates: Effective %	US 10 year AAA bonds (Moody's)	Commentary
July - Sept 14	12 - 13	12	12⅞ -12¾ (average of weeks: 12¾)	12¾ - 14⅝ (average of weeks: 13¾)	14.88 - 15.25 (average of weeks: 15.13)	1.84 (average)	93.1 (1 July) -87.0 (14 September)	13.95 (1 July) - 15.49 (14 September)	Between July and mid-September, money market rates which averaged 14 per cent were higher than the Banks intervention rate of between 12 and per cent.
11 September	12¾	12	12¾	13 13/16	15.17	1.79	87.6	15.57	
14 September	13¾ (discount window)	12	12¾	14⅛	15.17	1.78	87.0	15.49	On Monday 14 September the Bank required the discount houses to borrow through the discount window at 13¾ per cent to signal the authorities' desire for higher interest rates. Two days later base rates rose to 14 per cent. Market rates continued to rise, going to nearby 15 per cent .
16 September	14 5/16	14	14⅜	14 11/16	15.64	1.84	88.6	15.33	
30 September	14¾ - 15¾	14	15½	16¾	16.05	1.81	87.4	15.81	The Bank moved its intervention rate up again on 30 September to consolidate increases in longer short term market rates. Clearers responded by rasing base rates to 16 per cent on 1 October.
1 October	15¼ - 15¾	16	16⅛	16⅞	16.05	1.83	88.5	15.52	
14 October	15-15¼	15½	15 13/16	15¾	15.70	1.86	88.2	15.15	Market rates softened in early October. The clearers cut their base rates to 15½ per cent 13 - 14 October.
9 November	14⅞ - 14¾	15	14⅞	14 15/16	15.77	1.89	89.3	14.69	Indications that US monetary policy might be softening as the American economy enters recession led to lower US money rates and softening UK market rates. Clearers dropped base rates by ½ per cent to 15 per cent on 9 November. The Bank also reduced its intervention rates but on 16 November required discount window lending at 15⅛ per cent to stem fall in UK rates.
13 November	14⅝ - 15	15	15¼	14 7/16	15.52	1.91	91.3	14.07	
16 November	14⅝ bill purchases & 15⅛ discount window	15	15¼	14 7/16	15.90	1.92	91.2	14.04	
3 December	14⅛ - 14 13/32	14½	14¾	14⅞	15.80	1.94	91.4	14.07	A fall in 7 day marked rates allowed clearers to cut base rates again to 14½ per cent on 3 December. During calendar December UK market rates firmed, peaking at around 16 per cent, before easing later in the month. The behaviour of US rates was a contributory factor: despite a further cut in the Federal Reserve discount rate, American rates rose during the month.
14 December	14⅜ - 14⅝	14½	15⅛	15⅝	15.78	1.86	89.6	14.14	
22 December	Sales at 13⅛ - 14¼	14½	14 15/16	16	15.93	1.89	90.2	14.22	
31 December	14⅜ - 14½	14½	14¾	15 7/16	15.79	1.91	90.9	14.53	
7 January	14 - 14 7/16	14½	14 13/16	15½	15.90	1.91	91.7	14.87	

TABLE 2

THREE MONTH INTEREST RATES : 7 MAJOR ECONOMIES

The quarterly figures are averages for that quarter %

	US (Eurodollar)	UK (Inter-bank)	France	W.Germany	Italy	Japan	Canada
1980 Q1	16.3	17.8	13.0	9.2	17.8	10.2	14.3
Q2	12.7	17.2	12.7	10.2	17.2	12.1	13.5
Q3	10.8	16.2	11.7	9.1	17.6	11.3	10.8
Q4	16.5	15.6	11.6	9.5	18.0	9.9	13.6
1981 Q1	17.1	13.3	12.0	11.4	18.0	8.2	17.1
Q2	17.8	12.5	16.4	13.1	20.3	7.1	18.4
Q3	18.5	14.3	17.7	12.8	21.2	7.2	20.6
end-Sept	17.7	16.5	18.2	12.2	21.4	7.2	20.0
end-Oct	15.6	16.8	16.2	11.6	21.2	7.1	18.7
end-Nov	12.4	15.1	15.4	10.7	21.5	7.2	15.5
end-Dec	13.9	15.7	15.2	11.0	21.6	6.5	15.6
11 Jan 1982	13.7	15.6					

"REAL" INTEREST RATES: 4 OF THE MAJOR ECONOMIES

In this table nominal interest rates are converted to "real" rates by deducting a figure which is an estimate of relevant inflationary expectations. The nominal rates used are 3 month rates* at the end of each year. The figure for inflationary expectations is estimated by using the change in the price level which actually occurred between the middle of the year concerned and the middle of the following year, ie starting 2 quarters before and ending 2 quarters after the date to which the nominal 3 month rate applies.

For 1981 the nominal rates used are those for the end of November and the calculation of a figure for inflationary expectations uses Treasury forecasts for inflation rates 6 months ahead.

%

End-Year	UK	US	W. GERMANY	JAPAN
1960	1.4	1.1	1.5	3.3
1961	1.5	1.5	-0.1	2.2
1962	1.5	1.7	0.5	1.4
1963	0.5	2.1	0.2	4.0
1964	1.6	2.3	-0.7	4.2
1965	1.4	1.6	0.5	0.9
1966	4.1	1.9	4.4	1.8
1967	2.2	0.8	-1.0	2.0
1968	1.7	0.8	0.4	2.4
1969	1.9	2.1	4.7	0.9
1970	-2.1	0.5	1.5	2.0
1971	-1.4	0.5	-0.7	0.9
1972	-0.2	-1.2	-0.6	-7.1
1973	-5.2	3.5	3.4	-13.9
1974	-13.6	-2.1	2.0	1.6
1975	-3.6	-0.6	-0.5	-1.3
1976	-2.7	-2.1	3.3	0.9
1977	-2.2	-1.5	-0.6	1.2
1978	-0.9	-2.0	0.4	1.0
1979	-0.9	-1.7	4.6	-0.5
1980	2.1	4.0	3.3	4.5
1981	3.6	1.7	6.5	3.2

*3 month rates for UK and US, call money rates for Germany and Japan.

Table 4

EXCHANGE RATES, AND INTEREST RATE AND INFLATION DIFFERENTIALS

This table shows quarterly average exchange rates, interest rate differentials and inflation differentials between the UK, US and Germany. Interest rates are three-month inter-bank rates for the UK and Germany, and the three-month euro-dollar rate for the US. Inflation rates are in each case the increase in the consumer price index over its level one year earlier.

	UK-US			UK - W.Germany			£
	Interest rate differential	Inflation differential	£/$ exchange rate	Interest rate differential	Inflation differential	£/DM exchange rate	Effective exchange rate index
1979 Q1	1.8	-0.6	2.02	8.5	6.5	3.74	82.4
Q2	1.5	-0.4	2.08	6.3	7.1	3.94	87.0
Q3	2.3	4.2	2.23	6.8	11.5	4.06	91.3
Q4	0.9	4.5	2.16	6.4	12.0	3.81	88.5
1980 Q1	1.5	5.3	2.25	8.6	14.1	3.99	93.0
Q2	4.4	7.8	2.29	7.0	16.4	4.13	94.5
Q3	5.3	3.7	2.38	7.0	11.2	4.23	96.7
Q4	-0.9	3.0	2.39	6.1	10.2	4.55	100.2
1981 Q1	-3.8	1.8	2.31	2.0	7.4	4.81	101.4
Q2	-5.3	1.9	2.08	-0.7	6.2	4.73	97.8
Q3	-4.2	0.4	1.84	1.6	5.2	4.47	90.6
end-Dec	1.8	2.4*	1.91	4.9	5.4*	4.29	90.9
11 Jan 1882			1.90			4.32	91.2

* November

TABLE 5: RECENT GROWTH OF MONETARY AGGREGATES

Percentage annual rates

	MO	M1	£M3	'Augusted' £M3	PSL2
Change in 12 months to:					
1981 February	5.9	8.1	17.7	15.4	13.4
March	7.5	6.8	17.4	14.4	12.8
April	7.4	10.5	18.9	14.0	13.9
May	5.3	11.9	18.7	12.6	13.7
June	5.8	11.3	17.8	10.7	13.3
July	6.6	9.8	14.7	10.3	13.0
August	3.4	9.2	13.7	11.1	13.0
September	5.1	10.9	15.7	13.1	13.8
October	4.6	8.8	14.8	11.9	12.5
November	3.8	10.0	14.1	12.0	12.1
December	4.8	7.8	13.6	12.0	11.7
Change in 6 months to:					
1981 February	4.8	8.2	11.0	9.9	11.5
March	3.3	7.2	11.9	11.0	11.6
April	8.3	13.9	11.5	8.4	11.8
May	5.6	16.3	12.5	9.2	13.2
June	6.2	10.2	11.3	7.6	12.5
July	6.1	16.5	14.9	10.0	14.5
August	2.0	10.2	16.5	12.2	14.5
September	6.9	14.7	19.5	15.0	16.0
October	0.9	4.0	18.2	15.5	13.2
November	2.0	4.1	15.7	14.7	10.9
December	3.6	5.5	16.0	16.5	10.9
Change in 3 months to:					
1981 February	10.9	11.5	6.3	6.3	9.1
March	9.7	1.0	5.8	5.1	8.9
April	14.2	24.8	13.4	7.8	15.6
May	0.6	21.2	19.0	12.2	17.5
June	2.8	20.3	17.0	10.0	16.2
July	-1.4	8.7	16.4	12.2	13.3
August	3.5	0.2	14.0	12.2	11.5
September	11.3	9.3	22.1	20.3	15.7
October	3.4	-0.5	19.9	18.9	13.1
November	0.5	8.1	17.5	17.4	10.4
December	-3.6	1.8	10.2	12.8	6.3
Change since Mid-Feb (target period) at annual rate to:					
August			16.5	12.2	
September			17.5	13.7	
October			18.2	14.0	
November			16.8	13.9	
December			15.4	13.4	
Forecast					
1982 January			16.5	15.0	
February			15.6	14.6	
March			15.7	15.0	

Note 6.

MONETARY PROSPECTS: JANUARY-MARCH

1. The projections for the next three months are set out in Tables 1 and 2. The main features are:

(i) Growth of £M3 is projected to average 1¼ per cent over the next three months (though it could be as much as 2 per cent in January). Thus the December figure looks like a flash in the pan - probably something to do with a reaction to November or imperfect seasonal adjustment of a short month.

(ii) By February, which with a March Budget is effectively the end of the target period, recorded growth over the period could be around 15½ per cent and perhaps 1 per cent less after allowing for the Civil Service strike - despite help of nearly 1 per cent from the redefinition of the monetary sector.

(iii) The narrow aggregates have continued to grow slowly, the 12 month rate for M1 fluctuating in recent months between 8 and 11 per cent. We are expecting growth to remain slower than £M3. The growth of PSL2 - 12 per cent over the past year and close to the rate of inflation - is also likely to remain below that of £M3, reflecting in part the continued strength of National Savings at the expense of building societies and banks.

(iv) The PSBR over the three forecast months is expected to be less than £1 billion, though this benefits from an estimated recovery of tax revenue of £2 billion. It should be noted, however, that in nine of the last twelve months the PCBR has been overestimated.

(v) Gilt sales in January have been disappointing. We are projecting only £650 gross, mostly coming from the call on the short tap. It is assumed that a suitable market opportunity for launching a new IG will not appear in banking January. National Savings are impressively strong-projected to average over £250 per month.

(vi) In retrospect, we may have overeacted to November's high bank lending figure in estimating the underlying rate. We have scaled this down from £1.35 billion to £1.2 billion for the next three months - still too high for comfort. There are signs that lending to persons other than for housing may be weakening and that housing lending may not be accelerating further. Lending to companies may be taking over as the strongest element.

(vii) Taking the twelve months of the target period (including forecasts for the last months) debt sales (£11.2 billion) fund all but £½ billion of the PSBR (£11.7 billion).

(viii) Money market assistance of £1-1¼ billion is projected for each of the next three months.

H. M. Treasury
8 January 1982

TABLE 1: CGBR AND GROWTH IN £M3

Banking months

	Actual			Forecast			
	Oct	Nov	Dec	Jan	Feb	March	Mid Feb 1981 to Mid Feb 1982
£ million							**Cumulative**
CGBR, underlying s.a	+ 70	+ 50	+616	+1360	+423	+414	+ 7582
Strike effect	+840	-1100	-900	- 625	-730	-560	+ 2680
Actual/forecast CGBR	+910	-1050	-284	+ 735	-307	-146	+10262
							Annual rate
Per cent							
Increase in £M3, underlying	+1.3	+ 1.0	+0.7	+ 2.4	+0.8	+1.5	+ 14.6
Strike effect	+0.3	- 0.5	-0.4	- 0.3	-0.3	-0.2	+ 1.0
Actual/forecast £M3	+1.6	+ 0.5	+0.3	+ 2.1	+0.5	+1.3	+ 15.6
£ million							
Estimated underlying growth in bank lending	+1122	+1938	+597	+1200	+1200	+1250	

Note: The figures for £M3 and bank lending are based on the new definition of the monetary sector

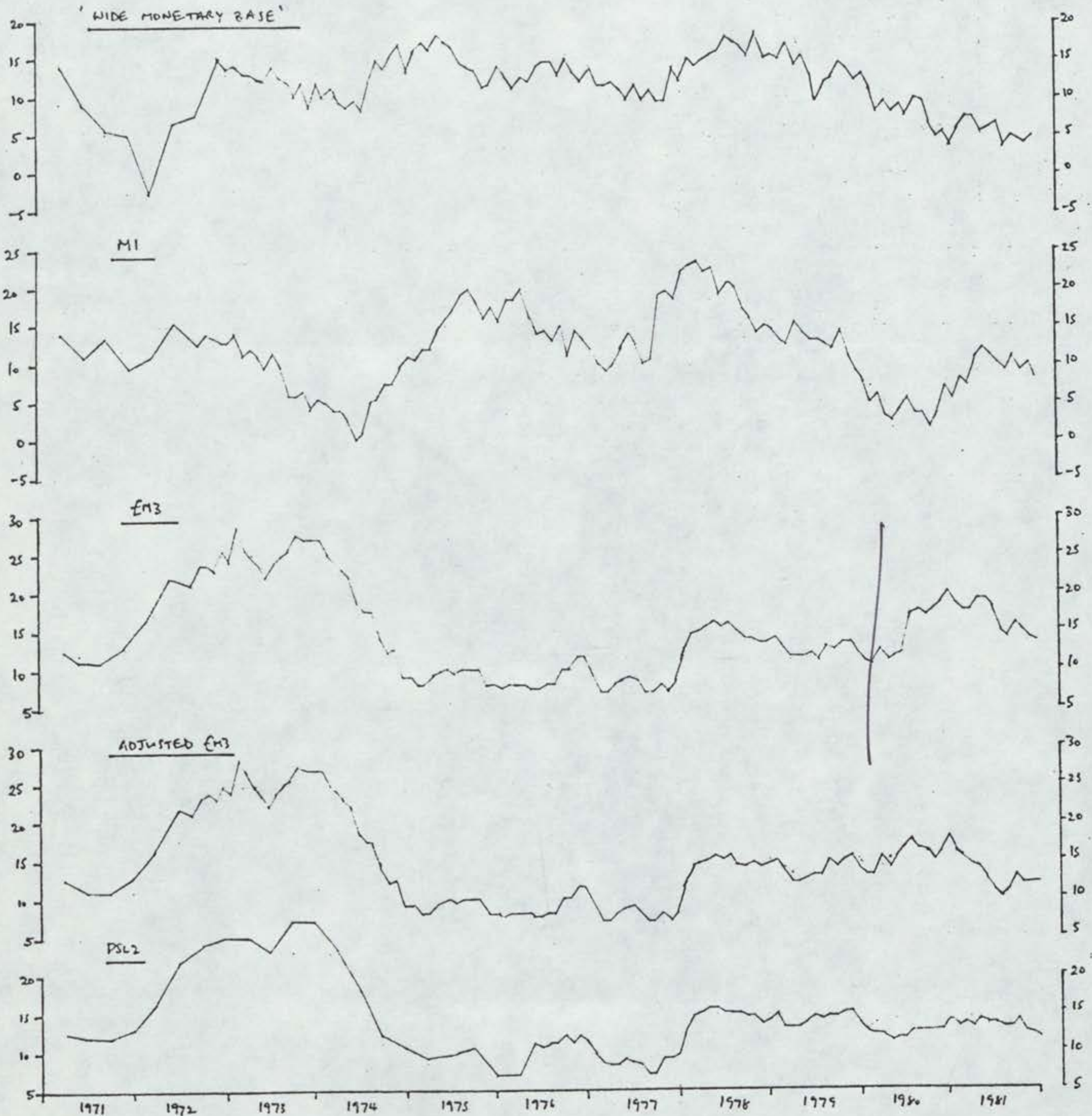
SECRET (AND PERSONAL UNTIL 2.30 P.M. ON 14 JANUARY)

ANNEX B

CHART 1 ANNUAL PERCENTAGE INCREASES IN THE MONETARY AGGREGATES: M0, M1, £M3, £M3 adjusted for the effect of the Civil Service strike and the corset, and PSL2

1971 - 1981.

% increase over 12 months



ANNEX C

(16)

INDEXED GILTS: DERESTRICTION

Case For

When restricted IGs were first issued earlier this year it was agreed that indexed debt, sold by auction, offered important advantages:

- the elimination of uncertainty about future inflation rates should reduce the implied risk premium in debt yields and result over time in lower interest rates.
- it would allow the authorities to sell debt at a time of uncertainty about inflation which, in turn, might:
- maintain the impetus of the funding programme
- improve control over £M3 with consequent additional benefits for inflationary expectations and
- demonstrate the Government's confidence in its strategy of achieving a sustained reduction in the rate of inflation.

2. But, principally because the exchange rate was very strong at the time, IGs were issued with eligibility restricted to pensions business. This carries with it a number of disadvantages.

- the amount of indexed debt we can sell is limited by the appetite of the eligible institutions.
- pensions funds are influenced by their actuaries who look for a high real rate of return as a sort of virility symbol.
- they have homogeneous expectations and long term liabilities, so that secondary market trading has been very limited.

3. The current yield on the IG is around 3%. But the real yield has tended to drift without any worthwhile demand emerging. In these circumstances the restricted IG looks to be of limited use.

4. Since the fear of pushing sterling higher is no longer with us, derestriction appears to be the logical move. It would, by broadening the market and encouraging trading, reduce the real yield on IGs and allow us to sell more if we want to, with more flexibility on timing.

Case against

- The dangers of institutionalising inflation, which were thought to be limited in the case of restricted IGs for long term institutions only, might be more serious if IGs are made generally available (though granny bonds are now available to all).

- The UK would be the only major country offering marketable indexed assets of this kind. Many other western governments are facing large budget deficits. Unlike the UK, some also have severe balance of payments difficulties. But none resort to indexed debt. For us to do so might be seen as an indication of lack of confidence in our ability to manage our debt programme, rather than the reverse.

- The creation of an asset with these unique characteristics creates the risk of sizeable resource transfers across the exchanges if inflation accelerated, and sterling did not depreciate accordingly. There is a corresponding risk with fixed interest stock, if inflation turns out to be lower than expected.

- We would be exposed to criticism from our EC and OECD partners, particularly those with balance of payments deficits to finance, who have made it clear that they are opposed to the issue of indexed assets available to non-residents, and especially to OPEC investors.

- IGs do not necessarily deliver all the advantages claimed. It may be necessary to pay unacceptably high real interest rates to sell the stock in some circumstances.

- The Government would be accused of further disadvantaging other borrowers by issuing debt on terms no-one else can match. (The stock would be CGT exempt). There might be a serious adverse effect on the equity market.

10 DOWNING STREET

From the Private Secretary

Prime Minister

Monetary policy / EMS meeting

① The Treasury have put forward an annotated agenda (flag A) for the meeting: pages 1-6 are immediately relevant, and the rest of the material is for background information only.

② The other papers before the meeting are:

(i) Treasury note of 14 December (flag B)

(ii) On the pure EMS issue

a) Chancellor's minute of 18 Sept (flag C)

b) letter from the Governor of 13 Nov (flag D)

③ You also have briefs from Alan Walters and Robert Armstrong (which the other participants have not seen).

④ Lord Carrington and Robert Armstrong and Ken Couzens will join the meeting at ~~12.30~~ 1200.

MCS 12/1

FILE

21/1

MR GOLDSMITH

8 January 1982

I am writing on behalf of the Prime Minister to acknowledge your letter of 6 January. This is receiving attention and you will be sent a reply as soon as possible.

MICHAEL SCHOLAR

Walter Goldsmith, Esq.

SECRET

PM has seen

MLS 8/1

17

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

PRIME MINISTER

INTEREST RATES

I had a further discussion this morning with the Governor and officials from the Treasury and the Bank.

2. The action which the Bank have, with my agreement, been taking in recent weeks has successfully prevented a rise in interest rates. This has entailed assistance to the markets amounting to some £2 billion in Banking November, and £½ billion in Banking December: a further £1¼ billion was already foreseen for Banking January.

3. There was general agreement today on the objective of trying to secure an early further reduction in bank base rates of about ½ per cent. Such a move would, it is true, not be consistent with the growth of the wider monetary aggregates in relation to the £M3 target, nor with concern over the continuing strength of bank lending to the personal sector. But it could be justified by the recent relative strength of the exchange rate, the more favourable position with regard to the narrow aggregates, and the relatively good figure for £M3 in December - though January promises to be another bad month for £M3.

4. There would however be considerable risk in forcing a cut in base rates by heavy-handed action in the money markets. The markets would be taken by surprise, and could be worried as to what our action signified, particularly for monetary policy.

/We could dislodge

We could dislodge the exchange rate, so that it began to move down rapidly. And there would be a risk that we might have to put interest rates back up.

5. This means that it would be unwise for the Bank to attempt to give a dramatic signal of lower interest rates - of the sort which might be given if the market were forced to borrow at lower interest rates through the discount window. We want to use the present strength of sterling to bring interest rates down a little, rather than take measures which might make the markets think we wanted to bring the exchange rate down a lot.

6. The Governor therefore undertook to do what he could to bring about the desired fall in interest rates by appropriate day-to-day action in the markets. This will have to depend on the circumstances prevailing in the market - but these should be helpful in a technical sense over the next two weeks. Therefore, although there is always a risk of unfavourable developments overseas, or indeed at home, I am reasonably confident that we shall be able to meet the agreed objective in the near future.

7. I am sending copies of this minute to the Governor and to Sir Robert Armstrong.

G.H.

(G.H.)

8 January 1982

SECRET

8 January 1982

DRAFT MINUTE FROM PRIME MINISTER TO CHANCELLOR OF THE EXCHEQUER

INTEREST RATES

1. Your memorandum of 8 January gives me some cause for concern.

2. As you know, for many weeks I have thought that there was a good case for a slight easing in interest rates - to the extent of half a percentage point. This was consistent with our general strategy, and within the spirit of the "new arrangements". No such reduction has occurred, and it seems that we have lost the initiative.

3. In your memorandum, you say"the Governor undertook to do what he could to bring about the desired fall in interest rates". This appears to be another case where the policy which we agree to be desirable on both political and economic grounds, is being frustrated by "technical"difficulties.

Alternative endings

4.(1) In view of the likely difficulties over the next 2 or 3 weeks, I believe it would be best if I were involved, as First Lord of the Treasury, in meetings on interest rates between you and the Governor. Such meetings could be held, preferably on Wednesday, at No.10 with the appropriate staff attending. We should put these arrangements into effect from next Wednesday, 13 January onwards.

4.(2) In view of the likely difficulties over the next few weeks, I would like to keep very close contact with the decision-making on interest rates. It is a central part of our strategy and we must not allow our initiative to be frustrated by either "technical" difficulties or by the Bank's judgment overriding ours. On the one hand, the Bank must solve its technical problems, and on the other hand the Treasury must instruct the Bank to implement the Government policy.

SECRET

7 January 1982

ALAN WALTERS

Top copy returned to Alan Walters. 9/1/82.

PRIME MINISTER

NOTES FOR YOUR MEETING WITH THE GOVERNOR

1. The unpublished band of interest rates is 14-16%. The dealing rate is effectively at the lower limit of the band at fourteen and three-eighths.

2. If the dealing rate is at the lower end of the unpublished band, and the market guesses roughly where that unpublished band is, then this is an indication to the market that the Bank expects interest rates to rise. So the market will expect an increase also.

3. The Bank may give a number of reasons why they do in fact expect interest rates to rise. Among the factors are a possible rise in American interest rates, a coal miners strike, ASLEF trouble, etc. Yet there are powerful reasons why they should not. The monetary aggregates, and even the wayward M3, were very reassuring last month. However, the Bank may argue that the January ones may be more worrying. Most convincing, however, is the fact that the exchange rate is very high, at approximately 91.5.

4. All the normal indicators point to a fall in interest rates. The Bank's objections are really of the form that we may possibly have to raise interest rates later to deal with a coal miners strike or some other such contingency. But the essence of the new system is that there be <u>flexible</u> interest rates. If we do not reduce interest rates because of fears that we may have to raise them later, then we will never reduce interest rates.

5. <u>What is really important is that the dealing rate comes down</u>. This is the rate which the market observes and to which base rates will eventually adjust. Moving the band down half a percentage point will give room for a similar reduction in base rates from fourteen and three-eighths to thirteen and seven-eighths percent.

6. I am quite convinced that technically the Bank could do this immediately by suitable indicators to the market, through the usual nods and winks that it is so proud of. But if they want to achieve this reduction in their own inimitable way, then I see no powerful argument against giving them a little time to do so.

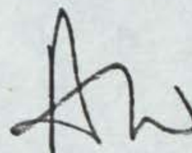
/7. The Bank

SECRET

7. The Bank, however, will continue to be constrained with respect to interest rates in a downward direction if we leave the band at 13½-15½%. I think it would be a good idea to propose to the Governor that we move the band down again in a week or two's time so that there is room for the market effects to reflect themselves in the dealing rate.

8. The Governor may object that he expects interest rates to rise. Our argument is, if they do rise, then the dealing rate can go up to the top of the band and we'll consider moving the band upwards. This is the basic idea behind flexibility of interest rates.

9. The Governor may confuse the issue by arguing that the Bank is merely interpreting the expectations of the market with respect to interest rates. This is misleading. The market knows that the Bank is the major influence on interest rates and the market forms its expectations from what it can devine about Bank and Government policy. From recent evidence the market would adduce that the Bank (and the Government) are concerned to keep money tight with respect to the narrow aggregates and to maintain an exchange rate well over 90. But that expectation is generated largely by the Bank's policy and not by the markets.



7 January 1982 ALAN WALTERS

SECRET

Prime Minister ② 15

MCS 7/1

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

7 January 1982

cc: Economic Secretary
Sir D Wass
Sir K Couzens
Mr Burns
Mr Ryrie
Mr Middleton
Mr Monck
Mr Britton
Mr Turnbull
Mr Scholar : No 10.
Prof. Walters : No 10.

T.E. Allen, Esq.,
Private Secretary to the Governor,
Bank of England

Dear Tim,

The Chancellor was grateful for the Governor's letter of 6 January confirming their earlier agreement to reduce the interest rate band. I write to record his agreement, conveyed orally earlier today, that the undisclosed band should now be set at 13½%-15½%.

A meeting has been arranged tomorrow to consider the rate at which the Bank should provide cash to the market.

Yours ever,

John Kerr.

J.O. KERR

SECRET

JAN 1982

Prime Minister

MS 7/1

10 DOWNING STREET

Prime Minister

You, the Chancellor and the EST have often raised the point that Ted Heath used M_1 in 1970-73 and was misled and duly lulled into a false sense of inflation-free growth.

This note shows that the Heath view is not warranted by the evidence. M_1 was warning enough.

AW

7.1.82.

CONFIDENTIAL

M1, M3 AND THE MONETARY MYTHS OF MR. HEATH

1. It is frequently said that one of the main arguments for not adopting a narrow aggregate such as M1 is that the Heath Government was concerned with monitoring M1 in 1970, 71 and 72, and that they missed the great expansion in M3 which occurred during that time. Mr. Heath said that on the basis of M1 there was no undue growth in the quantity of money over this period. The implication is that the inflation was generated by outside causes, trade union pressure, and the other rag-bag of extraneous events.

2. Although the Heath view is widely accepted, it is quite untenable. While it is true that M3 was a somewhat better indicator of the inflation that was to come, both M1 and the monetary base pointed in the same direction and almost the same order of magnitude. The annual increases in M1, £M3 and the monetary base are shown in the attached table.

3. If we judge by these annual figures then there is a clear indication of a rapid increase in the M1 figures beginning in 1970 and going through at an increasing rate to 1972. There was virtually no increase in M1 in 1969, but over a 9% increase in 1970, rising to a near 14% increase in 1972. Similarly, there was a rise in the monetary base figures, but these were slightly later than the M1 and only really got under way in 1971.

4. As I have often argued, we should really examine the trend of money supply over about a three-year period for the purposes of discussing its effect on inflation. Let us therefore do that for the periods 1967-1969 and 1970-1972. The average for M1 increased from 4% to 11%, that is to say a 7% rise. The monetary base average rose by 5 percentage points whereas the M3 average rose by 10 percentage points.

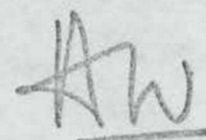
5. All these data are consistent with the increase in inflation of 7-10 percentage points which we experienced in 1973/4. I believe that the evidence points to M3 as being somewhat superior to M1 for this period. And there were good reasons why it should be the better measure. Competition and credit control suggested that there would be a switch from non-interest-bearing deposits into interest-bearing money deposits. This occurred. But the movements of M1

/were

CONFIDENTIAL

were a good and convincing indicator that the inflation was coming and that it would be in the order of about an 8% or so increase - that is to say, on top of the existing 7%, about 15% overall.

6. I conclude that in spite of CCC, the trend of M1 adequately predicted the inflation that ensued. In consequence the 1970-73 period does not discredit the proposition that suitable control of M1 (or MO) would have mitigated much if not all of the increase in inflation in 1974 et seq.



7 January 1982

ALAN WALTERS

CONFIDENTIAL

THE MONEY STOCK AND THE MONETARY BASE

(Percentage change from end of previous year)

End of	M1	3 Year Average M1	£M3	3 Year Average £M3	MO	3 Year Average MO
1964	3.0		5.6		7.9	
1965	3.7		7.6		5.3	
1966	-0.2		3.4		3.6	
1967	8.7		9.5		4.1	
1968	4.2	4	6.9	6	4.6	4
1969	0.1		2.4		3.3	
1970	9.4		9.5		5.0	
1971	10.9	11	13.9	16	8.8	9
1972	13.6		24.5		12.4	
1973	5.1		26.3		8.9	
1974	10.7		10.2		15.6	
1975	13.1		6.6		11.6	
1976	11.3		9.5		11.1	
1977	21.5		10.0		17.1	
1978	16.4		15.0		13.2	
1979	9.1		12.7		9.7	

Source: Bank of England, Bank of England Quarterly Bulletin, and Bank of England Statistical Abstract.

Note: The money stock data are adjusted by the Bank of England for breaks in the series.

CONFIDENTIAL

PRIME MINISTER

Here is a letter from Walter Goldsmith. He writes to urge on you a programme of joint action by Government and employers to link all workers directly with the results of any upturn in the economy. He originally put forward these ideas in a speech to a businessmen's lunch on 10 December. His ideas are summarised at Flag A.

We will let you have a draft reply.

7 January 1982

MR. GOLDSMITH

File

bc Mr. Duguid

10 DOWNING STREET

From the Private Secretary 7 January 1982

I enclose a copy of a letter to the Prime Minister from Mr. Walter Goldsmith, Director General of the Institute of Directors. He urges on her the need for a "Workers' Charter", which will link all workers directly with the results of any upturn in the economy.

I should be grateful if you could provide a draft reply for the Prime Minister to send to Mr. Goldsmith by 21 January, consulting other departments as necessary.

I am copying this to Marie Fahey (Department of Employment), Jonathan Rees (Department of Trade) and Richard Riley (Department of Industry).

W.F.S. RICKETT

Miss Jill Rutter,
HM Treasury.

10 DOWNING STREET

THE PRIME MINISTER

Personal Minute
No. M2/82

CHANCELLOR OF THE EXCHEQUER

Interest Rates

Following our discussion this morning, I should like to re-emphasise my wish which was originally conveyed in my Private Secretary's letter of 7 December 1981 to your Private Secretary that Alan Walters should always be involved in any consideration given by the Treasury or the Bank of England to interest rate policy generally, or to changes in the rates themselves, and that I am to be consulted before any decisions are taken.

Margaret Thatcher

7 January, 1982.

SECRET

bc Mr. Duguid

PRIME MINISTER

Here is a letter from Walter Goldsmith. He writes to urge on you a programme of joint action by Government and employers to link all workers direct with the results of any upturn in the economy. He originally put forward these ideas in a speech to a businessmen's lunch on 10 December. His ideas are summarised at Flag A.

We will let you have a draft reply.

J.W.F.S. RICKETT

7 January 1982

INSTITUTE OF DIRECTORS

From the Director General

Director General
Walter Goldsmith

6th January, 1982

The Rt.Hon. Margaret Thatcher, M.P.,
10 Downing Street,
London S.W. 1.

116 Pall Mall
London
SW1Y 5ED
Telephone
01-839 1233
Telegrams
Boardrooms
London SW1
Telex 21614

Dear Prime Minister,

It is now increasingly widely recognised that 1982 will see the beginning of the steady economic recovery, based upon a more secure industrial and economic foundation, for which you and your Ministers have been working. Private sector employers are encouraged by the omens for trades union reform, for further privatisation of nationalised industries, and for a Budget in which personal tax cuts will continue progress towards a tax system that rewards enterprise and offers real incentives.

I felt, however, that I should write to you on two matters that may be of increasing concern as economic recovery continues during the year.

It is widely and correctly felt that the coming year should see greater emphasis, by government and employers alike, on methods of linking individual employees more closely with the free enterprise system. There is a need to press ahead with means to widen and personalise the ownership of wealth, and to give employees a vested interest in the capitalist system.

But the Institute of Directors considers that recent suggestions that legislation to impose industrial democracy or to put workers on company boards would help industry or improve the Government's chances of re-election are misconceived.

The electorate would quickly see through any pale imitation of left-wing industrial democracy proposals, especially if in practice they were to mean trades union nominees sitting on company boards, and the Institute considers that such experiments as have taken place with "worker directors" - most notably in the Post Office - have shown that insuperable conflicts of interest arise which militate against the necessity for boards to operate by consensus.

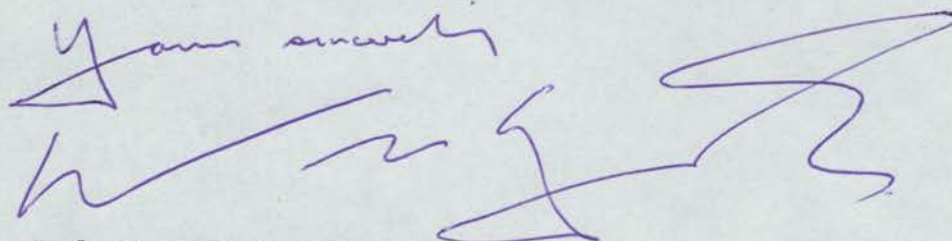
Britain needs, rather, a more radical Workers' Charter that includes tangible evidence in the pay packets of individual workers of the success of free enterprise policies, and I am enclosing a speech in which I attempted to outline a number of areas in which there is scope for progress. They include proposals for tax incentives to lure workers out of the black economy and into small business start-ups, new incentives for civil servants, measures to encourage easier home ownership and far more widespread individual employee share ownership.

These proposals are geared to workers as individuals, not to supposed solutions reliant upon central planning and control, and this raises a second major issue: that of pay levels in 1982.

In the coming year, workers in companies where productivity and profitability have improved will expect and deserve pay rises to give a fair reward for their successful efforts. Ministers should not fall into the trap of "talking pay down" across the board in these circumstances; rather they should distinguish more clearly between the continuing economic crisis in the public sector, militating against any but the smallest pay rises for workers, and the healthier outlook for many private sector companies.

There is a danger that the Government will appear as Scrooge, preaching a continued message of gloom on pay, when it has the opportunity to point out more clearly that there is a clear trend to better pay, career and employment prospects in successful private sector companies than in a state sector which must continue to contract.

The reality is that, against a background of general economic improvement, workers who have co-operated in companies which have made the sacrifices, restructured their operations and planned for high productivity and performance will now begin to earn the rewards of their efforts. The Institute of Directors hopes that it is a message which will be heard from many Ministers in 1982.



Walter Goldsmith

SECRET

13

c A Walters

(1)

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

Prime Minister

Restricted eligibility again - and more funding.

If Alan has any strong view we will get it to you in the course of tomorrow morning.

MCS 6/1

6 January 1982

Michael Scholar Esq.
10 Downing Street
LONDON
SW1

Dear Michael,

GILT-EDGED FUNDING

The Prime Minister will wish to know that the Chancellor has agreed in principle to the issue* of a third indexed linked gilt on the same restricted eligibility basis as before. No firm decisions have yet been reached on the size, maturity or date of issue, but it may be that it will be appropriate to make an announcement on Friday next, 8 January with subscription on 13 January, depending on the state of the market. Banking January ends on 20 January so that 8 January would be the best date if we wish to secure sizeable additional funding this month. As with the two previous issues, the stock will be made available to the market by auction.

* of, I understand, £½ - ¾ billion MCS

Yours ever,

John Kerr

J.O. KERR
Principal Private Secretary

CONFIDENTIAL

Eco Pol 2

10 DOWNING STREET

From the Private Secretary

30 December, 1981.

Deposit Protection Scheme

The Prime Minister has seen the Chancellor's minute of 23 December about this scheme. The Prime Minister has no objection to the conclusion reached by the Chancellor. She has commented that she hardly thinks the Government can be accused of being too cosy with the banks after this year's taxation measures. She is therefore content for the Chancellor to proceed as he proposes. She hopes that he will prepare the ground carefully for an announcement.

I am sending a copy of this letter to David Wright (Cabinet Office).

M. A. PATTISON

John Kerr, Esq.,
HM Treasury.

CONFIDENTIAL

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

PRIME MINISTER

DEPOSIT PROTECTION SCHEME

You may remember that the Banking Act 1979 included a scheme for the protection of depositors, under which the banks would contribute to a fund to provide partial reimbursement of depositors if an institution became insolvent. The banks indicated at the time - and since - that they did not like the scheme. Nor, in Opposition, did we, though we were prepared to acquiesce in its reaching the Statute Book before the Election because there were other things in the Act to which we attached importance.

2. The scheme has not yet been implemented. I frankly don't believe that we can leave it in limbo any longer. There are two risks in doing so. First, banking supervision should reduce the risk of banking failure, but it cannot eliminate it. In particular, some deposit-taking institutions have been given transitional licences on the basis that they are given the benefit of the doubt, rather than put out of business, and on the assumption that the scheme would in the end be introduced. We could be vulnerable to criticism if an institution were to fail, and we had not set up the safety-net for depositors which Parliament approved. Secondly, we might be obliged, in such circumstances, to concede compensation at public expense.

3. It follows, I think, that we must either make it clear that we are not going to implement the relevant provisions of the Act, and repeal them, or implement the scheme. Doing nothing could initially be justified as giving us time for reflection: but this is becoming more and more implausible.

4. Repeal, it seems to me, is simply not on politically. There would be widespread criticism, some of it from the benches behind us, that our relationship with the banks had clearly become altogether too cosy. While we would not have chosen to put the scheme on the Statute Book if we had been drafting the 1979 Act, it is now there, and to repeal it would be a much more significant, and controversial, political act than not to have introduced it in the first place.

5. Implementing the scheme will of course be unwelcome to the clearing banks, and they will point to the lack of a similar provision for building societies. But the building societies have given assurances about their readiness to help, if one of them gets into difficulty, and are discussing a voluntary scheme of their own. Moreover, and more important, the banks have to recognise that the crucial difference is that, whereas Parliament has not been asked to consider legislating for a comparable scheme for the building societies, the bank deposit protection scheme has been on the Statute Book for 2½ years.

6. I intend therefore to announce fairly soon that the scheme will be activated. But I thought I ought first to let you know why I have reached this rather unsatisfactory, but I think unavoidable, conclusion. We face a choice of evils, but implementation is, I am sure, the least unsatisfactory of the three available options.

7. A copy of this minute goes to Sir Robert Armstrong.

G.H.

23 December 1981

FILE SAW

12

Copy No 4 of 4 copies

10 DOWNING STREET

From the Private Secretary

21 December, 1981

BF — Seminar Cancelled

Prime Minister's Seminar on 7 January 1982

The Prime Minister was grateful for the note on monetary policy and the exchange rate which was attached to Peter Jenkins' letter to me of 14 December.

The Prime Minister continues to be concerned about the level of UK interest rates. As the Chancellor knows, she is concerned both about the threat that a continuing high level of interest rates poses for the recovery of output, and by the possibility that our present interest rate levels are being too much influenced by the choice of £M3 as the target monetary aggregate. It is the Prime Minister's view that we should be looking for a further fall in bank base rates within the next couple of weeks; and that we should be looking over a somewhat longer timescale for further falls so as to reduce or eliminate the gap between sterling and dollar rates. The Prime Minister recognises that, given the extent to which £M3 is currently overshooting the target range, such a move may be taken as a decisive sign that the Government has abandoned £M3 as the principal target variable. Her conclusion, however, is that this should lead us to a much more rapid decision about a new monetary regime; she has commented that, if the pressure were on, we could as easily reach such decisions in three days as in three months.

The Prime Minister hopes that these issues will be discussed at the seminar on 7 January. She also wishes then to consider debt management and indexation policies. She hopes, too, that there will also be a discussion of our policy towards the EMS.

Finally, the Prime Minister hopes that the seminarists will join her for lunch at the end of their proceedings on 7 January.

Perhaps you and Tim Allen (Bank of England), to whom I am copying this letter, would let me know in due course what papers you propose to produce for the occasion; and who will be attending.

M. C. SCHOLAR

John Kerr, Esq.,
H.M. Treasury

10 DOWNING STREET

From the Private Secretary

21 December 1981

BF 29-12-81 — Seminar cancelled

CC: HMT. file

Seminar on EMS

I attach a copy of a letter I have sent to the Treasury and Bank of England about a seminar on monetary policy which the Prime Minister will be holding on 7 January.

You will see that the Prime Minister hopes that the EMS will be one of the subjects covered in the discussions. The Prime Minister's intention is to discuss the EMS after lunch on that day and she accordingly invites Lord Carrington to the lunch and to the discussion thereafter.

I would be grateful if you could let me know if this is a convenient arrangement for Lord Carrington. I will arrange for you to be sent copies of the papers which the Treasury and Bank of England will be producing so far as they relate to EMS.

I am sending a copy of this letter to John Kerr in the Chancellor of the Exchequer's Office.

M. C. SCHOLAR

Francis Richards, Esq.,
Foreign and Commonwealth Office

SECRET

MR SCHOLAR

10 DOWNING STREET

MR. BURNS
MR. MIDDLETON

NOTES ON THE MTFS

I have put down in a shorthand form some of the ideas I had about the new MTFS. I think I differ significantly at times from the draft which we discussed earlier this week. However, I am not at all certain that I am correct in my interpretation of some of the numbers involved. I would like you to put me right if you think I have gone substantially wrong.

I am not proposing to circulate this draft any wider for the time being. In particular, I will not circulate it to the Prime Minister at this stage.

18 December 1981

ALAN WALTERS

CONFIDENTIAL

ALAN WALTERS

NOTES ON THE MTFS

THE INCREDIBILITY OF M3 TARGETING

1. I believe that any target for M3, even if we believed it was feasible, effective and desirable, would be straining the credulity of all the commentators. For what I believe are very good reasons we have departed with various degrees of deliberation from the target path of £M3. Everyone knows this. Why should there be any degree of belief at all in our announcement now of £M3 targets.

2. This is not to say that our monetary policy has been substantially different from the real intentions underlying the policy announcements. On the contrary, I think our actual monetary policy has been broadly in line with the intentions, except perhaps for the undue stringency in part of 1980. Thus in an odd sort of way, the £M3 targets, by our missing them, have served us quite well. But I suspect that our line of credibility is now exhausted.

FORECASTS OF FUTURE M3 FIGURES

3. I believe that we cannot forecast the £M3 figures with any suitable degree of accuracy. We have not been successful in the past in forecasting the shift from non-bank to bank intermediation, and the great expansion of credit generated by the marked differences in degrees of prosperity of the various sectors of the economy. The 60% of interest-bearing deposit liabilities which comprise £M3 seem to be extraordinarily volatile and to be a consequence of factors which we find very difficult to predict. I am convinced that eventually the £M3 figure will come back into the general fold of the other aggregates. But I am equally sure that I cannot predict with any certainty when this will occur, for all the reasons set out above.

USING M1, MO AND RETAIL M1

4. Clearly on the issue of controlability, M1 or the other narrow aggregates are to be preferred. Current account deposits are very sensitive to interest rates. And while we are constrained to using interest rates to control the quantity of M1, at least in the short run, some narrow aggregate of this kind ought to be our preferred target.

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/5. Paradoxically,

5. Paradoxically, however, the fact that M1 is interest rate sensitive is thought to present difficulties in targeting. In Terry Burns's draft of 2 December, the expectation that nominal interest rates will fall means that the forecast M1 growth which is consistent with something like an 8% growth in money GDP is 14-18% in 1983/84. This may be correct but it does depend crucially upon first the predictions of changes in nominal interest rates and secondly, the stability of the behaviour of M1 with respect to changes in interest rates. There is also a third problem; much of this high increase must be due to a once-and-for-all stock adjustment process. It must be a once-and-for-all shift not a continuous trend process. Thus the 14-18% in 1983/4 foresees a fall in nominal rates over that year.

6. There are also other constraints on the growth of M1 which seem to me to be likely to begin being effective as the rate of inflation and nominal interest rates fall. We have been told by the clearing banks that the cost of operating current accounts is some 8% or 9%. If we, naively perhaps, accept this figure, then as interest rates fall below this value one would expect that the increased competition would bring with it charges for the operations on current accounts. Or, alternatively, there may be some minimum balance condition. This would have the net effect of decreasing M1 velocity if the minimum balance condition were imposed on current accounts. If, however, it were imposed on savings accounts there would be likely to be some increase in M1 velocity.

7. Apart from all these side effects, I would argue that the interest rate effects on the demand for M1 balances are likely to be self-regulating and counter-cyclical. If interest rates rise then the demand for M1 is reduced and consequently with the same rate of growth, the monetary stringency is automatically reduced. (This of course occurs only during the adjustment period.) If, on the other hand, nominal interest rates fall then, during the adjustment period, the effect of a constant rate of growth of M1 is to introduce more monetary stringency than had hitherto existed. I would expect these effects to occur not in response to short term transitory changes in interest rates but only when the rates persist for some months. As a consequence, I would be tempted to ignore forecasts of interest rates in planning the appropriate M1 target. This is especially the case if, and I shall argue we should, we take the view that the

/target rate of

target rate of growth should be considered over a fairly long period, such as 2-3 years.

M1 AND THE RATE OF GROWTH OF MONEY GDP

8. I take it that apart from CCC distorted conditions from September 1971 onwards, there is some evidence that M1 is not inferior to £M3 as the appropriate magnitude to control in influencing nominal incomes. I believe that David Howard's study has shown that M1 is superio to £M3. The question is what sort of numbers should we therefore adopt for targeting purposes?

9. My inclination is to argue that over the three year period to 1984/85 we should ensure that the average growth of M1 does not exceed 6%. Ideally one would like to deliver a figure somewhere in the region of 3 or 4% at the end of the period. But I do not think that any such number should be spelled out. It may be wise to deviate from it for that particular year. However, 3-4% would be roughly the value we had in the fifties and early sixties. And it would be consistent with an inflation rate of about 5%.

10. I believe it would be a good idea to think about a similar target for the monetary base. It would be important, of course, to explain the basis for any such figure. The monetary base at present has many statistical difficulties of interpretation and volatility. But we expect that these will be reduced over time. In this sense I should have thought a monetary base, again over a three-year period of not exceeding 5% per annum, would be both appropriate and achievable.

11. In view of the discussion in paras 5, 6 and 7, I think any targets should be heavily qualified with statements about institutional and regulatory changes which would much affect the figure concerned. In other words the commitment to a target is not open-ended and unconditional. These should be heavily qualified.

£M3 AND ITS ROLE

12. While we are agreed that £M3 should not be used for the purposes of interest rate adjustments, most of us would accept the view that there is information in £M3 and PSL2 which is useful for determining the impact of monetary policy. I think it is best to say that we will continue to monitor £M3 closely. But we shall not use £M3 as an indicator in determining policy with respect to interest rates. We

/might

might go on to say that we should expect £M3 to grow over the three-year period at something like a 6-8% rate of growth. But we should heavily qualify this by statements like saying that this depends very much on the role that the banking system plays in total credit markets etc.

THE ROLE OF THE EXCHANGE RATE

13. For reasons which we shall probably have to discuss elsewhere, I think it would be most unwise to have a target band for exchange rates in conducting either intervention or strictly monetary policy. Nevertheless, again it is useful to keep a close eye on the exchange rate since it gives us some indication of the stringency of monetary policy. However, it is very difficult to interpret. Exchange rates are affected by many factors, particularly by monetary policies of our competitors and of course by political events. Although it is difficult to exclude these factors, I still believe that the exchange rate again conveys some useful information.

18 December 1981

ALAN WALTERS

CONFIDENTIAL

10 DOWNING STREET

Prime Minister

Meeting with the Chancellor

16/12/81

Agenda (1) No subjects being proposed by the Chancellor.

(2) I have told his office that you wish to discuss Mr Heseltine's ideas about private sector finance for increased construction investment. X Papers attached. I also attach

[PTO

the papers from the Treasury you asked for over the weekend on the PSBR definition (see your note on the De Lorean minute) – they came up in the questions briefing context.

③ Will you wish to revert to monetary policy, in the light of the Treasury letter (put in last night's box? With Alan Walters present?

MCS 15/12

10 DOWNING STREET

Prime Minister

You asked to see Alan about his note on the Howard study.

But we have not yet responded to the Treasury note of 14/12 (put into Monday's box).

Do you wish to discuss both, before Alan goes abroad on Monday?

MCS 17/12

SECRET

15 December 1981

ALAN WALTERS

PRIME MINISTER

FEDERAL RESERVE BOARD'S STUDY OF MONETARY AGGREGATES IN THE UK

Prime Minister
Alan argues that we cannot and should not keep Howard's study under wraps - content to allow matters to take their course? Or would you like us to keep the UK distribution to the minimum (we can't affect the US distribution)?
MCS 16/12

Would Alan come in & see me. We can't possibly conceal Howard's work but that is not the point. !!

1. I am concerned at the annotations which you put on my memorandum of 10 December.

2. Let me try to set out the facts as I understand them.

a. Howard's study is merely one among a very large number that have concluded that £M3 has been a misleading indicator during recent years. Examples are numerous and ubiquitous; they include Niehans, Budd and Christopher Johnson. (Terry Burns and Peter Middleton are now quite convinced that £M3 was and is a misleading indicator.) But they are not recommending that we leave it until they are clear about what to do.

b. By our actions in November 1980 and subsequently we have pursued policies which were inconsistent with our announced targets for £M3. Commentators have observed this deviation - and in general they have, rightly in my view, applauded it. It has been observed, again rightly, that our monetary policy in 1980 was restrictive in spite of the overshoot of the £M3 target.

c. I believe that it was to the Government's great credit that the severity of the monetary squeeze of 1980 was relaxed in November of that year. This adjustment of policy, together with the further relaxation in March 1981, was seen by the vast majority of commentators, as entirely justified. (The only exceptions were Brian Griffiths and his group at City University.) Of course it was possible for our enemies to say that we were wildly overshooting our £M3 monetary targets. But those critics wanted us to overshoot them even more! Such critics have little intellectual integrity and should be discredited or ignored.

/3. Opinions differ

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3. Opinions differ on what will be the best guide for monetary policy. However, considering M1 and £M3, I believe that the vast majority of commentators would prefer M1 (or M0 or retail M1).

4. You raise also once again the experience in 1971-74. Indeed, I used M3 in 1971-2 to predict the inflation which ensued in 1974. Although I had worked mostly with M1, for example in my "Money in Boom and Slump" (1968), I believed that "competition and credit control" would render M1 quite unreliable in this period. The changes brought about by the CCC regime were bound to channel monetary growth into interest-bearing deposits during the period in which the banks were adjusting their portfolios. I believe that I was correct in interpreting £M3, or as it was in those days M3, as the most reliable aggregate during the years after the CCC regime was brought into effect. My judgement at the time has been confirmed by another study by David Howard called "Inflation, Indexation and the Oil-Price Shock: The British Experience", July 1981. After an extensive discussion of monetary aggregates over the period 1970-79, he concludes:

> "Thus it is probably the case that during this period the behaviour of the £M3 aggregate was the more appropriate measure of underlying monetary growth."

What I believed were the good reasons for using M3 during the CCC period have not been discredited by subsequent research and reflection. But this is a convenient argument to explain

5. Using similar arguments since 1980, I am convinced that the M3 figures have been severely distorted, primarily by the corset and the aftermath. During these recent years the narrower aggregates have been the appropriate indicators of monetary stringency. (I have also argued that all the other measures, real interest rates, the exchange rate and other "real" effects are consistent with this interpretation.)

6. Finally, I think it is quite impossible to suppress or even effectively to discourage views of this kind being expressed. And even if it were possible, I believe it would be undesirable. We have nothing to fear from the truth. Apart from being a shade too severe in 1980, our policies have been entirely right and can be easily defended.

AW

ALAN WALTERS

Econ Pol

(1)

PRIME MINISTER

We have to settle the representation at two meetings which are coming up:-

1) Meeting with the nurses on Friday at 1530

The nurses are asking, as in the past, to have about 10 people present. Norman Fowler should be there, and asks if he can bring with him Sir K. Stowe, Dame Phyllis Friend, a Mr. Benner from his Department and also perhaps Dr. Vaughan. On our side I suggest that both Bernard Ingham and John Vereker should be present.

2) Monetary seminar on 7 January at 1000 hours

The Chancellor will, I think, want to bring Sir D. Wass and Messrs. Burns and Middleton, as well perhaps as the Financial and Economic Secretaries. He will also want the Bank (perhaps the Governor and Deputy Governor) to come; and, indeed, if we really are to change tack on monetary policy as you were suggesting on Wednesday I think it would be essential to have the Governor there. Obviously, Alan Walters will also be present.

Content for us to set up these meetings on the above lines?

MCS

Yes

15 December 1981

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~~CE~~ AD
AW
JV

B

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

14 December 1981

M.C. Scholar, Esq.,
Private Secretary to the Prime Minister,
No.10 Downing Street

Dear Michael

MONETARY POLICY AND THE EXCHANGE RATE

The Chancellor has suggested that the Prime Minister might like to see the attached note which picks up some of the points they discussed on 9 December.

As you know the pound was weak again on Friday and there was a further rise in interest rates in the inter-bank market: the one month and three month rates were about ⅜ per cent higher than yesterday's closing rates at about 15½ per cent. The yield implied by the Treasury Bill Tender was about ¾ per cent higher than a week earlier. The rates at which bills were offered to the Bank also rose. In the circumstances the Bank raised its dealing rates for bills - the rates at which it assists the market - a little. But the move was smaller than that of the corresponding inter-bank rates and the dealing rate for "band 1" bills (2 weeks) remained unchanged at 14⅜ per cent. The Bank was thus perceived to be leaning against the market-led movement towards higher interet rates, without - it is hoped - appearing to encourage any further fall in the exchange rate.

Yours ever
Peter

P.S. JENKINS

MONETARY POLICY AND THE EXCHANGE RATE

Introduction

The current basis of monetary policy is largely as presented in the MTFS and the Budget Speech and agreed at the Prime Minister's seminar in the Summer. £M3, for which the MTFS set out declining ranges for the following three years remains the main target variable. But in assessing monetary conditions and in setting interest rates other factors are taken into account. These include the growth of the other monetary aggregates, both narrow and wide; the exchange rate and its implications for inflation; and the growth of nominal GDP. The Government's aim is to maintain financial conditions such that they exert a "steady, though not excessive, downward pressure on monetary variables" in order to restrain inflation and create conditions for a recovery of output. This position has been reaffirmed on a number of occasions e.g. the announcement of the new monetary control arrangements, the Mansion House Speech and evidence to the TCSC.

Distortions to monetary aggregates

2. The conduct of monetary policy has been complicated by several problems. First, there have been distortions to the monetary aggregates. In 1980 these stemmed mainly from the unwinding of the corset. This year the figures have been distorted by the Civil Service strike. We have attempted to discern an "underlying" rate of monetary growth but this is subject to error at several points. We could be wrong in our estimate of the extent to which this feeds through into money. However, our best estimate is that by the end of banking November the strike was adding about 2-3 per cent to £M3 and perhaps half as much to PSL2. M1 might be relatively free from distortion.

3. In addition to this there have been structural changes in financial markets. The banks have entered the market for mortgage lending in a major way. The effect of this on the

monetary aggregates and the implications for inflation are difficult to interpret. If all we were witnessing was a change in the channel through which housing lending is made and bank lending was substituting for lending by building societies, the implications for inflation would probably be rather limited and there would simply be a downward shift in the velocity of circulation and PSL2 would be unchanged. Although £M3 would be inflated it would be appropriate to adjust the monetary targets. If, on the other hand, bank lending were additional to that by the building societies, we would expect, though possibly with a lag, that inflationary pressure would develop. When this phenomenon first appeared in mid-summer it looked as though much of the lending was additional, as building society lending continued at a high level. In recent months, however, building society lending has weakened substantially and much more of the bank lending appears to be in substitution. The growth in housing lending by banks may be just the most conspicuous example of a wider trend towards a larger role for banks in intermediating between savers and borrowers. But even allowing for these factors the growth of bank lending remains worrying.

4. The problems of interpreting movements in £M3 are not confined to the estimation of the size of statistical distortions of this kind. Although the relation of £M3 to inflation and the growth of nominal incomes appears reasonably stable in the medium term it is not close or predictable year by year. Economists are divided on the significance for future inflation of the rapid growth in £M3 over the past two years. Some continue to argue that £M3 is still the best guide to future price inflation. Others would attribute the rapid growth of the wider aggregates, here and in several other countries, to increased private sector savings, to a preference for liquidity in uncertain times and perhaps to a perverse effect of high interest rates.

The Exchange Rate

5. The second problem is how the exchange rate should be taken into account. There is no target for the exchange rate. But its level and movement have implications for the rate of inflation and may in some circumstances help in the interpretation of domestic monetary conditions. Last year for example the rise in the exchange rate may have been partly the consequence of tight conditions in UK financial markets. Uncertainty about the movement and significance of £M3 is a further reason for the recent emphasis on the exchange rate as a factor in monetary policy decisions. Although it is sometimes important to look at particular exchange rates, e.g. against the dollar and the deutschemark, the best single indicator is the sterling effective exchange rate index - see Annex A.

Conflicting evidence

6. The third problem of monetary policy arises when there is conflicting evidence, particularly for the prospects for inflation. Sometimes the evidence points clearly in one direction as it did in September when the exchange rate was weak and £M3 and the other wider aggregates appeared to be accelerating. Since September the evidence has appeared to be much more in conflict as Mr Burns and Mr Middleton explained to the TCSC on Monday. As interest rates abroad fell, the exchange rate strengthened, the effective rate at one point reaching about 92. Having weakened in the last couple of days it now stands at about 90 compared with 87 in mid-September. Bank lending, meanwhile, has continued at a high level both to persons and to companies, though the housing market remains weak and consumer spending restrained. There have been differences in the growth of monetary aggregates with £M3 growing noticeably faster than either M1 or PSL2, though correction for the effects of the strike would tend to narrow the differences. The very slow growth of the wide monetary base (Mo) probably reflects trend changes in the use of notes and coin, its main component, rather than providing a reliable indicator of financial conditions in the economy.

Percentage change	Mo	M1	£M3	PSL2
Target period Feb-Nov Actual rate	1.1	7.4	13.1	10.3
Annual rate after adjustment for strike	1.5	10.0	14.5	12.2

Thus there are conflicting indications both between the exchange rate and the monetary aggregates on the one hand and within the monetary aggregates on the other, though the differences between the latter (Mo apart) are currently not as extreme as a year ago.

Are monetary conditions too tight?

7. The conduct of monetary policy is necessarily a judgemental process but a number of observers have argued that this judgement has not been exercised correctly. In particular, the Government is accused of following £M3 excessively and allowing monetary conditions to become too tight both now and during 1980. In the 1980/81 target period there was a substantial overshoot of £M3 (18 per cent compared with a target of 7-11 per cent). This overshoot was not only tolerated but while it was occurring interest rates were reduced because the other evidence, the exceptional strength of the exchange rate, the speed with which inflation was falling, the squeeze on the company sector, the slow growth of M1, all pointed to very tight monetary conditions. In addition much of the growth of £M3 was thought to represent the replenishment of financial assets which had been eroded by inflation in earlier years. Thus it is unfair to argue that the Government followed £M3 blindly though a case could be made that it reacted too slowly.

8. The current position shows some similarities and some differences. The growth of £M3 appears to be accelerating and by February 1982 £M3 may have grown by around 16 per cent compared with a target of 6-10 per cent. Perhaps 1 per cent could be accounted for by the effect of the strike, and a further

$1\frac{1}{2}$ per cent at most could be accounted for by bank lending for housing if all such lending were in substitution for building society lending. Thus even allowing for these factors, a significant overshoot is likely to remain. Though the exchange rate has fallen substantially from its peak, the real exchange rate still remains high relative to its historical position, and the competitiveness squeeze on companies exposed to international competition is strong, with cost competitiveness still over 20 per cent worse than in Spring 1979. Nevertheless, company liquidity and profitability have improved in recent months. Against this there has been a setback in the progress towards reducing inflation and the imbalance between the company and personal sectors which was thought to have contributed to the rapid growth of £M3 in 1980 is now being reduced.

9. The evidence from the other monetary aggregates is not clear cut; although the growth rate of M1 and PSL2 are less than that of £M3, they remain close to that of the rate of inflation, whereas in November last year, there was an enormous difference between the narrow and wide aggregates. (Over the previous year M1 had grown by 4 per cent and £M3 by 19 per cent.) Thus Mr. Pepper's charts give a less than complete picture of the diverse growth of the aggregates. He has highlighted an annual rate of growth of M1 in the three months to this October, which shows a fall of 4 per cent. In fact moving on one month to November takes this figure up to plus 8 per cent. His estimate of 5 per cent for the annual rate of growth of PSL2 in the second half of the target period looks a substantial underestimate.

10. There has been a striking disparity in the growth of the counterparts to £M3. The growth of bank lending to the private sector is substantially in excess of that of £M3. This reflects the fact that lending to the public sector is not growing. Over the target period the recorded PSBR is expected to be almost exactly matched by debt sales. This, taken in conjunction with a rising note issue, produces a cash drain from the banks which is being relieved by substantial money

market assistance. At present this is largely taking the form of purchases by the Bank of England of local authority and commercial bills. In the absence of this assistance there would be substantial upward pressure on short term interest rates as the banks bid for deposits in order to restore their liquidity. Thus the combination of selling debt to fund the PSBR and supplying money market assistance has the effect of reducing the growth of £M3, while holding short term interest rates down rather than up.

10. It is not the case that short term interest rates are being held up in order to ensure sales of conventional gilts and obviate the need for an unrestricted indexed gilt. The funding position is not, in fact, having a major influence on decisions on short term interest rates. The decision on whether to issue an unrestricted indexed gilt is under consideration, but it is a difficult one, with powerful arguments on both sides.

Conclusion

11. In the face of conflicting evidence the Government has proceeded cautiously, allowing interest rates to fall from their peak though not to the extent of reflecting fully the fall in interest rates abroad. However, in this year as well as last, the level of interest rates has been held substantially below that which would be required if monetary policy were being determined solely by reference to the £M3 target which is again likely to be overshot. Account is thus being taken of distortions to the data, structural changes and of the other indicators of financial conditions. Although the public presentation of the Government's financial policies is evolving, and less emphasis is being placed on £M3 as the central target, it has been possible to achieve this shift while still maintaining credibility in the Government's objective of maintaining a firm but not excessive anti-inflationary pressure on the economy.

ANNEX A

EXCHANGE RATE MOVEMENTS

Although it is sometimes important to look at particular exchange rates, e.g. against the dollar or deutschemark, the best single indicator is the sterling effective exchange rate index. This weights different currencies in a sophisticated way (devised by the IMF) in relation to their importance for UK trade. The dollar's weight in the index is 25 per cent, about twice the share of our exports going to or imports coming from the US, in part reflecting the importance of US competition in third country markets. It is sometimes said that the dollar rate is particularly important for UK inflation because of the number of basic commodities prices in $s. But this effect will be relatively short term and limited to existing contracts: beyond that commodity prices will tend to reflect supply and demand, and their dollar prices adjust to rises or falls in the dollar. Since the effective rate index gives the dollar a relatively heavy weight it probably already sufficiently allows for any extra importance of the dollar for inflation. Commentators, of course, still tend to concentrate on the £/$ rate - and that rate will be particularly important for some companies, as the £/DM rate will be for others - but for policy it contains no special magic.

The table below shows how the main sterling exchange rates have moved this year. Between the Budget and the end of August the £ fell by around 16 per cent against the dollar, and the effective index fell by 7 per cent - both falls largely reflecting the general strength of the dollar against all currencies. During September sterling was weak against all currencies with the effective rate falling a further 6 per cent, despite significant rises in UK interest rates in relation to those abroad. Thereafter sterling recovered generally with the effective rate rising again to its mid-August level before falling back again in the last couple of days. It is hard to be sure of the reasons for these movements, but changes in

overseas interest rates, prospects for the world oil market and other countries' current accounts, and confidence factors have all played a part, as well as changes in domestic economic conditions.

	May 1979	10 March	28 Aug	14 Sept	29 Sept	11 Dec
£/$	2.06	2.21	1.85	1.78	1.79	1.88
£/DM	3.93	4.66	4.53	4.24	4.15	4.25
Effective exchange rate index	86.3	98.6	91.3	87.0	87.0	89.8

14 DEC 1981

(1)

10 DOWNING STREET

Prime Minister

This is the promised letter from the Treasury on interest rates. Although a good defence of their actions it seems to me a long way from what you were saying on Wednesday last.

Shall I say

(i) you are looking for a further ½% cut in base rates before Christmas

(ii) your longer term aim is to get our rates much nearer US levels

(iii) you very strongly support an unrestricted indexed gilt

(iv) ~~[illegible]~~ we must get off the £M3 target quickly – that means devising a justified and defensible alternative policy guideline quickly?

(Alan Walters would support each of these points).

Or would you like a discussion with Alan tomorrow before I write?

MCS 14/12

10 → Alan Walters (copied to AW) 2.

SECRET

10 December 1981

ALAN WALTERS

PRIME MINISTER

FEDERAL RESERVE BOARD STUDY OF MONETARY AGGREGATES IN THE UK

1. As you know, the Federal Reserve Board is very interested in our experience of monetary policy in Britain. One of its main research economists, David Howard, and his team, have been working on the subject for at least three years. He has sent me, on a personal and confidential basis, his first draft of a paper entitled "The Nonbank Demand for Monetary Assets in the United Kingdom: An Examination of Monetary Growth and Policy".

2. The paper is sophisticated and technically most complex. It is, however, highly competent; I can find no important error in the analysis.

3. The conclusions are modest and do not make extravagant claims. They are, however, entirely consistent with the views which I have expressed for more than a year now, and which Gordon Pepper has urged in his recent letter.

4. The summary conclusions of David Howard:

".... on the criterion of control ability the choice for intermediate target would seem to be M1 rather than sterling M3.

"With regard to the relationship with ultimate goals .... the preferred intermediate target is M1."

5. There are some subsidiary conclusions which are of interest for policy purposes. The first conclusion is that he discovers a high substitution effect of foreign currency with respect to domestic interest rates. Secondly, from other research, Howard reports that the monetary base instrument could be used to control either M1 or sterling M3 but that control would probably be better in the case of the narrow aggregate M1.

6. I have asked Howard to distribute his paper to the Treasury and the Bank.

SECRET

A

INSTITUTE OF DIRECTORS

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EMBARGO 12 am THURSDAY 10 DECEMBER 81.

PRESS INFORMATION

DIRECTORS CALL FOR A 'WORKERS CHARTER' TO SPREAD BENEFITS OF RECOVERY

Britain needs a 'Workers Charter' of new Government policies designed to give all workers a real share in the coming economic recovery, the Institute of Directors said today.

Walter Goldsmith, IOD Director-General, called for a programme of joint action by Government and employers to link all workers directly with the results of economic upturn and shift economic power back into the hands of the individual.

"In the next two years the Government must emphasise not 'unparallelled austerity' but policies to ensure that the rewards of the sacrifices that have been made are transferred directly into the pay packets of workers and their spending power as customers", Mr Goldsmith told a meeting of businessmen in London.

"Businessmen do not want Mrs Thatcher to change course. What they do, desperately, want to see is the entrenchment of the capitalist system in our society. To achieve a closer connection between individual workers and growing economic success, a new range of policies is required that will challenge in its radicalism both long-established prescriptions and the spurious solutions that are widely offered today

Among the components of the 'Workers Charter', Mr Goldsmith urged measures to enable workers:

To share in the financial rewards of successful enterprise

- through employers' undertaking not to hold down artificially the pay of workers who have achieved gains in productivity leading to profitability

- through cash incentives to civil servants to introduce more efficient and cost-effective working practices
- through luring moonlighting workers out of the black economy by generous new tax reliefs for those starting small businesses or becoming self-employed

To find real employment opportunities

- through a fundamental re-examination of comprehensive education and current and planned training systems to improve workers' job prospects as employment opportunities change
- through lower stamp duties to boost home ownership and Rent Act reform to encourage job mobility
- through broader action to strengthen the rights of individual workers against job restrictions imposed by power blocs in society.

To share in the responsibility for success

- through new laws to expand tax relief for employee share purchase schemes - not just in their own firms but in any quoted company, greater use of bearer share certificates and simplified, less formal means for workers to buy and transfer shares
- through radical measures to give to the people shares in the assets of nationalised industries which resist conventional privatisation
- through a commitment by employers to introducing voluntary but effective machinery for consultation with, and communication to, their workers.

The call for a new package of measures to intensify Government economic policy reinforces the Institute's pressure for significant personal and business tax cuts in the 1982 Budget. The IOD has urged the Chancellor to take 2p off basic rate income tax, financed out of the sale of public sector assets and the privatisation of nationalised industries.

The Institute's call follows pressure on the Prime Minister from the Centre for Policy Studies, where a group headed by former IOD Council member Nigel Vinson has urged more positive Government policies to widen and personalise the ownership of wealth in all forms. Both calls reflect concern that existing policies will fail to build an adequate investment-led recovery as Britain emerges from the recession.

NOTE TO EDITORS: The Institute's call for a 'Workers Charter' will be introduced at a Press Conference at the IOD, 116 Pall Mall, London SWI, at 11.30 am on Thursday 10 December.

For further information please contact:
Steve Crowther 01-839 1233 (office)
01-834 6223 (home).

EXTRACT OF A SPEECH BY WALTER GOLDSMITH, DIRECTOR GENERAL OF THE INSTITUTE OF DIRECTORS
TO A BUSINESSMEN'S LUNCH IN LONDON
THURSDAY 10 DECEMBER 1981

You have invited me to speak to you at a time which is critical for the future economic policies of Mrs. Thatcher's Government, and for that reason critical also for the longer term economic, social and political development of British society.

The policies which are pursued now and implemented over the next two years will settle the balance of the great interests in the economy: they will determine the future shape of the public and the private sectors and their rate of growth.

In our economy some key indicators have consistently pointed upwards and others have now begun to mark the onset of a significant recovery. Export performance and balance of payments have been consistently good. Productivity is now set to rise at about 11% this year. The decline in manufacturing output has been halted and reversed. The level of sterling has settled within a band which would appear to satisfy all but the most extreme advocates of devaluation.

But what many businessmen see to be a significant threat to long-term social stability posed by high unemployment levels remains unsolved; real standards of living are likely to decline in the immediate future as lower wage levels confront continuing high price inflation in the cost of public utility services and the costs, in both charges and subsidisation through taxation, of notoriously unproductive uncompetitive and monopolistic nationalised industries.

We must face the reality that many in Britain are deeply unsettled by both the pace and the effects of the economic

changes that have taken place since 1979. In 2½ years the Government has attempted to put into reverse the accretion of power in the hands of the controllers of nationalised industry, local authorities and the trade union movement which occurred between 1970 and 1976.

The high water marks, with the consequences of which we wrestle today, are the reorganisation of British Leyland and British Steel, the Heath-Walker reorganisation of local government, and Michael Foot's Trades Union and Labour Relations Acts of 1974 and 1976.

To begin to put into reverse the centralisation of power in the hands of these institutions is a major achievement of the present Government. It may be dismissed easily with a facile phrase about one government reversing the policies of its predecessor in a game of swings and roundabouts. But to businessmen who believe in free enterprise it is a success of the most spectacular kind.

A WORKERS CHARTER

But now we must turn our attention to the next two years.

Waiting in the wings are those who wish to return to the old ways, who wish to strengthen and renew bureaucratic power with themselves at the pinnacle; and those who seek the transformation to a full-blooded socialist society which amounts to a declaration of war on the free enterprise system.

Making the choice will be Britain's employees: those for whom your businesses are responsible, and their families and dependants.

And where Mrs. Thatcher's government has suffered its most disturbing failure is in its inability to present its policies in a manner which links employees directly to the results of economic upturn.

Nor has it pursued with sufficient radicalism policies geared to make a fundamental and irreversible transfer of ownership of resources in society from the state to the individual worker.

That is why the Institute of Directors is calling today for a second wave of Thatcher policies to share out the rewards of economic recovery.

Norman Tebbit's proposed legislation on trade union reform will restore the balance of industrial power between employers and trade union movement. Now is the time to go further with broader measures to strengthen the rights of individual workers against collectivist power blocs.

In the next two years the Government must emphasise not 'unparallelled austerity' but policies to ensure that the rewards of the sacrifices that have been made are transferred directly to the pay packets of workers and the spending power of customers.

What Britain must see is a Workers Charter in which joint action by Government and by employers will strengthen the vested interest of employees in the free enterprise system by carrying through a decentralisation of wealth and power; and in particular from a sagging public sector to an expanded private sector in which every worker could share.

Businessmen do not want Mrs. Thatcher to change course. What they desperately want to see is the entrenchment of the capitalist system in society. To achieve this closer connection between individual workers and economic success, a new range of policies is required that will challenge in its radicalism both long established preconceptions and the spurious solutions widely offered today.

New policies in bringing ownership to the people. In taxation. In profit-sharing, and share-ownership and asset formation. In wages. In reversing an alarming failure of education and training policy. Giving new incentives for the ownership of property in all forms. Boosting small businesses by more radical measures than those yet employed.

We must not shield the British workforce from domestic and international change but strengthen workers' capability to cope with change from a stronger individual position.

To pursue this Workers Charter would not amount to a U-turn for Mrs. Thatcher's government. It would rather amount to the implementation of the policies the Government was elected to pursue, with overwhelming business and electoral support.

But it would challenge an entrenched bureaucracy in national and local government which has grown fat on the existing way of doing things.

Civil Service Incentives

If the scale of public sector economic activity is to be reduced by a shift of wealth into the hands of individuals it is now a high priority that the vested interest of public officials in the expansion of their empires be countered.

Already, measurement of labour turnover - which alone can identify the non-cash benefits of public sector employment - is being built in to civil service pay determination arrangements.

Now it is time to go further. Civil servants should be given a tangible personal financial interest in the contraction of departmental activity.

It is a rare industrial concern that does not operate a suggestion scheme with cash rewards for the introduction of more efficient and productive working methods. Let us now introduce a Civil Service equivalent: cash rewards for Departmental staff securing cost savings through the better employment of available personnel and cash resources.

Pay and promotion patterns should also reflect these factors.

Let the Comptroller and Auditor-General, with the aid of his professional staff and the assistance of external consultants for specific investigations, now assume a clear role with the responsibility to the House of Commons of monitoring a new regime of civil service economy in which it pays officials

personally to secure the contraction, rather than the expansion, of their administrative establishment.

It is difficult to imagine that the most elementary incentive or monitoring scheme would not, for example, have called an early halt to the empire building of the Manpower Services Commission which has established an unenviable record for profligacy in the setting of Job Centres in expensive High Street locations - 672 by the end of 1980, planned to increase to 1,020 by 1983-4. They work in a system whereby an unemployed worker may often be under the suzerainty of no fewer than three public bodies simply to register as unemployed and collect benefits: the Department of Employment Unemployment Benefit Office at one town centre site, the Department of Health and Social Security in another and the Manpower Services Commission in the third and most affluent.

It is time, too that civil servants at comparatively junior levels were involved more closely in the organisation of their work. Questioned in a significant survey of job satisfaction undertaken by Hugh Livingstone and Roy Wilkie of the University of Strathclyde, higher executive staff showed that dissatisfaction with pay levels was outstripped by over 7 to 1 by dissatisfaction in 'job content'. Significant numbers of civil servants felt underused, or without any sense of challenge; that they were performing a job of no use to anyone; or a general lack of responsibility.

As the authors said, "Our figures almost point too clearly in the direction indicated by the popular and over-simplified view of the nature of work in public bureaucracies".

Civil servants at these level deserve a better deal, a management system more clearly linked to curtailment of functions and greater cost-efficiency of operation.

Wage Levels

But worker perception of pay levels is becoming a significant problem in the private sector of the economy.

It is becoming clear that there is a danger that general calls for wage restraint, especially those involving the use of norms or coded phrases to suggest pay norms, are being overstressed by Government ministers and some business spokesmen.

Of course, I do not deny for a moment the general and demonstrable reality that wage levels have been far greater than accurate measures of productivity and profitability would justify. Wage inflation in the public sector continued at 30% in 1980.

But workers in the private sector are in many cases now beginning to suspect that the effect of a general pay clampdown will be to penalise the efficient and productive. Let us therefore make it quite clear, Government and employers alike, that workers in businesses where productivity and profitability have improved deserve higher pay packets to reward their achievement.

To do otherwise is shortsighted: employers who artificially seek to hold down pay will suffer low employee morale, worsening industrial relations, and skill shortages as employees move to more progressive employers.

Already there are signs, monitored this month by Incomes Data Services, that "very low norms sought by the Government and the CBI are not being followed at company level".

And there is renewed emphasis on productivity bonuses on top or low basic rate increases.

So let us give a clear message to our employees that performance and success will be properly rewarded. Good communication cannot be fostered by talking pay down against improved results.

Britain is a low pay society. We must move rapidly to high performance, high productivity and higher pay rewards.

Incentives to Workers

In many cases the most acceptable means of rewarding improved performance resulting in increased profits will be through cash bonus or incentive schemes.

A Workers Charter will mean employers in companies of all sizes re-examining pay arrangements to consider the introduction of these well-tried and self-policing systems.

Existing profit-share legislation, although fostering a welcome rise in the number of companies operating profit-sharing schemes - the consultants Copeman Paterson have estimated that by 1984 around half the country's quoted companies will have such schemes - artificially limits their effectiveness.

First, the legislation does not provide tax concessions for profit share bonuses taken in cash. But a survey by the Industrial Participation Association has shown that more than 70% of employees received the bonus in cash.

So a Workers Charter would involve legislation broadening the scope of employee share schemes to give tax relief for cash bonuses used to purchase shares in businesses outside those employing an individual worker.

Cash bonuses from existing profit share schemes should be tax free when used to purchase more shares in other companies. We also need, as has been urged by the Centre for Policy Studies, measures to eliminate stamp duty and to simplify transfer arrangements for small parcels of shares.

We want to see individual employees able to buy and transfer shares with the minimum of formality, the maximum tax advantage and the fewest difficulties.

A new system to encourage the use of bearer share certificates would be worth careful consideration. The administrative burden on company registrars would be significantly reduced by this boost to individual share ownership.

Then many private companies wish to reward employees without diluting share ownership. Companies should be permitted to issue employee bonds which would be treated for tax purposes in the same way as shares but would enable control to remain with the company.

It is a false conception of the wishes of workforces to seek to confer statutory powers of co-determination of company policy upon them or - in Britain - upon their representatives in the trades union movement who have signally failed in national terms adequately to reflect their wishes. That is why a true Workers Charter would reject the EEC's 5th, 9th and Vredeling Directives which seek to monopolise bargaining power in industry in the hands of representatives of collectivist bureaucracy.

This does not mean that workers are not fully entitled to have relevant details of company performance communicated to them; to be consulted about changes affecting their own work: to be involved in a wide field of work, extending beyond an individual's own task, where they have a contribution to offer; and where appropriate to individual financial participation in a company's success.

The Institute has called upon its members to introduce formal consultative and communicative procedures in all companies of over 100 employees.

Far more relevant to the British scene, is a dramatic expansion in employee share ownership. A House of Lords Select Committee on asset formation found that only 3.8% of the whole population own shares directly. This is a scandalously low figure.

And the scale of the problem is illustrated more dramatically still, when the same committee found that by January 1981 only 145,000 of a total working population of 24 million employees were covered by employee share schemes.

The need is primarily to increase ownership directly by individuals - not just through pension funds or unit trusts. The French Loi Monory has been examined in Britain time and again. In innumerable submissions to the Treasury the advantages of a simple tax rebate to those who purchase shares in British companies has been stressed. The French experience suggests that the Monory measure led to share purchase by about 400,000 taxpayers who were completely new to share investment. Between £400 and 440m of new funds came to the stock market through the measure.

It didn't stop the election of President Mitterand, but a very significant increase in new shares issues occurred in the first year of the scheme and French firms significantly increased their equity capital.

Workers must certainly not be led to place all their eggs in one basket, in the shares of their employing company, or into wild speculation with the family income. But Mrs. Thatcher and her Treasury ministers must now squarely confront the need to make much faster progress in employee share ownership.

Property Ownership

We must turn our attention, also, to wider questions of property ownership. Mr. Michael Heseltine is, in his inimitable and commendable way, beginning to deal with local authorities which appear to have gone slow on council house sales.

But meanwhile his Treasury colleagues have persisted in failing to amend thresholds of stamp duty on house purchase which have become punitive through property inflation.

It is now urgent, in the interests of property ownership and indeed job mobility that stamp duty thresholds be raised significantly. The Government must follow the lead given by private sector housebuilders who have recognised that stamp duty is a significant disincentive to wider home ownership.

At the same time more dramatic measures are needed to bolster the private rented market and help job mobility.

Let us in a Workers Charter end the fixing of rental levels by rent officers and rent tribunals for new rental agreements as the first move in a phased deregulation of the private rented housing sector.

Nationalised Industry Privatisation

It is no less urgent that the privatisation of nationalised industries proceeds more quickly in a more imaginative manner than has been the case to date.

Not only does the transfer of ownership of nationalised industries to free enterprise offer more secure long-term employment opportunities for workers whose future prospects as state employees are often slimmer than they may think. They are conditional upon the continuing stranglehold upon the taxpayer for subsidisation of their managements and trades unions, and on political whim.

But it tackles the reality that the influence of individual members of the working population is at its weakest when pitted against bodies which, in theory publicly owned, are in practice susceptible to the control neither of their sponsoring Departments, nor of Parliament or their customers.

A Workers Charter will reassert Parliamentary control of nationalised industries by strengthening the statutory powers of their controlling ministers over their board, by extending the role of the Comptroller and Auditor General to allow meaningful public and Parliamentary scrutiny of their financing, and by revamping the system of nationalised industry consumer councils which have failed overall to exercise a sufficiently independent and incisive role as the guardians of the public interest.

Not only are the measures announced by the Financial Secretary to the Treasury of Monopolies Commission examination of nationalised industries once every four years clearly inadequate as a means of supervision of nationalised industries. They have also succeeded in provoking a significant clash between Parliament and the Executive where members of the House of Commons are legitimately concerned at the ineffectual nature of public monitoring and supervision of nationalised industry finance.

In Britain today, what is everybody's is nobody's. We must give ownership back to the people.

So a Workers Charter for the nationalised industries would involve a parallel redoubling of the privatisation drive and a strengthening of the control mechanisms over industries remaining for the time being in the state sector.

In its failure to take up Samuel Brittan and Norman Riley's brave concept of giving North Sea Oil to the people through the distribution of North Sea Oil tax and royalty revenue direct to every UK taxpayer, the Government failed to take up a significant opportunity to move towards people's or workers capitalism.

But there is a need to pursue this line of thinking.

"Why should there not be a more general fund into which the revenues of all the nationalised industries are placed, and in which every citizen enjoys a stake?" asked Brittan and Riley in 1979, pointing out that it would be difficult to decide whether such a move should be termed denationalisation or more genuine public ownership.

It is time that Government looked into these challenging opportunities more carefully.

Let me give an example in the case of British Rail. That public sector organisation has just been bailed out to the tune of £110m for its losses in the last financial year, in addition to the extension of the already subsidised 'social railway'.

At the same time, BR is demanding an additional £5.67 bn of further subsidisation in a 10 year investment programme, its response to appeals from the Secretary of State for Transport to finance further investment internally has been to launch a political advertising campaign demanding more public money, and the fruits of privatisation to date extend to the sale of a mere three railway hotels to a consortium including itself and the railway unions.

Unless this rate of progress improves the Secretary of State should consider more radical measures to restore British Rail to effective public ownership. He could start setting in motion moves to transfer the assets of the British Rail Property Board, of about £700 - 800m, to the people through marketable share or bond certificates sent to every UK taxpayer and saleable through the Giro service at every Post Office, to private sector property and investment company buyers.

By such methods the assets of the British Rail Property Board, the British Gas Corporation, or any other limpets clinging obstinately to the public sector could be transferred to the stock market in a manner which brought home to every taxpayer his individual stake in their ownership.

Little or no published work has been conducted into the mechanics of transferring state industries through true public ownership to the market. But it is a central feature of any effective Workers Charter attempting to secure a wider dispersion of different kinds of property ownership.

Education and Training

The working population of this country has been scandalously ill-treated by our existing educational and vocational training systems.

That is the conclusion any businessman must reach, not merely by the evidence around him but also from a beautifully researched and written study by Mr. S.J. Prais of the National Institute of Economic and Social Research, a paper which has received far too little attention since it was published a fortnight ago.

Comparing, for the first time with the results of official household surveys, the vocational qualifications of the British and West German labour forces, Mr. Prais shows that the proportion of the workforce with intermediate qualifications - apprenticeship, City and Guilds, a full secretarial qualification - is double the British figure in West Germany.

60% of the German workforce falls into this qualified category - and only 30% in the British.

Two thirds of the British labour force have no vocational qualifications compared with a third in Germany, and this level of difference exists almost right across the two economies.

The Germans produce each year between two and three times as many qualified craftsmen as Britain in agriculture, (12,000 as opposed to 6,000) construction (35,000 compared with 14,000) and miscellaneous services such as catering, hairdressing etc (34,000 and 9,5000 respectively).

In its review of recent training legislation (Outlook on Training, 1980) the Manpower Services Commission had not been able even to put together statistics of the number of trainees reaching specified levels of competence.

This NIESR work suggests clearly what many businessmen have long suspected: that Britain's comprehensive education system and vocational training arrangements have signally failed to provide an adequate level of qualified workers in the crucial intermediate qualification area which tends to determine inter-industry variations in productivity levels.

As a part of a new Workers Charter, let us now open a fundamental re-examination of our secondary education and training systems and be prepared to admit that a new generation of specialised secondary technical schools or colleges may offer the most effective means of catching up with our European competitors.

The Government must face the need for an education voucher system to allow parents themselves to influence school curricula.

A lower school leaving age coupled with legislative encouragement of continuing part-time vocational training in the private sector could restore Britain's competitive position in education and training.

<u>Taxation Policy</u>

At base any new contract with Britain's workforce must depend upon the more efficient allocation of resources in society, the reduction of the tax burden upon the individual, and the restoration of individual consumer spending power as the most accurate determinant of profitable investment.

Measures to strengthen individual economic power will fall at the first hurdle unless the basic rate of income tax is reduced step by step to the Government's declared target of 25p in the pound.

The Institute of Directors, in its 1982 Budget submission, has demonstrated that the Chancellor has the flexibility to reduce basic rate income tax by 2p, to 28p; and to trim the rates of capital gains and capital transfer taxes to provide incentive for family businesses, in addition to a 2 percentage point cut in corporation tax.

More radical measures are required to bring home to individual workers the benefits and opportunities of small business activity - whether part-time or eventually full-time.

The Institute calls upon the Government to introduce a clear and unambiguous tax free starter for workers moving for first time into small business activity as a self-employed. A £5,000 tax free starter for the first few years of self-employment would reflect the reality that little tax is payable through the operation of the existing Schedule D system. Making the relief conditional upon prior registration with the Inland Revenue would lure thousands otherwise tempted into the black economy back into the real economy, where they would be free to advertise, to employ people and expand and develop their businesses without the attention of Mr. Ridley's new Inland Revenue anti-tax evasion squads.

Incentives of almost every kind now exists for those who make losses investing new small businesses, or for those who invest under the Business Opportunities Programme in other people's businesses.

We need to see now a Workers Charter in which employees who wish to do precisely what a Government is always urging upon them - to move into the self-employment sector - should have a clear individual tax advantage in doing so.

Employers have a responsibility, also. Many contracts of employment adopt a perhaps unduly restrictive approach to spare time economic activity by employees.

They encourage workers to play darts or drink in the evening, but not to take part in any sideline which might make a small profit pursuing a comparatively enjoyable leisure activity.

Employers should now consider relaxing the terms of employment which could preclude their workers from outside activity in spare time employment or self-employment, and concentrate more narrowly on areas where employees might compete with or otherwise damage the activities of their main employer.

Conclusion

Mrs. Thatcher's Government has reached a turning point in the way in which its relations will develop with the working population which elected it to power in 1979.

The siren voices are now at their loudest, urging ill-considered reflationary economic packages that would weaken rather than improve the economic position of the workers they are supposedly designed to assist. The public sector chieftains, accountable to no-one, are attempting to snatch back the power and the resources which they have seen begin to be returned to people. The manipulators of the trade union leadership similarly hope to grab back their corporate control of Britain's workforce, which has been so decisively rejected by working people themselves.

But, Mrs. Thatcher now has the opportunity to steal the clothes of her opponents. To put capitalism and free enterprise at the centre of the political stage. To fill the empty phrases of British political debate about decentralisation, participation and involvement with a new reality: a Workers Charter that pursues Government economic policy to its declared conclusion by making a fundamental and irreversible shift in economic power in society.

I am confident that she will have the courage to follow this route.

MS

10 DOWNING STREET

PERSONAL

10 December 1981

Dear David

Thank you so much for your letter of December 4, and for enclosing the draft of your study of the demand for money in the UK. Your paper comes at a very opportune moment when we are thinking about the next stage in the medium term financial strategy, and as you know, many of your conclusions are consistent with my own views about the relative values of M1 and sterling M3 as targets. Are you proposing to send your paper to the Bank of England and the Treasury?

I will read it carefully and comment later. There is just one point that occurs to me at this stage. I think it is widely appreciated now that sterling M3 responds slowly and not very predictably to changes in interest rates. I believe there is an understanding creeping in that sterling M3 is probably best controlled through the Budget deficit on the one hand, and through open market operations at the long end of the yield curve. Although the latter has some relationship with interest rates at the short end, again it is very unpredictable and uncertain.

I wonder if you would be kind enough to send me copies of your International Finance Discussion Paper No. 185 and the recent version of "The British Banking System's Demand for Cash Reserves" which you are publishing in the Journal of Monetary Economics.

Yours
Alan

Mr. David H. Howard,
Federal Reserve Board,
Division of International Finance,
Washington DC 20551,
USA.

Econ Pol

PRIME MINISTER

MEETING WITH THE CHANCELLOR OF THE EXCHEQUER AT 1730: 9 DECEMBER

I understand that the Chancellor is likely to raise two issues at this meeting:

(i) he will wish to review generally the public expenditure statement and its aftermath;

(ii) although he will be minuting you tomorrow or Thursday on interest rates he is likely to want to run over the ground with you. This may well lead him into a discussion of where we go from here on monetary targetery now that the primacy of sterling M3 has been eroded.

MCS

8 December 1981

PRESS ANNOUNCEMENT

PROVISIONAL ESTIMATE OF MONEY SUPPLY: 18 NOVEMBER 1981

Preliminary information suggests that during the four weeks to 18 November, sterling M_3 may have grown by about ½ per cent after seasonal adjustment. Some £1¼ billion of taxes delayed by the civil servants' strike were collected during the month, thereby reducing the CGBR, and this appears to have added substantially to bank lending.

BANK OF ENGLAND
8 December 1981

Thank you [handwritten]

Prime Minister
You asked for this earlier today. I have sent a copy to the Chancellor, in case it's of use for him tomorrow. MCS 7/12 [handwritten]

7 December 1981
ALAN WALTERS

NOTES ON THE CLARE GROUP'S RECOMMENDATIONS OF DECEMBER 6, 1981

DEFICIENCY OF DEMAND VERSUS REAL WAGE STICKINESS

1. The Clare Group argues that there are two elements which explain the high level of unemployment in the UK. First they argue that there is deficiency of demand. At one point on page 15, they say that deficiency in general effective demand is of "dominant importance". But they do not suggest how they have reached this conclusion. It remains an assertion rather than the result of an argument.

2. But aggregate money demand is translated into aggregate real demand by dividing by the price and wage level. For a given increase in money demand, roughly 10-12% in the UK, we can get an increase in real demand by subtracting from it the rate of wage and price inflation.

3. They argue, consistently with the Government, that real wages per unit of output are too high and should be reduced. But they argue that the normal pressures of monetary policy, and indeed unemployment, are not effective in the highly rigid labour markets of Britain. They are in favour of measures to improve the workings of the labour market, such as trade union reform and the various subsidies, they believe that the only way to bring back growth is by an increase in "demand reflation".

INCOMES POLICY

4. In order to make sure that increases in demand are not dissipated in increases in wage costs, they propose some sort of incomes policy. This policy, however, is not specified. Broadly speaking this takes the form of "conditionality"; that is to say the Government says that only if pay settlements and price increases are reasonable (say the former below 5% and the latter less than say 7%) will the expansionary policy be embarked upon. If pay settlements are excessive then presumably the expansionary policy will be reigned back.

5. It may have escaped the notice of the Clare Group that this is the sort of policy we have been pursuing, for example on the railways.

/6. And in effect

6. And in effect through the medium term strategy there is an automatic reduction in aggregate demand if inflation is too high.

7. To do the authors justice, one must recognise that they do admit that there are problems in operating an incomes policy. But it seems a little rash to rest the whole expansion programme on such a fragile basis as the so-called conditionality type of incomes policy. Since the conditionality would apply, presumably, to the whole economy, as distinct from our railway example, then this would in no way constrain any individual union or individual shop steward from breaking ranks. Even though it were possible for the TUC to enter into any such undertaking, I cannot see how one would prevent the individual unions or shop organisations from busting the policy wide open and declaring an open season.

INTEREST RATES AND DEVALUATION

8. Their proposal for lower interest rates, although unspecified quantitavely, and a 10% devaluation of sterling seem to me to be not at all inconsistent with our policies. In spite of the various messages which the Chancellor has issued, the Clare Group are clearly concerned that we shall pursue a restrictive policy for interest rates in order to deliver on the MTFS target for M3. Clearly, however, if we give more weight to the narrow aggregates, there is no reason why interest rates should not fall along with international interest rates. And a trade-weighted average for sterling of 86 (1975 = 100) is well within the bounds of acceptability.

TAX CHANGES

9. Their proposal to eliminate the National Insurance Surcharge, since it is a tax on the employment of labour, is one we would put fairly high on our agenda. Since the objective, however, is largely to increase employment and output, it is odd that the Clare Group did not consider the benefits/tax system in working to make unemployment an attractive state. They do mention the poverty trap and the need to index the tax thresholds and allowances, but it is en passant. They do not consider at all the effects of the benefits/tax system on keeping up the level of real wages.

10. They recommend a reduction of VAT by 2½ percentage points. Apparently they believe that the main effect of this would be to help in wage bargaining since it would give a reduction in the final price level. The decrease in VAT will also "raise demand".

THE EFFECT ON PSBR, MONEY SUPPLY, INFLATION AND INTEREST RATES

11. The Clare Group appear to argue that there would be off-setting gains of £5.5 plus billions to the cost of their £6.8 billion package. So the net cost would be less than £1.3 billion in 1983. They do modestly say that these are only "orders of magnitude" so perhaps we should not expect too much from that. But the net reduction on the recorded unemployed is alleged to be only about 320,000; the output of goods is thought to be about 3% higher than it would otherwise be. The lion's share of the reduction in unit labour costs is brought about by the proposed devaluation down to 86. A reduction in the National Insurance Surcharge adds another 3%, giving a total of 7½%. These reductions generate much of the increase in output that the Clare Group anticipate. It is to be noted that the devaluation effect has always the strong, positive, and no negative effects on reducing the PSBR, whereas the reduction of the National Insurance Surcharge does involve a loss of revenue.

12. There is an important lacuna in the Clare Group's arguments. Although they show the PSBR increasing, nevertheless they require interest rates to be lower. How they manage the trick of having an increased demand for credit, both from the private and public sectors, and lower interest rates, is never explained.

13. The Clare Group are also confused in saying that our policy has cut out the "automatic stabilisers in the system to counter the falling tendency of output by raising the PSBR". I should have thought that there was ample evidence that in 1980/81 the PSBR was some 5 billion above target. Much of this was an automatic regulator. Their judgement is valid for the announced policy, but does not apply at all to the realised outcome.

CONCLUSION

14. The Clare Group is not so far from the Government's position as the press appear to think. However, the optimistic results of the Clare Group's policy depends upon heroic assumptions which have been so discredited in the past - such as an incomes policy. Furthermore, there is a basic inconsistency between financing the Clare Group's proposals for an increased PSBR and falling interest rates. We might ask how they solve this central conundrum.

Prime Minister

If this analysis is correct it argues caution about becoming identified with a $ parity as high as £1 = $2.00 or $2.10.

CONFIDENTIAL

cc Mr. Hoskyns
Mr. Wolfson
Mr. Scholar
Mr. Duguid
Mr. Vereker

PRIME MINISTER

MCS 7/12

MONETARY POLICY AND THE EXCHANGE RATES

1. You have said on a number of occasions that you would like to see sterling at about two dollars to a pound. The main reason seems to be that a higher pound would mean cheaper imports and a slower rate of increase in the RPI.

2. This may, however, give rise to misleading signals about the effects of monetary policy. Our basic strategy has been to control the monetary aggregates and allow the exchange rate to be freely determined by the markets. In the long run the exchange rate will reflect the relative purchasing power parity of the pound as against the dollar. And this value to be determined in turn by the relative long term monetary policy (over a 3-5 year period) of the UK compared with that of the States. (For what its worth my guess is that the purchasing power parity of the pound compared with the dollar is round about $1.70 to $1.80.)

3. In the short run the exchange rate will reflect many other factors. The exchange rate is the price of one asset relative to another and, like any other asset price, will react to a whole spectrum of events and expectations, both political and economic. In the short run monetary policy is, however, usually the dominant influence. We could for example increase the dollar parity of sterling by pursuing a restrictive monetary policy - just as we did in 1979/80. There would then be a sharp but transitory increase in sterling which would take us well above the purchasing power parity. This would "help" with the RPI increase in that six month or so period. But you would pay for it later since inevitably sterling would come down again towards its purchasing power parity - which is what has happened since March 1981. Then the depreciation of sterling would be reflected "unhelpfully" in increasing the rate of growth of the RPI.

4. As far as the general thrust of inflation is concerned, it is best to ignore the oscillations in the RPI which are due to changes in sterling. One should concentrate only on domestic inflation. This is what we control directly and monotonically through the monetary

/aggregates.

CONFIDENTIAL

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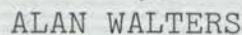
aggregates. The effects brought about by the short term movements in exchange rates are misleading.

5. Trying to maintain a high dollar rate may be particularly damaging in the months ahead. It looks as though the restrictive monetary policy in the United States will really bite in the first half of next year. This may dramatically revise expectations in the United States and may indeed bring the inflation rate down to 5% or even below. This would normally be associated with a marked hardening of the dollar relative to sterling. Thus it may require a very drastic and very damaging monetary squeeze in order to keep sterling at a level above $2.

6. This argument applies mutatis mutandis to other currency parities. As far as our exports are concerned, the main currency that matters is the Deutschemark. As far as the Bundesbank is concerned, however, the Deutschemark dollar rate is the most important one for Germany. Sterling is a side-show. We cannot affect the DM/$ rate which determines relative export/import prices.

7. My main conclusion is that it is unwise to regard the value of sterling as an aid in the battle against inflation. It is best to concentrate where we can on monetary policy and leave sterling to find its own value. Occasionally, when the monetary aggregates are obscured, we can use short-run changes in the exchange rate as indicators of movements in M1. But they should be strictly used and carefully interpreted as indicators. In particular, entertaining idée fixe about the dollar value of sterling may be very damaging if, as seems likely, the Americans go into a sharp reduction of inflation during the first half of 1982.



7 December 1981

ALAN WALTERS

CONFIDENTIAL

SECRET

Econ Pol vb 9

bc Alan Walters.

7 December 1981

Interest Rates

As I mentioned to you on the telephone this morning, the Prime Minister hopes that she would be consulted before any action was taken by the Bank or Treasury which was designed, or could be construed as being designed, to push up interest rates; or to prevent the market from going down.

The Prime Minister has also asked me to record her wish that Alan Walters be invited to meetings held by Treasury Ministers on interest rate policy and developments.

MCS

John Kerr, Esq.,
H.M. Treasury.

SECRET

Michael - I spoke to Alan on Sunday. I think we shall have to take action with the Treasury & Bank on Monday. MS

Prime Minister

I have told Alan about the seminar we are fixing for early January; and that the Treasury will be writing next week. MCS 4/12

SECRET

PRIME MINISTER

LETTER FROM GORDON PEPPER

1. Gordon Pepper points out that we are in danger of repeating the extraordinarily tight monetary squeeze that we imposed, albeit inadvertently, in 1979/80.

2. He argues that the narrow indicators are much more reliable than M3 as indicators of monetary stringency. He also shows that among the wider aggregates PSL2, the most reliable of them, exhibits some stringency, (5% annual growth in recent months).

3. Gordon Pepper's view is entirely consistent with the view I put in my memo of 30 November, which urged you to allow the interest rate to fall. I understand that yesterday a meeting of Treasury Ministers and the Bank decided that a reduction in the band was not appropriate at the present time, primarily because of the expansion of bank lending. The statistics suggest, however, that much of this lending is simply banks substituting for non-banking institutions.

Alan was not invited - but neither were several Treasury Ministers: the Chancellor wished to keep it small. MCS 4/12

4. I believe there is an underlying reason for the Governor's reluctance to let interest rates follow the market. I think it arises from his opposition to the possible issue of non-restricted indexed gilts. During September, when there was great difficulty in selling ordinary gilt-edged, there was considerable pressure on the part of the Treasury to issue a non-restricted gilt. I believe that such is the Governor's opposition to such an issue, that he would wish to keep interest rates high in order to be absolutely certain that there would be no excuse for issuing non-restricted indexed gilts.

5. All this suggests that the quicker we move to some form of monetary base control the better.

Some copy of Hopkins to AW
Write to Ch/Ex

AW

4 December 1981

ALAN WALTERS

SECRET

BOW BELLS HOUSE (7th FLOOR),
BREAD STREET, LONDON, EC4M 9EL
Telephone: 01-236 2040

Professor A.A. Walters,
10, Downing Street,
London, SW1.

3rd December, 1981

Dear Alan,

As you know, I telephoned you earlier in the week to express my concern that monetary policy is becoming dangerously tight and you asked me to put my comments in writing.

Let me assume, for the moment, that I am correct about the current tightness of policy - why the concern? Arguing from example, a primary cause of the extraordinary appreciation in sterling in the second and third quarters of 1980 was the tightness of monetary policy in the first half of 1980. If monetary policy had not been allowed to become too tight, the intensity of the squeeze on manufacturing and employment would not have been as severe and the siren voices of the Wets would not have become as troublesome as they are now.

If a similar mistake is made this time the result will be very serious. The economic recovery in the UK is extremely fragile, particularly as the US is having the second leg of its recession. In my judgement the monetary indicators are starting to signal that the UK is suddenly going to dive into the second leg of its recession. To put it mildly, that would not be a policy of "gradualism".

One of the ways in which gradualism works in practice is to confront companies with the serious possibility of bankruptcy without them actually going out of business. Some managements and unions have to be frightened into "putting their houses into order" but the company must survive for the outcome to be positive. If the UK develops secondary recessionary momentum to a major extent, the result will be the slaughter of many companies. Hence my concern, particularly at a time when, contrary to popular impression, the Government's economic policy is close to being on course.

/Continued ....

Professor A.A. Walters 3rd December, 1981

Turning to the best way of judging the current stance of monetary policy, I have the following points to make:

i) Sterling M3 and PSL1 are currently distorted upwards by competition between the clearing banks and building societies. PSL2 is the best current measure of broad monetary growth.

ii) Even so, PSL2 has been distorted upwards by the civil servants' dispute. The likely outcome in the financial year as a whole now appears to be about 11%, i.e. growth of 5% per annum during the second half of the year.

PSL2 has also been inflated by genuine savings being invested in liquid instruments, as described in our recent Bulletins. A distinction should be made between buoyant growth that is a result of genuine savings and buoyancy that is the result of unintended savings, the latter being the usual phenomenon. The short run effects are different (the long run effects may, however, be similar; I accept that allowing excessive liquidity to build up in the economy may store up problems for the future).

iii) All the narrow monetary aggregates are flashing warning signs that the squeeze is dangerously tight. They are likely to continue to do so if short term interest rates are not reduced.

I know that Brian Griffith's judgement about the stance of monetary policy is different from mine. I accept his point that during the last decade or so sterling M3 has statistically been the most reliable measure but it has only been the most reliable on average and not in every year. Financial conditions in the last two years have been without precedent and the statistical evidence of earlier years must not be followed blindly.

I am all too aware that when in the past I have sounded warnings of excessive monetary tightness I have been misunderstood. The last time was in 1979/80. I have been re-reading the warnings that I sounded then and enclose some extracts together with our latest Bulletin, with the relevant passages marked. You will see that the parallels, particularly about not following US interest rates down, are too close for comfort. With the benefit of hindsight, I am convinced I was right in 1980. I fear a similar situation is developing now.

Yours

Gordon

Gordon Pepper

PS. I am sending a copy of this letter with enclosures to Terry Burns and Peter Middleton.

Encl.

W. Greenwell & Co.

Bow Bells House, Bread Street, London EC4M 9EL
Telephone: 01-236 2040 Telex: 883006
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Telephone: 212 832 7428 Telex: 710 5815122

BAROMETRIC PRESSURE

A Column by Gordon Pepper
in The Observer on 12th August, 1979

Will Margaret Thatcher, like Edward Heath in 1971, be forced to make an about-turn in her economic policies, either this winter or next? The odds must be heavily on 'Yes', if the money supply is allowed to grow too slowly, and on 'No' if it is not.

It may surprise some people to read that a person with my reputation is worried about the prospect of the money supply rising too slowly, but the popular image misrepresents the true position.

In common with most monetary economists, I argue for policies which exert controlled financial pressure. It takes time for the economy to adjust to changes in financial pressures. The economy should be given that time. If it is forced to react too abruptly, it will suffer quite unnecessary disruption. I, therefore, disagree with policies which lead to sudden and acute pressures.

One of the best barometers of financial pressure is the behaviour of the money supply. Most monetary and financial economists argue just as strongly against inadequate monetary growth as they do against excessive monetary growth.

A good example of a too abrupt reaction being forced on the economy was the inadequate monetary growth in 1969-70. The same thing occurred in 1974-75. On both occasions, Britain subsequently paid the price in a stream of unnecessary bankruptcies and higher unemployment and, in 1971, Mr. Heath was forced into an about-turn.

Unhappily a replay in 1980 is threatened. A recession seems almost certain to start soon. Once it does, it will tend to feed on itself. As the recessionary pressures gather momentum, the growth of the money supply will decelerate. It always does, because the money supply is a barometer, not only of financial pressures which result from Government policy, but also of internally generated pressures.

I should stress that inadequate monetary growth is not our problem at the moment. On the contrary, monetary growth in the recent past has been excessive and appears only now to be coming back under control, but inadequate growth will be a danger by next year.

If we are to avoid a repetition of the upheavals of 1974-75, the authorities must prevent the money supply from growing too slowly as we enter the recession. For example they should ration the sales of gilt-edged stock to ensure that adequate finance is available for the corporate sector. Otherwise, the recession could get out of control.

P. G. E. Greenwell, R. H. Lawson, C. E. Frappell, G. T. Pepper, The Lord Annaly, J. A. Rickards
L. Gooderham, T. Quinn, A. T. Boanas, M. T. Higgins, D. G. Thomson, H. N. Seely
T. G. Wakeley, J. F. R. Hammond, J. Wigglesworth, E. J. Fenton, A. J. Bonner, N. S. King
G. P. P. Stewart, K. P. Joseph, A. G. P. Davidson, P. D. Jones, R. L. Thomas, K. C. Brown
J. C. Finch, S. J. D. Posford, K. G. Sykes, R. W. Walker, W. E. A. Bain, R. M. Harvey
R. B. Pomphrett, M. R. F. Wonfor, A. L. Bucknall, M. S. Jaskel, P. B. Lilley, A. J. E. O'Sullivan
Associated Members: O. J. Olcay (U.S.A.), Graham H. Greenwell, The Lord Renwick

Virtuous circle

What is true for the money supply is also true for sterling. In both cases, gradual change is desirable. Many of us hope that sterling will tend to rise gently, as part of a virtuous circle where a rising exchange rate reflects and supports a successful domestic policy to lower inflation.

But sterling can rise too sharply. A fortnight ago, it was too high. If it had remained at that level, the pressure on export industries and the squeeze on profits of domestic manufacturers would have been too acute.

As far as I was concerned, danger lights flashed a fortnight ago when there were reports that some members of the Government did not accept that sterling was too high. They argued for the higher the better, because that would help to reduce inflation. If they argue that way about sterling, they may argue similarly about a monetary squeeze - the tighter the better.

If they get their way in 1980, Mrs. Thatcher will eventually be forced into an about-turn similar to Mr. Heath's. I do not think that Mrs. Thatcher's Government contains many such Selsdon men. If it does, my message to them is that the good things of life should be taken in moderation. Overindulgence can kill.

W. Greenwell & Co.

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MONETARY BULLETIN

No. 105, May 1980

Crowding Out

The financial pressure on the corporate sector is becoming progressively tighter. As explained on page 2, the monetary squeeze in real terms is now of a similar order to that in mid-1974. It should not be allowed to tighten further. If financial pressure is allowed to become too acute, some parts of industry will not participate in the subsequent recovery, because they will not survive.

Matters have been made worse by the fact that industry has been, and is continuing to be, crowded out of long term capital markets. This may have been inevitable when monetary growth was excessive but, now that the money supply is within its target range, this crowding out should stop.

Industry is not significantly tapping the huge cash flow of life assurance companies and pension funds; for example, Stock Exchange issues have been minimal. If market forces were not dominated by official transactions, industry would now be borrowing both short and long term to cover its huge financial deficit. But market forces are dominated by official transactions.

The Government is not merely raising long dated rather than short dated finance. It is actually borrowing long and repaying short dated debt. During the last six months, the Government has raised almost £5,000m. by selling mainly long dated gilt-edged stock to the non-bank private sector; during the same period, sales of central government debt to the non-bank private sector have exceeded the CGBR by some £2,000m. (seasonally adjusted) i.e. the Government has been repaying previous borrowing from the banking system. This process of repayment cannot continue much longer, because banks' holdings of central government debt must now be close to a working minimum.

One reason why the Government has been issuing so much gilt-edged stock is that it has been trapped in a vicious circle. Companies have been relying on banks for the bulk of their external financial needs. This bank lending has been increasing monetary growth. The large sales of gilt-edged stock have been needed as an offset. The Government should now begin the process of breaking this vicious circle.

The time has come for the Government to begin to restrict its issues of long dated stock. The aim should be to allow market forces to re-establish the level at which companies are again prepared to raise substantial quantities of long term capital, either ordinary shares or long term debt. This may take some time to materialise but, when it happens, companies will borrow less from banks, the pressure on monetary growth will be reduced and the Government will need to sell less gilt-edged stock.

R. H. Lawson
G. T. Pepper
C. E. Frappell
The Lord Annaly
J. A. Rickards
L. Gooderham

T. Quinn
M. T. Higgins
D. G. Thomson
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Associated Members
O. J. Olcay (U.S.A.)
P. G. E. Greenwell
Graham H. Greenwell
The Lord Renwick

Whilst monetary growth was excessive, there was some pressure on the authorities both to issue more gilt-edged stock than the market wanted and to offer the type of stock for which there was the greatest demand. In general, when monetary growth starts to undershoot, the Government should issue less stock than the market wants and should offer the type of stock which the authorities prefer. As far as the latter is concerned, it should be remembered that not only has the Government a large borrowing requirement but also life assurance companies and pension funds have a huge cash flow, the one being a reflection of the other. When monetary growth is excessive, the authorities are on the defensive; but when monetary growth tends to be inadequate, the boot is on the other foot.

The current stance of monetary policy

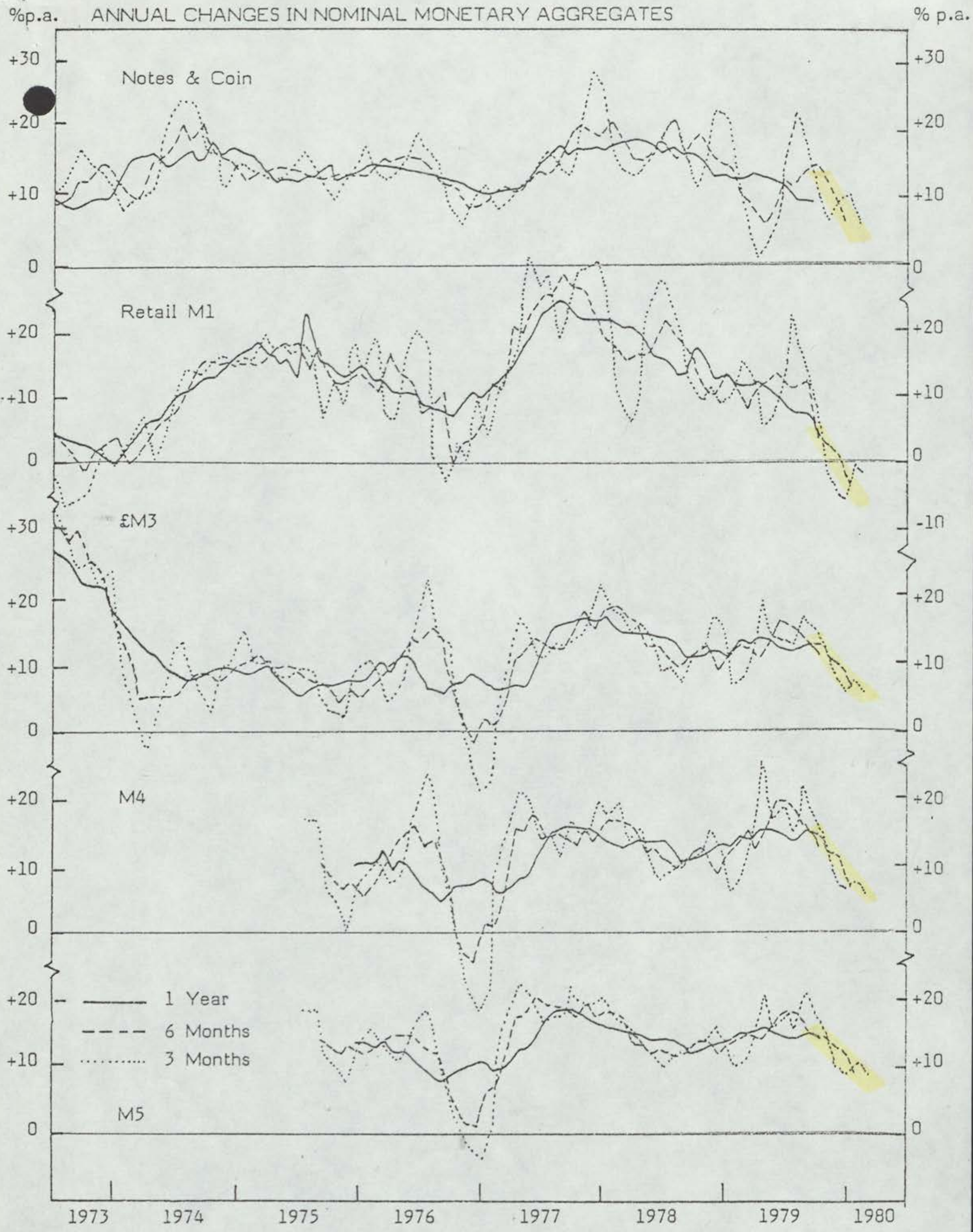
It was agreed in 1971, when Competition and Credit Control was published, that the best measure of the stance of monetary policy was the behaviour of the monetary aggregates and not interest rates, either in nominal or real terms.

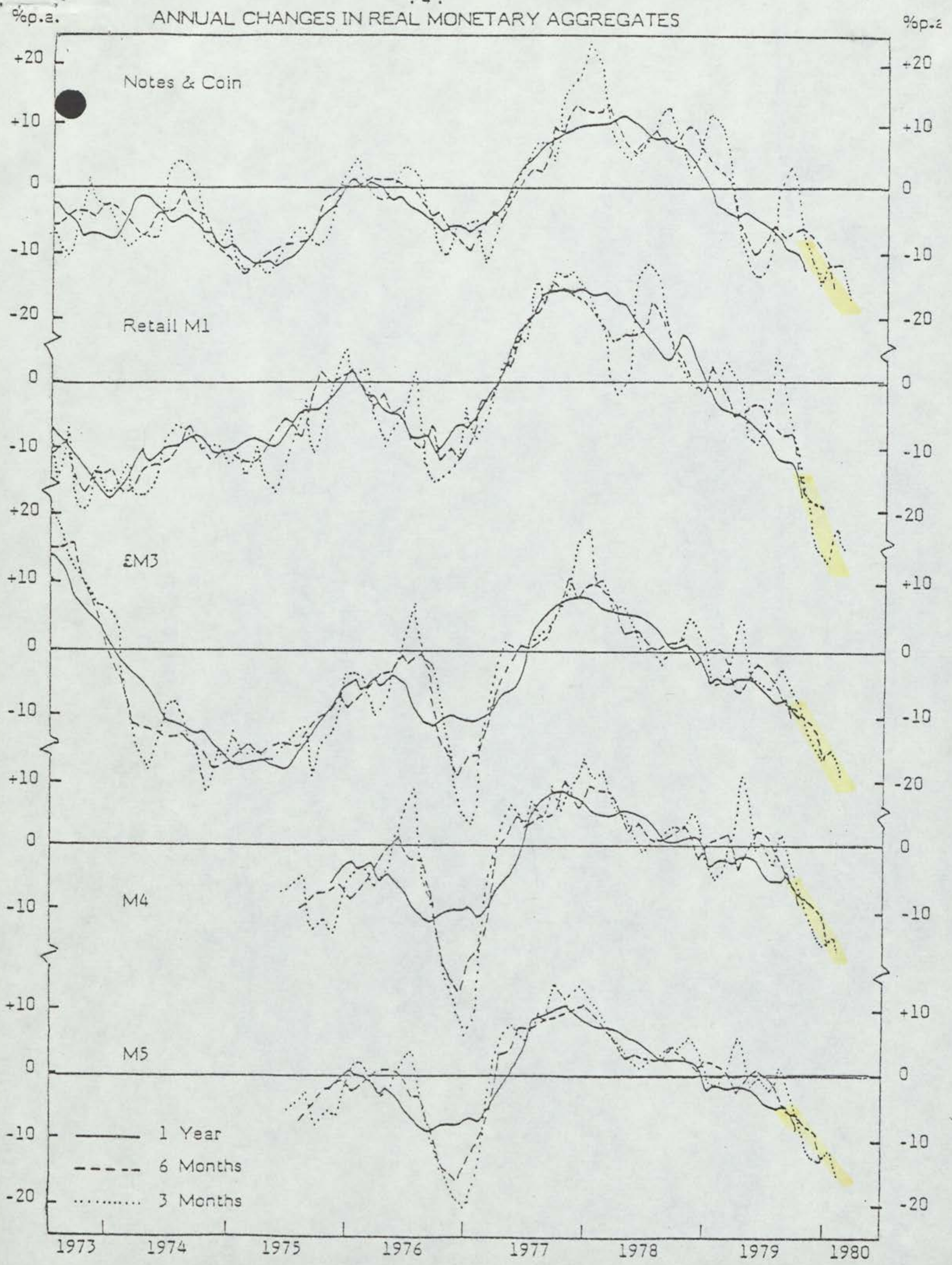
The behaviour of sterling M3 is not the only indicator of the current tightness of monetary policy. Both the narrower and broader definitions of the money supply confirm the squeeze. Graphs are shown of the important definitions in nominal terms on page 3 and in real terms on page 4 (the definitions of our series for M4 and M5 have been revised, as explained on page 6). It will be seen that the squeeze in real terms is extremely severe. It is, in fact, more severe than that in mid-1974, as shown in Table I, below.

Table I : Real Monetary Growth

	At mid-April, 1980			At mid-July, 1974		
	3 months	6 months	1 year	3 months	6 months	1 year
Notes & coin	-17% p.a.	-14% p.a.	-12%	-8% p.a.	-8% p.a.	-8%
Retail M1*	-24% p.a.	-24% p.a.	-18%	-15% p.a.	-13% p.a.	-17%
Sterling M3	-18% p.a.	-14% p.a.	-11%	-15% p.a.	-12% p.a.	-1%
M4	-17% p.a.	-14% p.a.	-9%	n.a.	n.a.	n.a.
M5	-15% p.a.	-12% p.a.	-9%	n.a.	n.a.	n.a.

*Data in 1974 are for M1 because those for Retail M1 are not available.


%p.a.
ANNUAL CHANGES IN NOMINAL MONETARY AGGREGATES
% p.a.
Notes & Coin
Retail M1
£M3
M4
M5
1 Year
6 Months
3 Months
+30
+20
+10
0
-10
1973
1974
1975
1976
1977
1978
1979
1980



ANNUAL CHANGES IN REAL MONETARY AGGREGATES
%p.a.
%p.a
+20
+10
0
-10
-20
Notes & Coin
Retail M1
£M3
M4
M5
1 Year
6 Months
3 Months
1973
1974
1975
1976
1977
1978
1979
1980

W. Greenwell & Co.

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MONETARY BULLETIN

No. 106 June, 1980

Before the publication of the latest banking data, which disclosed buoyant growth of sterling M3 in the banking month to mid-May, we were becoming increasingly concerned that the monetary squeeze was becoming dangerously tight. Although the latest data have changed the situation somewhat, we are still concerned about the degree of financial pressure on the corporate sector.

The current target range for sterling M3 is 7% - 11% per annum. This range was originally set for the ten months between June 1979 and April 1980. It was reset in the March Budget to cover the fourteen months between February 1980 and April 1981.

The background prior to the latest data

The monetary data for the banking month to mid-April showed that the growth of sterling M3 was just below the top end of the target range set in June 1979 and below the bottom end of the range set in February 1980. The period of slack growth started in the middle of October, the picture being altered only slightly if allowance is made for the so-called bill leak. Further, the squeeze in real terms, i.e. after allowing for inflation, was even more severe than in the middle of 1974. In short, the squeeze appeared to be tighter than the gradualist path advocated by most monetarists.

In spite of the tightness, the Government did not begin to reduce interest rates. Even the rapid fall of rates in the U.S. did not prompt a start in the U.K. This raised the question of whether the Government had abandoned the gradualist approach which was implicit in many of its earlier statements and explicit in the sequence of gradually falling target ranges set out in the Medium Term Financial Strategy.

The Chancellor's speech

In a speech in the House of Commons on 7th May, during the debate on the Public Expenditure White Paper, the Chancellor added to the uncertainty about the Government's monetary strategy by stating that interest rates could not be allowed to fall whilst the excessive rate of growth of bank lending persisted. Later in the speech he stated that he did not want to be faced with having to increase interest rates again later this year, which a "premature" reduction in MLR would risk.

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The first of these statements was worrying because, relative to the business cycle, bank lending to the private sector is a lagging indicator; in contrast, the money supply is a leading indicator. Allowing interest rates to be determined by the behaviour of the money supply helps to smooth the business cycle. Determining them by bank lending would tend to magnify it. The Chancellor would be foolhardy if he overrode for long this automatic monetary stabiliser at a time when the Keynesian stabiliser of demand management is not being used and a worldwide recession is developing.

There was some reassurance soon after the Chancellor's speech from reports of non-attributable briefings to the press to the effect that the authorities had not changed from monetary to credit targets. The central government's borrowing requirement (CGBR) had been erratically low between mid-December and mid-April and was apparently expected to fluctuate in the opposite direction during the next month or so. The authorities apparently feared that bank lending would remain at the very high level of the previous few months; taken together with the large CGBR, this would have tended to produce excessive monetary growth once again. During the previous twelve months or so bank lending had, in fact, tended to fall when the CGBR rose (as people had to borrow less to pay taxes). From the press briefings, it appeared that the authorities wanted to make sure that this offset continued on a sufficient scale before they reduced interest rates. (The latest published data show that the authorities were right to be cautious about monetary growth in the banking month to mid-May.)

The second of the Chancellor's statements continues to be perturbing. His disinclination to run the risk of having to increase interest rates again later this year implies a desire to control both the money supply and interest rates. A basic rule is that both quantity and price cannot be controlled at the same time. If the money supply is to be controlled, interest rates must be allowed to fluctuate. If the authorities are unwilling to risk upward fluctuations, they are bound to reduce interest rates by too little, too late. The result will be an unnecessarily deep recession.

Monetary strategies

Last month it seemed possible that the Government was drifting into a most dangerous type of monetary policy. The following types of tight policy can be distinguished:

(i) gradualism
(ii) shock treatment and
(iii) sustained pressure significantly more severe than gradualists advocate.

Gradualism

These Bulletins have consistently argued for continuous and gradual reductions in the growth of the money supply. They have argued against both excessive and inadequate monetary growth. The main reason for advocating the gradualist approach is the desire to avoid the Government suddenly being faced with a Hobson's choice of either allowing wholesale bankruptcies, the consequences of which cannot be predicted or controlled, or making a policy U-turn.

After the ravages of years of inflation, balance sheets are generally weak. Many companies can stand only a limited degree of financial pressure without going bankrupt. Individual bankruptcies can be tolerated, but not those which lead to chain reactions and "domino effects." The financial system as a whole should not be put under so great a financial pressure that individual bankruptcies will trigger uncontrolled chain reactions.

Shock treatment

The great disadvantage of the gradualist approach is that reducing inflation in this way can be a long drawn out process. There are doubts about whether people will be sufficiently patient to allow the policy to run its course. In order to avoid this drawback, some economists argue for shock treatment. It is claimed that inflationary expectations can be reduced quickly and, after this has happened, economic growth can be resumed.

If a Government decides to run the risk of shock treatment, the shock should be short and sharp. As far as the sharpness is concerned, the shock should be large to ensure that inflationary expectations are broken. It should also be very highly publicised, a whole package of measures being announced, and will be greater if the measures are unexpected. As far as the shortness is concerned, the shock should be very brief, so as to minimise the risk of chain reactions to bankruptcies.

The U.S. measures of 14th March were a good example of short, sharp shock treatment. Many Savings and Loans Associations were probably technically bankrupt on 15th March but, before they had time to declare it, interest rates had fallen sharply and their bankruptcy had disappeared.

Sustained excessive pressure

The third of the tight policies, namely sustained pressure significantly more severe than gradualists advocate, runs the greatest chance of an enforced policy U-turn. The monetary pressure involved is neither restricted to a level deemed to be safe nor is it of strictly limited duration.

It is important that the Government does not drift into this type of policy. Such a drift appeared possible last month and it cannot yet be ruled out.

Pages 8-11

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MONETARY BULLETIN

No. 124. November 1981

The imbalance between long and short term markets for credit

We have recently drawn attention to the rapid rise in the demand for finance and the vicious financial circle in which the UK has been trapped. There is a related problem, to which this Bulletin is addressed, namely the imbalance between long and short term financial markets. The ideas put forward in the conclusions starting half-way down page 4 are our contribution to finding the key to entering the virtuous circle.

Background

For about a decade, industry has raised only a small amount of long term finance. Historically, the bulk of its long term capital has been bond finance, with genuine risk capital being a comparatively minor source. Companies started to become unwilling to make long term bond issues when coupons reached 10%, with the cut-off becoming almost total when coupons rose through 12%. The risk to an issuer was considered to be too great; the burden, if inflation and interest rates were to fall, was unacceptable. (A rather similar phenomenon appeared in the US although the cut-off point was higher, probably because corporate bonds in the US are usually "callable", i.e. the issuer has the option to repay, albeit at a premium). During the last decade, therefore, companies have been obtaining from banks most of the finance which they would previously have raised by bond issues. In this sense, there has been a transfer in the demand for credit from the long to the short term market. Compared with the 1960s, the transfer is currently of the order of £2,000m per annum.

An important consequence of this transfer has been a tendency for banks' assets to grow rapidly. There has been, of course, a corresponding rise in liabilities, the bulk of which are deposits. As the deposits of UK residents are by far the largest component of sterling M3, there has been a clash between the control of the money supply and the banks' provision of finance to industry. It is, therefore, important to explore ways in which this clash can be resolved.

Responses within the banking system

The clash can be resolved within the banking system in three ways. Firstly, banks can run down their holdings of public sector debt. The growth of their total assets and of their demand for deposits is thereby curtailed. Banks have now been running down the relative importance of their holdings of central government debt for more than 25 years and to all intents and purposes they have none left. Being more precise, the holdings reached a working minimum in the summer of 1980 (when the Bank had to resort to export credits in order to make sale and repurchase agreements). Some leeway was subsequently created when the Bank allowed commercial bills to replace Treasury bills as reserve assets-cum-liquidity. The civil servants' dispute has masked the way in which this leeway has been used up. Banks' holdings of central government debt will again reach a working minimum in the coming tax paying season. The graphs on page 2 illustrate what has been happening.

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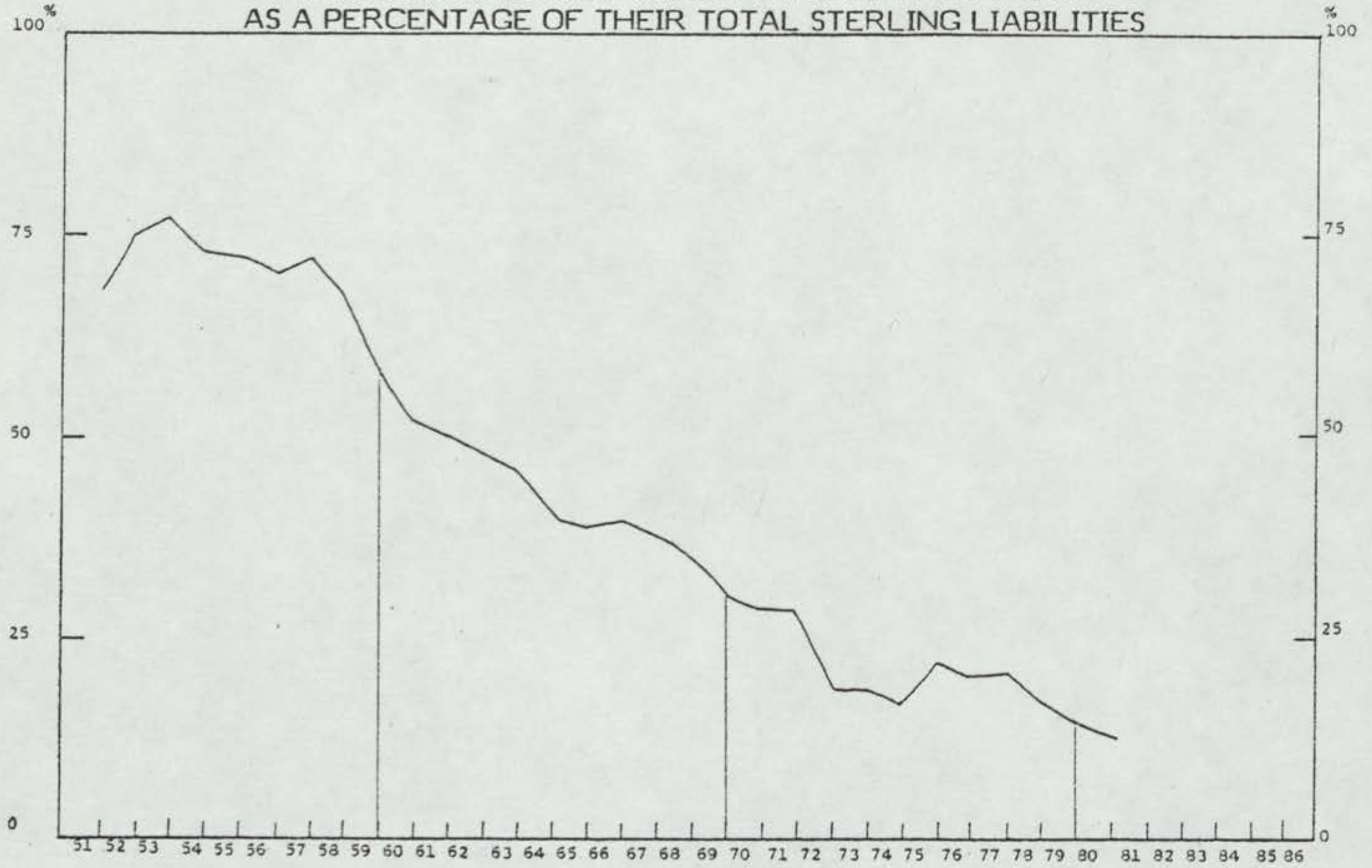
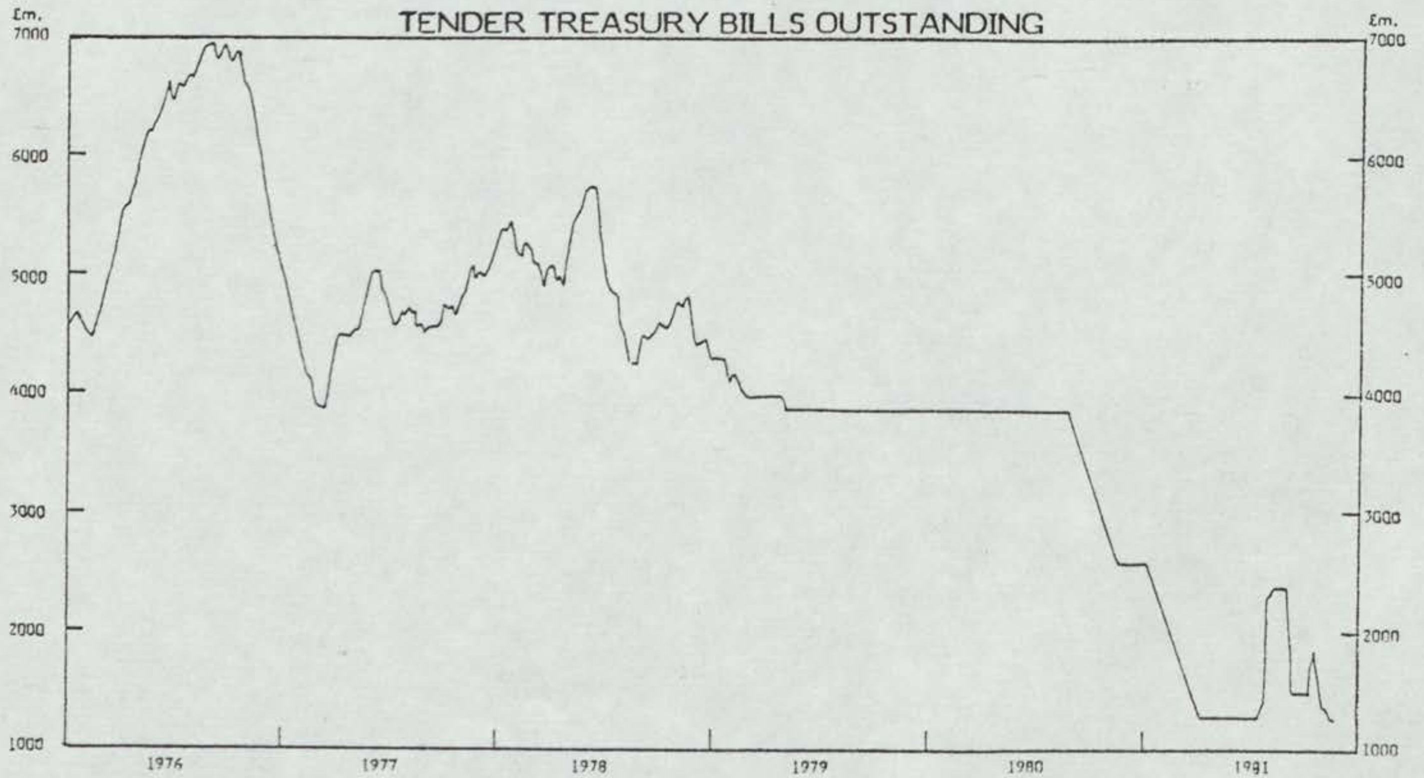

BANKS' HOLDINGS OF CENTRAL GOVERNMENT DEBT
AS A PERCENTAGE OF THEIR TOTAL STERLING LIABILITIES
100%
75
50
25
0
51 52 53 54 55 56 57 58 59 60 61 62 63 64 65 66 67 68 69 70 71 72 73 74 75 76 77 78 79 80 81 82 83 84 85 86


TENDER TREASURY BILLS OUTSTANDING
£m.
7000
6000
5000
4000
3000
2000
1000
1976
1977
1978
1979
1980
1981

The second course of action open to the banks is to borrow from abroad. Such borrowings are excluded from the definition of the money supply so industry can be financed without the published data for the money supply increasing. For various reasons, however, it is probably imprudent to rely on banks' borrowing from abroad, for example, the sterling deposits of non-residents can be "hot money."

If the banks are to continue to meet the great bulk of industry's need for external finance, and at the same time if sterling M3 is to be controlled, there remains only one other possibility. The banks must enter the market for those longer term liabilities which lie outside the definition of sterling M3. Stripped to basics, the argument is that if banks are to continue providing medium term capital for industry they should match it, irrespective of whether the finance is at a fixed or floating rate, with longer term liabilities than at present. In the US banks have, to some extent, been encouraged to accept term deposits by the differential reserve requirements imposed by the Fed. With the present regulations in the UK, however, it is difficult to envisage how the Bank could encourage even this development.

Other private sector responses

If the banks cannot continue to be as dominant a financial intermediary for industry, what are the other solutions? There are three possibilities within the non-bank private sector. Firstly, the problem will disappear if an instrument can be designed which industry is prepared to issue and which life offices and pension funds, in particular, are prepared to buy. So far, nobody has managed to design such an instrument. The principal difficulty is that inflation is asymetrical - what suits the issuer does not suit the long term investor.

In the summer of 1980 there was, in fact, an attempt to revive the corporate bond market. The Bank made only one long dated (over fifteen year) gilt-edged issue between mid-April and mid-September of that year. Long dated gilt-edged yields fell to 12½% in July; the sterling bulldog market was re-opened with a coupon of 13% on the first issue. If yields had fallen a little further and had remained there, companies would have started issuing bonds, the proceeds would have been used to repay bank loans and sterling M3 would have been reduced. A virtuous circle would have been entered; but it was not to be. Another attempt along these lines will not be worthwhile until long term interest rates fall significantly.

The second solution which bypasses the banks is to design an instrument which industry is prepared to issue and which the private investor is prepared to buy. Floating rate issues in general, and a public offer for sale of a drop-lock issue with a Stock Exchange quotation in particular, are designed to meet this need. The concept of a drop-lock appeals to issuers. A finance director can be asked at what level he would be prepared to make a long dated issue. A drop-lock can then be designed, i.e. an instrument which is initially a floating rate note but is automatically converted into a long dated fixed rate issue if yields fall to the relevant level.

A quoted drop-lock is also designed to appeal to the private investor. A margin above the full wholesale rate of interest is obtained. The investment is trouble-free in the sense that it does not have to be rolled over, as does a fixed term deposit. It can also be encashed quickly by selling it on The Stock Exchange. Finally, the conversion into a fixed rate bond limits the risk of the investor having a substantial fall in income.

These are the attractive features of the drop-lock for the private investor, although there are some snags. In the event, experience in the secondary market suggests that the distribution and retail network of the conventional markets is inadequate for floating rate and quoted drop-lock instruments to raise substantial funds from the personal sector.

The final possibility within the private sector is that a new type of financial institution should be founded to market new instruments. There could be UK versions of the US money market mutual funds (a US mutual fund is similar to a UK unit trust). UK law, however, continues to hinder the extension of unit trusts into the gilt-edged and money market fields. The law about double taxation and gilt-edged stocks was amended in last year's budget, but the situation with respect to investments in money market instruments is still unclear. The law could be clarified to encourage the development of money market mutual funds in the UK. The argument against this solution, however, is that it would be cosmetic; money market mutual funds are likely to be too similar to a deposit account or a CD, both of which are included in the definition of sterling M3, for any switch to them to reduce the inflationary potential of this way of financing industry.

Public sector intermediaries

Having exhausted the private sector solutions, there remains a possibility of the public sector acting as the financial intermediary. Indeed, this is exactly what happens when the Bank of England acquires commercial bills or makes a loan to a discount house. Such transactions will, almost certainly, be the stop-gap solution in the coming months.

A longer term solution on similar lines is for the Bank to re-finance banks' industrial loans. Such a scheme would be similar to the original form of export and shipbuilding credits and would, therefore, raise the PSBR. The rise would, however, be of cosmetic rather than real significance and this solution has much to recommend it.

The only other public sector solutions involve a real rise in the PSBR; for example, an agency like the National Enterprise Board could be the financial intermediary. Solutions such as this are, presumably, unacceptable to the present Government.

Conclusions

This Bulletin has drawn attention to the current imbalance between the long and short term markets for credit. It has, in particular, analysed the clash between industry obtaining the required amount of finance and the target for sterling M3.

Before setting out the main conclusions of the analysis, one further alternative should be considered, namely that the Government should stop trying to control sterling M3 and the broader definitions of the money supply. This would only be appropriate, in our view, if the authorities adopted a system of monetary base control. Under such a system the growth of broader liquidity can, to a considerable extent, be ignored because the Bank of England would not permit excessive encashment of liquidity.

Assuming that the Government is unwilling to adopt the monetary base solution, the best course of action at the moment would appear to be for the Bank of England to purchase commercial bills in the short run. Such purchases should be followed, if necessary, by the Bank refinancing industrial loans. The hope is that this would allow enough time for long term interest rates to fall to a level at which the corporate bond market would re-open.

Finally, the Government could take two types of action to accelerate the latter process. When interest rates fall close to the level at which the corporate bond market is likely to re-open, the availability of bank loans could be constrained. The aim should be to induce banks into encouraging their corporate customers to seek alternative forms of finance. In the meantime, fiscal action could be taken to prompt companies into making issues sooner rather than later. In the US, for example, tax law encourages companies to issue low coupon bonds, even zero coupon bonds; in this country such issues are discouraged by the difference between the redemption payment and the issue proceeds not being an

allowable expense. Companies can set up capital redemption funds to enable them to make such payments and tax law in the UK could be changed to permit the annual contributions to these funds to rank as an allowable expense.

Such a change would not, alone, have much impact. The special appeal of low coupon bonds is to investors who are taxed at a higher rate on income than on capital gains. Gilt-edged stocks are very attractive to such investors because they have a capital gains tax concession under which an investor is not subject to tax on gains on any stock held for longer than a year. If low coupon bonds are to raise substantial funds for companies, this concession would have to be extended to corporate bonds, although it could be restricted to long dated issues.

Some commentators may argue, correctly, that such changes in taxation would increase the PSBR. The reply is that firstly the overall effect would be to reduce sterling M3 and that secondly the proposed changes would promote financial efficiency by reducing existing distortions. These changes are good practical examples of supply side economics to which this Government has committed itself.

In general, the present capital gains tax concession is a classic example of the Government crowding out the private sector - government stocks have an attribute which is denied to the private sector. The Government also issues index-linked bonds (although only pension funds are allowed to purchase them). A fixed rate low coupon bond is, in fact, the closest in terms of the profile of cash flow that most companies can get to an index-linked issue, the open-ended liability of the latter being too risky. The coupon can be chosen so that the cost of servicing the fixed rate bond in the first years of its existence is similar to that for an index-linked bond. The present tax law discouraging companies from making such issues is, accordingly, another form of crowding out. Neither of these forms of crowding out should be allowed to continue.

The Exchequer's residual surplus and the money supply

In a Bulletin in September (No. 121) we introduced a new financial indicator, available on a weekly basis. It measures the Exchequer's residual surplus or deficit and approximates to the three central government components of sterling M3, namely the CGBR less sales of central government debt to the non-bank private sector less external and foreign currency finance accruing to the public sector. The main inaccuracy is the extent to which banks buy gilt-edged stock and the non-bank private sector buys Treasury bills.

It is important to note that this measure is not a reliable indicator of money supply growth because it does not include bank lending or most of the external component.

The main value of the new indicator is that it gives an early warning of unexpected changes in the central government components of sterling M3. Such a change occurred in the final two weeks of the October banking month. Press reports two months ago indicated that the CGBR was expected to be extremely high in banking October because, following the civil servants' dispute, VAT rebates would be made good ahead of VAT receipts. In the event, as the table at the top of page 6 shows, the sharp swing from a residual deficit of £690m in the first three weeks to a surplus of £1,000m in the last two weeks gave an early warning that the central government components of sterling M3 were not as high as had been expected. It was this which led some commentators to make low forecasts of monetary growth. However, higher than expected bank lending, a positive banking sector external component and very large other public sector net borrowing together caused sterling M3 to grow by £1,248m.

Exchequer's Residual Surplus

Week ending	23rd Sept.	-£ 360m
	30th Sept.	-£ 270m
	7th Oct.	-£ 60m
	14th Oct.	+£ 740m
	21st Oct.	+£ 260m
Banking October		+£ 310m

Turning to banking November, this is a month when the Government normally needs to borrow large amounts on seasonal grounds. The table below indicates, however, that the Exchequer had a residual surplus of £2,090m. This raises the possibility that the growth of sterling M3 in banking November will be low or, perhaps, even negative. It must be pointed out, however, that bank lending tends to be high whenever the CGBR is small or negative. The encouraging behaviour of the Exchequer's residual surplus may, accordingly, be offset by buoyant bank lending and other factors, as in banking October.

Exchequer's Residual Surplus

Week ending	28th Oct.	+£ 140m
	4th Nov.	+£ 220m
	11th Nov.	+£ 560m
	18th Nov.	+£1,170m
Banking November		+£2,090m

Current monetary growth

In the five week banking month to 21st October, the seasonally adjusted behaviour of the monetary aggregates was as follows:

	£m.	p.a.
Currency	-16	-2%
Retail M1	-387	-17%
M1	-92	-3%
Sterling M3	1,248	20%
PSL1	961	15%
PSL2	1,358	12%
DCE	1,580	
Bank lending in sterling to the private sector	778	15%

The most striking feature of the published data is the degree to which the growth rates of the narrow and broad aggregates are divergent. This can also be seen in the growth rates over the longer term, which will now be reported regularly in a table immediately before the graphs at the back of these Bulletins.

The broader aggregates continue to be distorted upwards by the consequences of the civil servants' dispute. Thus, the Bank's press announcement indicates that in the month to mid-October the CGBR was inflated by between £750m and £1,000m, mainly because of an excess of VAT repayments over receipts of delayed taxes.

It is also notable that sterling M3 is continuing to grow faster than the broader aggregates PSL1 and PSL2. From the start of the current target period, for example, PSL2 has grown at an annual rate of 16%, four percentage points below that for sterling M3.

As is the case with the other narrow aggregates the monetary base has continued to grow very slowly. It has grown by 4% over the last year, 2% p.a. over the last six months and it is unchanged over the last three months.

GTP
RLT
RR

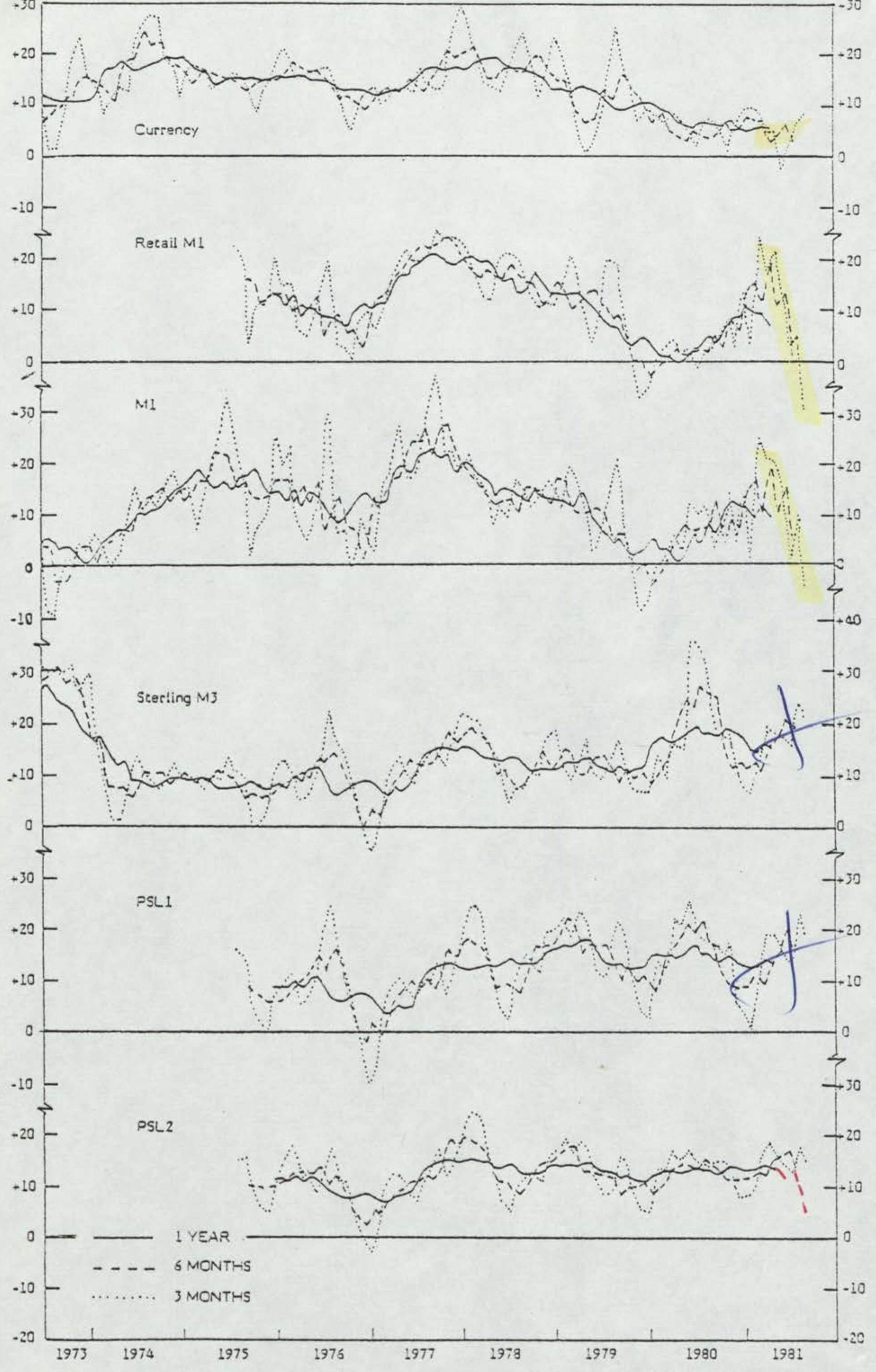
MONETARY GROWTH

In Nominal Terms

Percentage annual rates	Currency	Retail M1	M1	Sterling M3	PSL1	PSL2
Changes in year to:						
1980 Nov.	6	1	4	19	15	13
Dec.	5	3	7	20	17	14
1981 Jan.	7	3	5	19	15	13
Feb.	6	5	9	18	15	13
Mar.	6	4	7	18	14	13
Apr.	7	8	11	20	15	14
May	5	9	13	19	15	14
Jun.	6	9	12	19	13	14
Jul.	5	11	12	15	13	13
Aug.	6	10	10	14	13	13
Sept.	6	9	12	16	14	14
Oct.	5	7	9	15	13	13
forecast 1982 Apr						11
Changes in 6 months to:						
1981 May	7	15	17	13	11	14
Jun.	8	12	11	12	9	13
Jul.	3	19	20	16	14	15
Aug.	4	10	11	18	16	15
Sept.	6	13	16	21	20	17
Oct.	3	1	5	19	17	15
forecast 1982 Apr						5
Changes in 3 months to:						
1981 Aug.	3	3	1	15	14	12
Sept.	7	5	10	24	23	17
Oct.	8	-10	-4	21	19	15

In Real Terms

Percentage annual rates	Currency	Retail M1	M1	Sterling M3	PSL1	PSL2
Changes in year to:						
1980 Nov.	-9	-15	-12	3	-	-3
Dec.	-10	-12	-8	5	2	-1
1981 Jan.	-6	-10	-8	6	2	-
Feb.	-6	-7	-4	6	3	1
Mar.	-7	-9	-5	5	1	-
Apr.	-5	-4	-1	8	3	2
May	-6	-3	1	8	3	2
Jun.	-6	-3	1	7	2	2
Jul.	-6	-	1	4	2	2
Aug.	-6	-2	-2	3	2	2
Sept.	-6	-2	-	5	3	3
Oct.	-6	-5	-2	4	1	2
forecast 1982 Apr						0
Changes in 6 months to:						
1981 May	-5	3	5	1	-1	2
Jun.	-5	-	-1	-	-3	1
Jul.	-9	7	8	4	2	3
Aug.	-8	-2	-1	6	4	3
Sept.	-6	1	4	9	8	5
Oct.	-10	-11	-8	7	4	2
forecast 1982 Apr						-6
Changes in 3 months to:						
1981 Aug.	-9	-9	-11	3	2	-
Sept.	-5	-7	-2	12	10	5
Oct.	-5	-23	-17	8	6	2



%p.a.
CHART 1
MONETARY GROWTH IN NOMINAL TERMS
%p.a.
Currency
Retail M1
M1
Sterling M3
PSL1
PSL2
1 YEAR
6 MONTHS
3 MONTHS
1973
1974
1975
1976
1977
1978
1979
1980
1981

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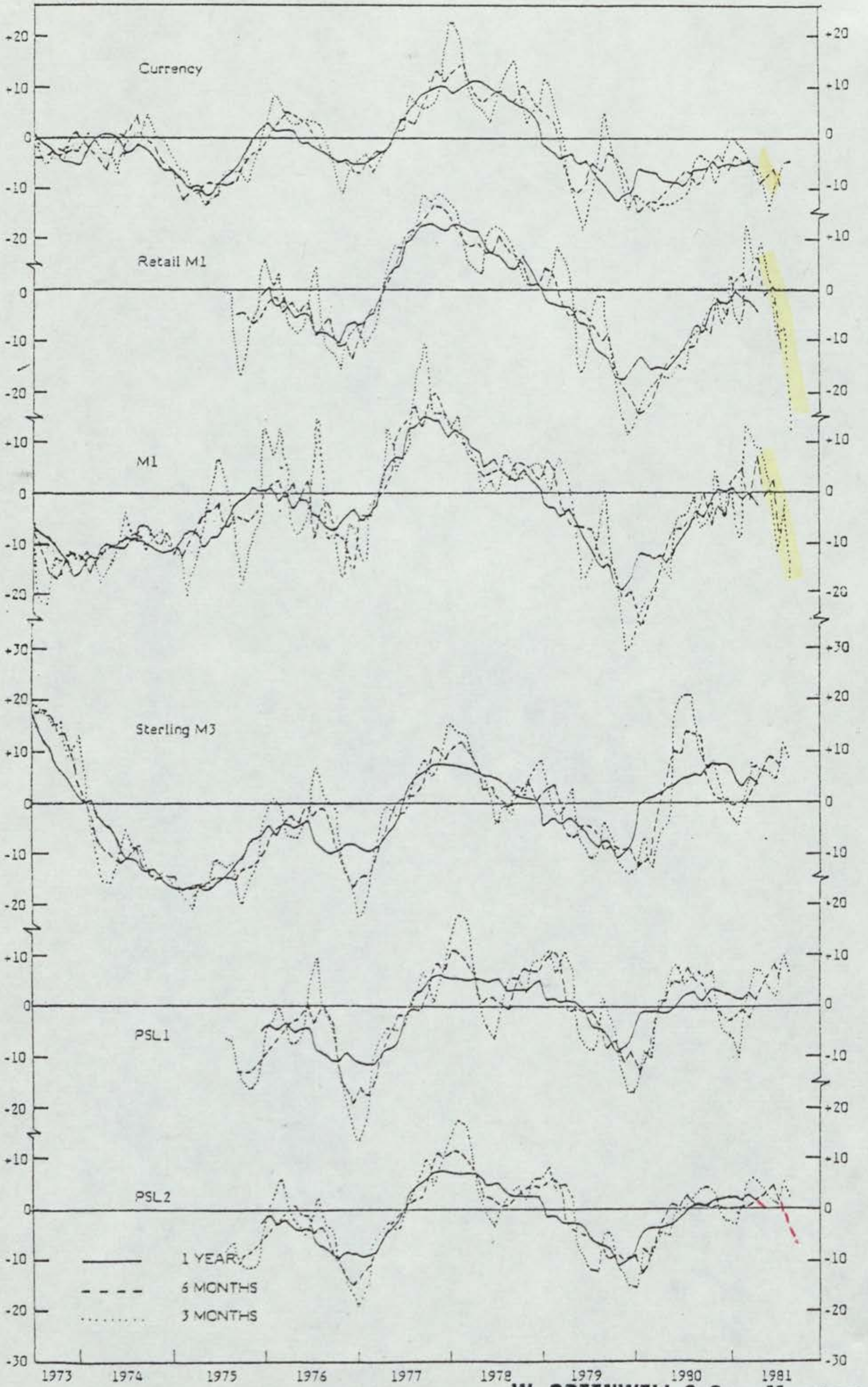


CHART 3 COMPONENTS OF MONETARY GROWTH

£bn £bn

1 YEAR
6 MONTHS
3 MONTHS

CGBR

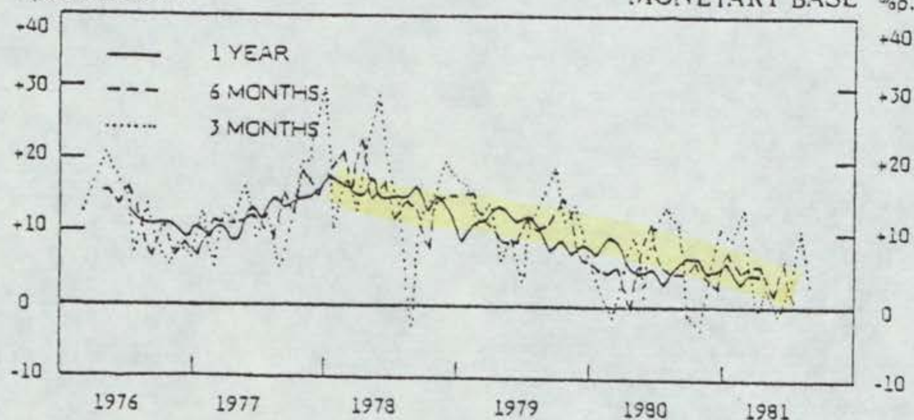
Sales of Gilt-Edged Stock to the non-bank Private Sector

Bank Lending in Sterling to the Private Sector

External Financial Component of £M3

+24 +20 +16 +12 +8 +4 0 +2 +6 +10 +16 +12 +8 +4 0 -4 0 -4 -8

1973 1974 1975 1976 1977 1978 1979 1980 1981



reprinted from Bank of England, *Banking Statistics*

[Table 11.3 in the *Quarterly Bulletin*]

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

£ millions

	Public sector borrowing requirement (surplus −): Central government borrowing requirement	Public sector borrowing requirement: Other public sector contribution / Purchases (−) of public sector debt by UK private sector (other than banks): Other public sector debt	Purchases (−) of public sector debt by UK private sector (other than banks): Central government debt [a]	Sterling lending to UK private sector [b]	Bank lending in sterling to overseas sector [c]	Domestic credit expansion [d]	External and foreign currency finance (increase −): Public sector	External and foreign currency finance: Overseas sector sterling deposits [c]	External and foreign currency finance: Banks' foreign currency deposit liabilities (net) [e]	Net non-deposit liabilities (increase −) [c]	Money stock sterling M_3 [f]
	1	2 3	4	5	6	7	8	9	10	11	12
Month ended (unadjusted)											
1980 Oct. 15	+ 631	+ 405	−1,081	+1,475	+ 234	+1,664	+ 462	− 327	+ 305	− 627	+1,477
Nov. 19	+1,698	+ 79	− 964	− 192	+ 515	+1,136	− 138	− 182	+ 55	+ 223	+1,094
Dec. 10	+1,896	− 193	− 703	+ 110	+ 236	+1,346	+ 279	− 144	− 456	− 39	+ 986
1981 Jan. 21	− 789	+ 373	− 943	+1,844	− 156	+ 329	− 179	− 158	+ 79	+ 254	+ 325
Feb. 18	+ 979	− 333	− 980	− 121	+ 403	− 52	+ 30	− 212	+ 276	+ 79	+ 121
Mar. 18	+ 125	+ 198	−1,587	+ 728	+ 611	+ 75	+ 247	− 253	− 192	− 80	− 203
Apr. 15	+2,915	+ 228	−1,147	+ 870	+ 323	+3,189	− 237	− 16	− 344	− 418	+2,174
May 20	+1,963	+ 456	−1,604	− 5	− 135	+ 675	− 32	− 82	+ 356	+ 70	+ 987
June 17	+2,670	− 50	−1,137	− 83	+ 292	+1,692	+ 45	− 314	− 387	− 576	+ 460
July 15	+1,725	− 322	− 765	+1,541	+ 592	+2,771	− 371	− 513	+ 279	− 154	+2,012
Aug. 19	+ 457	+ 254	−1,057	+1,048	+ 156	+ 858	+ 2	− 721	+ 406	+ 64	+ 609
Sept. 16	− 206	− 140	+ 437	+ 802	+ 450	+1,343	− 279	− 131	− 303	− 180	+ 450
Oct. 21	+ 439	+ 866	−1,365	+1,501	+ 461	+1,902	− 468	+ 447	− 363	− 248	+1,270
Month ended (seasonally adjusted)								(columns 8–10 combined)			
1980 Oct. 15	+ 999	+ 229	− 974	+ 944	+ 234	+1,432		+ 352		− 182	+1,602
Nov. 19	+ 984	− 155	− 931	+ 312	+ 515	+1,035		− 330		+ 10	+ 715
Dec. 10	+ 999	− 125	− 662	+ 472	+ 236	+ 920		− 232		− 132	+ 556
1981 Jan. 21	+ 396	+ 329	−1,005	+ 838	− 156	+ 402		− 200		+ 124	+ 326
Feb. 18	+ 412	− 76	−1,298	+ 649	+ 403	+ 90		+ 98		− 38	+ 150
Mar. 18	+ 673	+ 184	−1,719	+1,065	+ 611	+ 814		− 282		− 98	+ 434
Apr. 15	+2,102	+ 128	− 892	+ 396	+ 323	+2,057		− 600		+ 103	+1,560
May 20	+2,028	+ 501	−1,415	+ 48	− 135	+1,027		+ 237		− 135	+1,129
June 17	+1,659	+ 129	− 965	+ 51	+ 292	+1,166		− 593		− 391	+ 182
July 15	+2,293	− 486	− 590	+ 408	+ 592	+2,217		− 480		− 173	+1,564
Aug. 19	+ 272	− 252	− 899	+1,464	+ 156	+1,245		− 338		− 82	+ 825
Sept. 16	+1,227	− 242	− 181	+1,212	+ 450	+2,466		− 766		− 181	+1,519
Oct. 21	+ 914	+ 666	−1,239	+ 778	+ 461	+1,580		− 469		+ 137	+1,248

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

	Marketable debt: Stocks	Marketable debt: Treasury bills	National savings: Unadjusted	National savings: Seasonally adjusted	Tax instruments: Unadjusted	Tax instruments: Seasonally adjusted	Other [g]	Total (column 4 above): Unadjusted	Total (column 4 above): Seasonally adjusted
Month ended									
1980 Oct. 15	− 816	− 1	− 46	− 51	−219	−107	+ 1	−1,081	− 974
Nov. 19	− 710	− 12	− 6	− 22	−221	−172	− 15	− 964	− 931
Dec. 10	− 314	− 33	−254	−283	−179	−109	+ 77	− 703	− 662
1981 Jan. 21	− 786	+ 9	−238	−284	+124	+ 58	− 2	− 943	−1,005
Feb. 18	− 613	− 5	−465	−467	+ 98	−218	+ 5	− 980	−1,298
Mar. 18	−1,363	+ 18	−424	−424	+166	+ 34	+ 16	−1,587	−1,719
Apr. 15	− 510	− 59	−421	−363	−123	+ 74	− 34	−1,147	− 892
May 20	− 849	+ 79	−741	−732	− 97	− 83	+ 4	−1,604	−1,415
June 17	− 886	− 29	−281	−293	− 18	+166	+ 77	−1,137	− 965
July 15	− 194	+ 3	−239	−249	−329	−144	− 6	− 765	− 590
Aug. 19	− 833	− 69	−197	−199	+ 24	+184	+ 18	−1,057	− 899
Sept. 16	+ 4	+ 19	−179	−174	+594	− 29	− 1	+ 437	− 181
Oct. 21	−1,058	− 7	−254	−259	− 50	+ 81	+ 4	−1,365	−1,239

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

[c] See page 6.

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

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

[f] Sterling M_3 equals domestic credit expansion *plus* columns 8 + 9 + 10 + 11 (see also page 7).

[g] 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.

-- figures above and below are not strictly comparable.

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*.

Issued by the Financial Statistics Division, Bank of England, London EC2R 8AH.

[Table 11.1 in the *Quarterly Bulletin*]

Money stock: amounts outstanding

£ millions

	Notes and coin in circulation with public	UK private sector sterling sight deposits		Money stock M_1[b]		UK private sector sterling time deposits [c]	UK public sector sterling deposits	Money stock Sterling M_3[b]		UK residents' deposits in other currencies [c]	Money stock M_3[b]	
		Non-interest-bearing [a]	Interest-bearing	Unadjusted	Seasonally adjusted			Unadjusted	Seasonally adjusted		Unadjusted	Seasonally adjusted
	1	*2*	*3*	*4*		*5*	*6*	*7*		*8*	*9*	
Month ended												
1980 Sept. 17	9,882	14,338	4,168	28,388	28,390	33,832	1,019	63,239	63,800	5,481	68,720	69,280
Oct. 15	9,864	14,603	4,434	28,901	28,870	34,751	1,062	64,714	65,460	5,384	70,098	70,850
Nov. 19	9,852	14,583	4,420	28,855	28,770	35,679	1,280	65,814	66,260	5,769	71,583	72,030
Dec. 10	10,255	15,255	4,651	30,161	29,470	35,595	1,054	66,310	66,900	5,815	72,625	72,720
1981 Jan. 21	9,885	14,211	4,603	28,699	29,300	36,634	1,789	67,122	67,310	6,519	73,641	73,830
Feb. 18	9,953	14,704	4,560	29,217	29,690	36,804[d]	1,218[d]	67,239	67,540	7,182	74,421	74,720
Mar. 18	10,042	14,845	4,511	29,398	29,560	36,419	1,223	67,040	68,010	7,678	74,718	75,690
Apr. 15	10,499	15,826	4,911	31,236	31,010	36,677	1,303	69,216	69,570	8,063	77,279	77,640
May 20	10,318	15,938	5,003	31,259	31,210	37,617	1,337	70,213	70,700	8,810	79,023	79,510
June 17	10,273	16,047	4,757	31,077	31,060	38,337	1,259	70,673	70,350	9,609	80,282	80,460
July 15	10,486	16,687	5,146	32,319	32,060	39,029	1,336	72,684	72,380	10,103	82,787	82,480
Aug. 19	10,459	15,962	4,892	31,313	31,270	40,741	1,239	73,293	73,130	10,526	83,819	83,660
Sept. 16	10,456	16,071	5,200	31,727	31,790	40,586	1,130	73,743	74,580	10,747	84,490	85,330
Oct. 21	10,378	15,691	5,495	31,564	31,590	41,957	1,492	75,013	75,790	11,705	86,718	87,500

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

[b] M_1 equals columns 1 + 2 + 3. Sterling M_3 equals M_1 + columns 5 + 6. M_3 equals sterling M_3 + column 8.

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

[d] The changes in these items given in Table 11.2 for the four weeks ended 18 February do not equal the differences between the amounts outstanding. See footnote [b] to Table 6 on page 6.

[Table 11.2 in the *Quarterly Bulletin*]

Money stock: changes[a]

£ millions: *percentages in italics*

	Notes and coin in circulation with public	UK private sector sterling sight deposits		Money stock M_1[c]		UK private sector sterling time deposits [d]	UK public sector sterling deposits	Money stock Sterling M_3[c]		UK residents' deposits in other currencies [d]		Money stock M_3[c]	
		Non-interest-bearing [b]	Interest-bearing							Transactions	Valuation changes [e]		
	1	*2*	*3*	*4*		*5*	*6*	*7*		*8*	*9*	*10*	
Month ended (unadjusted)													
1980 Oct. 15	− 16	+ 265	+ 266	+ 515		+ 919	+ 43	+1,477		− 44	− 53	+1,380	
Nov. 19	− 18	− 20	− 14	− 52		+ 928	+ 218	+1,094		+ 343	+ 42	+1,479	
Dec. 10	+ 393	+ 672	+ 231	+1,296		− 84	− 226	+ 986		− 15	+ 61	+1,032	
1981 Jan. 21	− 357	−1,044	− 48	−1,449		+1,039	+ 735	+ 325		+ 928	− 224	+1,029	
Feb. 18	+ 72	+ 493	− 43	+ 522		+ 120	− 521	+ 121		+ 289	+ 374	+ 784	
Mar. 18	+ 85	+ 141	− 49	+ 177		− 385	+ 5	− 203		− 462	+ 34	+ 293	
Apr. 15	+ 455	+ 981	− 400	+1,336		+ 258	− 80	+2,174		+ 36	+ 349	+2,559	
May 20	− 191	+ 112	+ 92	+ 13		+ 940	+ 34	+ 987		+ 445	+ 302	+1,734	
June 17	− 45	+ 109	− 246	− 182		+ 720	− 78	+ 460		+ 454	+ 345	+1,259	
July 15	+ 214	+ 640	+ 389	+1,243		+ 692	− 77	+2,012		− 56	+ 550	+2,506	
Aug. 19	− 27	− 725	− 254	−1,006		+1,712	− 97	+ 609		+ 148	+ 275	+1,032	
Sept. 16	− 3	+ 109	+ 308	+ 414		+ 145	− 109	+ 450		+ 232	− 11	+ 571	
Oct. 21	− 78	− 380	+ 295	− 163		+1,071	+ 362	+1,270		+ 783	+ 175	+2,228	
Month ended (seasonally adjusted)													
1980 Oct. 15	+ 23	+ 177	+ 266	+ 466	*+1·6*	+1,102	+ 34	+1,602	*+2·5*	− 44	− 53	+1,505	*+2·2*
Nov. 19	− 27	− 88	− 14	− 129	*−0·4*	+ 684	+ 160	+ 715	*+1·1*	+ 343	+ 42	+1,100	*+1·6*
Dec. 10	+ 29	+ 405	+ 231	+ 665	*+2·3*	+ 4	− 113	+ 556	*+0·8*	− 15	+ 61	+ 602	*+0·8*
1981 Jan. 21	+ 186	− 316	− 48	− 178	*−0·6*	+ 303	+ 201	+ 326	*+0·5*	+ 928	− 224	+1,030	*+1·4*
Feb. 18	+ 32	+ 387	− 43	+ 376	*+1·3*	− 101	− 125	+ 150	*+0·2*	+ 289	+ 374	+ 813	*+1·1*
Mar. 18	+ 34	− 120	− 49	− 135	*−0·5*	+ 463	+ 106	+ 434	*+0·6*	+ 462	+ 34	+ 930	*+1·2*
Apr. 15	+ 142	+ 909	+ 400	+1,451	*+4·9*	− 78	+ 31	+1,560	*+2·3*	+ 36	+ 349	+1,945	*+2·6*
May 20	− 65	+ 168	+ 92	+ 195	*+0·6*	+ 909	+ 25	+1,129	*+1·6*	+ 445	+ 302	+1,876	*+2·4*
June 17	+ 43	− 59	− 246	− 144	*−0·5*	+ 425	− 99	+ 182	*+0·3*	+ 454	+ 345	+ 981	*+1·2*
July 15	− 40	+ 655	+ 389	+1,004	*+3·2*	+ 392	− 168	+1,564	*+2·2*	− 56	+ 550	+2,058	*+2·6*
Aug. 19	− 69	− 596	− 254	− 781	*−2·4*	+1,704	− 98	+ 825	*+1·1*	+ 148	+ 275	+1,248	*+1·5*
Sept. 16	+ 145	+ 86	+ 308	+ 539	*+1·7*	+1,031	− 51	+1,519	*+2·1*	+ 232	− 11	+1,740	*+2·1*
Oct. 21	− 16	− 371	+ 295	− 92	*−0·3*	+1,194	+ 146	+1,248	*+1·7*	+ 783	+ 175	+2,206	*+2·6*

[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_1 equals columns 1 + 2 + 3. Sterling M_3 equals M_1 + columns 5 + 6. M_3 equals sterling M_3 + columns 8 + 9.

[d] Including certificates of deposit.

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

[Table 6 in the *Quarterly Bulletin*]

UK banking sector: transactions in liabilities and assets[a]

£ millions

Liabilities

	Total	Domestic deposits: Total: Unadjusted	Domestic deposits: Total: Seasonally adjusted	Public sector: Sterling: Unadjusted	Public sector: Sterling: Seasonally adjusted	Public sector: Other currencies	Private sector: Sterling: Unadjusted	Private sector: Sterling: Seasonally adjusted	Private sector: Other currencies	Overseas sector deposits: Sterling	Overseas sector deposits: Other currencies	Non-deposit liabilities (net)
Month ended												
1980 Oct. 15	+ 5,178	+ 1,449	+ 1,535	+ 43	+ 34	+ 12	+ 1,450	+ 1,545	− 56	+ 327	+ 2,775	+ 627
Nov. 19	+ 3,498	+ 1,455	+ 1,085	+ 218	+ 160	− 12	+ 894	+ 582	+ 355	+ 182	+ 2,084	− 223
Dec. 10	+ 2,208	+ 578	+ 512	− 226	− 113	+ 10	+ 819	+ 640	− 25	+ 144	+ 1,447	+ 39
1981 Jan. 21	+ 11,982	+ 1,610	+ 1,068	+ 735	+ 201	− 24	− 53	− 61	+ 952	+ 158	+ 10,468	− 254
Feb. 18[b]	− 633	+ 338	+ 407	− 521	− 125	+ 8	+ 570	+ 243	+ 281	+ 212	− 1,104	− 79
Mar. 18	+ 4,925	+ 174	+ 862	+ 5	+ 106	+ 10	− 293	+ 294	+ 452	+ 253	+ 4,418	+ 80
Apr. 15	+ 4,545	+ 1,755	+ 1,454	+ 80	+ 31	− 4	+ 1,639	+ 1,387	+ 40	+ 16	+ 2,356	+ 418
May 20	+ 454	+ 1,623	+ 1,639	+ 34	+ 25	− 23	+ 1,144	+ 1,169	+ 468	+ 82	− 1,181	− 70
June 17	+ 5,543	+ 959	+ 593	− 78	− 99	+ 5	+ 583	+ 238	+ 449	+ 314	+ 3,694	+ 576
July 15	+ 5,431	+ 1,742	+ 1,548	+ 77	+ 168	+ 17	+ 1,721	+ 1,436	− 73	+ 513	+ 3,022	+ 154
Aug. 19	+ 1,657	+ 784	+ 904	− 97	− 98	− 21	+ 733	+ 854	+ 169	+ 721	+ 216	− 64
Sept. 16	+ 5,018	+ 685	+ 1,606	− 109	− 51	− 4	+ 562	+ 1,425	+ 236	+ 131	+ 4,022	+ 180
Oct. 21	+ 4,993	+ 2,131	+ 2,047	+ 362	+ 146	+ 33	+ 986	+ 1,118	+ 750	− 447	+ 3,061	+ 248

Assets

	Total	Lending to public sector: Sterling: Total: Unadjusted	Lending to public sector: Sterling: Total: Seasonally adjusted	Lending to public sector: Sterling: Central government	Lending to public sector: Sterling: Other	Lending to public sector: Other currencies	Lending to private sector: Sterling: Unadjusted	Lending to private sector: Sterling: Seasonally adjusted	Lending to private sector: Other currencies	Lending to overseas sector: Sterling	Lending to overseas sector: Other currencies
Month ended											
1980 Oct. 15	+ 5,178	+ 328	+ 583	+ 51	+ 277	− 175	+ 1,580	+ 1,049	− 7	+ 234	+ 3,218
Nov. 19	+ 3,498	+ 769	+ 168	+ 731	+ 38	+ 10	− 268	+ 236	+ 13	+ 515	+ 2,459
Dec. 10	+ 2,208	+ 1,015	+ 586	+ 1,146	− 131	− 122	− 19	+ 343	− 375	+ 236	+ 1,473
1981 Jan. 21	+ 11,982	− 601	− 35	− 931	+ 330	− 20	+ 1,264	+ 258	+ 171	− 156	+ 11,324
Feb. 18	− 633	+ 135	− 459	+ 327	− 192	+ 11	− 632	+ 138	− 115	+ 403	− 435
Mar. 18	+ 4,925	+ 304	+ 751	− 34	+ 338	+ 10	− 678	− 341	+ 480	+ 611	+ 4,198
Apr. 15	+ 4,545	+ 419	+ 39	+ 128	+ 291	− 6	+ 1,755	+ 1,281	− 14	+ 323	+ 2,068
May 20	+ 454	+ 286	+ 397	− 117	+ 403	− 348	+ 683	+ 736	− 135	− 135	+ 98
June 17	+ 5,543	+ 545	− 265	+ 9	+ 536	− 441	+ 945	+ 1,079	+ 419	+ 292	+ 3,783
July 15	+ 5,431	− 130	+ 641	+ 9	− 139	− 84	+ 1,724	+ 591	− 62	+ 592	+ 3,391
Aug. 19	+ 1,657	+ 593	+ 406	+ 565	+ 28	− 127	+ 138	+ 554	+ 409	+ 156	+ 438
Sept. 16	+ 5,018	− 378	+ 467	− 619	+ 241	− 33	+ 995	+ 1,405	+ 108	+ 450	+ 3,876
Oct. 21	+ 4,993	− 317	− 2	− 623	+ 306	+ 123	+ 1,368	+ 645	+ 244	+ 461	+ 3,114

[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*).

[b] The changes shown for public and private sector domestic deposits have been adjusted to exclude the effect of the transfer of British Aerospace from the public to the private sector with effect from 4 February; at the time of transfer, approximately £50 million of sterling and £15 million of other currencies were held on time deposit.

Components of private sector liquidity[a]

[Summary of **Table** 12 in the *Quarterly Bulletin*]

£ millions

	'Money': Unadjusted	'Money': Seasonally adjusted	Other money-market instruments: Total (net)	Other money-market instruments: *of which bank bills*	Savings deposits and securities: Total (gross)	Savings deposits and securities: *of which shares and deposits with building societies*	Savings deposits and securities: Total (net): Unadjusted	Savings deposits and securities: Total (net): Seasonally adjusted	Certificates of tax deposit: Seasonally adjusted: Gross	Certificates of tax deposit: Seasonally adjusted: Net	PSL_1[b]: Seasonally adjusted	PSL_2[c]: Seasonally adjusted
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*11*	*12*
Month ended												
1980 Oct. 15	62,603	63,331	5,528	*1,005*	51,957	*40,778*	48,207	48,586	839	715	69,698	118,160
Nov. 19	63,539	64,025	5,147	*836*	52,335	*41,096*	48,430	49,051	1,013	859	70,185	119,082
Dec. 10	64,808	64,838	4,987	*767*	53,318	*42,091*	49,255	49,255	1,124	940	70,949	120,020
1981 Jan. 21	64,373	65,036	4,708	*725*	54,252	*42,898*	50,427	50,213	1,070	877	70,814	120,834
Feb. 18	65,106	65,494	4,228	*494*	54,659	*43,120*	51,112	51,143	1,293	1,113	71,015	121,978
Mar. 18	64,887	65,848	4,100	*364*	55,071	*43,327*	51,777	51,860	1,262	1,095	71,210	122,903
Apr. 15	67,009	67,404	4,579	*427*	55,565	*43,636*	52,364	52,541	1,188	1,025	73,171	125,549
May 20	67,984	68,514	4,589	*426*	56,005	*43,959*	52,762	53,137	1,105	937	74,208	127,177
June 17	68,543	68,794	4,492	*515*	57,126	*44,989*	53,804	53,674	939	766	74,225	127,726
July 15	70,486	70,160	4,357	*543*	57,806	*45,579*	54,450	54,152	1,083	907	75,600	129,576
Aug. 19	71,242	71,065	4,497	*625*	57,897	*45,636*	54,472	54,412	899	723	76,461	130,697
Sept. 16	71,823	72,596	4,432	*515*	58,259	*45,910*	54,840	54,818	928	752	77,956	132,598
Oct. 21	72,752	73,679	4,393	*447*	58,581	*46,162*	55,142	55,215	845	669	78,917	133,956

[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_1 equals columns 2 + 3 + 9.

[c] PSL_2 equals columns 2 + 3 + 8 + 10.

PA

I must see the Chancellor before Wednesday – because of his statements

PRIME MINISTER

The Deputy Governor, in a telephone conversation with me last week, stressed that it was the Bank's desire to keep within, or as near as possible to, the target sterling M3 range which was their principle motive in their current money market operations.

Given:

1) the move, in the Budget and since, away from excessive dependence on a single indicator of monetary tightness and

2) the real danger of weakening, or even choking off completely, the recovery (a point noted in a number of recent forecasts, including Patrick Minford's Liverpool Group.)

Do you wish to raise with the Chancellor (at your Wednesday meeting? or separately, with Alan Walters present?) Alan's suggestion that there is no case for resisting the downward trend of interest rates?

MCS

30 November 1981

SECRET

30 November 1981

ALAN WALTERS

Prime Minister

MLS 30/11

PRIME MINISTER

INTEREST RATES

1. During the last two weeks there has been considerable downward market pressure on interest rates in the money markets. The Bank has countered the market by keeping interest rates considerably higher than they would otherwise be.

2. The rationalisation for the Bank's policy consists apparently of a number of strands. First, in my judgement least important, they have been concerned to prevent a considerable fall in interest rates because they wish to have a little in hand to do a traditional "Duke of York" operation in selling gilts. If this were the case it would be simply a tactical operation and one would see it unwind after a week or two. The second rationalisation, and the most important, is that they wish to constrain the expansion of bank credit to the private sector. They regard themselves as being constrained to control that expansion and its counterpart in the M_3 figures.

3. But I believe that all of us who keep a close watch on these statistics, including people such as Gordon Pepper and Tim Congdon in the City, believe that sterling M_3 is seriously flawed as an indicator of monetary stringency. Indeed the Chancellor argued as much in the Budget speech last March. The other indicators, M_1, retail M_1 and the monetary base (which is least influenced by the Civil Service strike) show that there has been, and continues to be, considerable monetary tightness. For example, the monetary base has grown only by 4% over the last year and only 2% over the last six months and is actually unchanged over the last three months. This view is confirmed by the appreciation of sterling over the last three months. That is consistent with a tightening of the money supply.

4. All these indicators, even including PSL2 in so far as one can remove the distortions, suggest that there is no case for resisting the downward trend of interest rates. The data on bank lending and their effects on M_3 are to a large extent the result of

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business which had been outside the banking system being attracted back into the banks. Structural changes in credit markets are no good reason for tightening the money supply, as we found in 1980. Furthermore, maintaining interest rates well above market values will undoubtedly have some significant effect in delaying the cyclical recovery.

30 November 1981 ALAN WALTERS

I understand this evening that Peter Middleton agrees with the position I have outlined above.* It is intended to let short rates come down during the course of tomorrow. It is doubtful if this will have any effect on the exchange rate since that has already been substantially discounted.

ALAN WALTERS

* I am told by the Treasury that it is by no means ?

clear that the Chancellor will agree to the proposal that short rates be allowed to drop on 1/12.

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CONFIDENTIAL

MR. WALTERS

cc: Mr. Hoskyns
Mr. Ingham
Mr. Scholar
Mr. Duguid

MONETARY TARGETS AND THE RECOVERY

Thank you for your note of 20 November in reply to mine of 19 November, about the issue raised in the exchange between Terry Burns and Alan Bailey.

I follow your argument as far as the first paragraph on page 2: that is, if I understand you correctly, we keep to our steady deceleration in the money supply regardless of what happens cyclically to economic activity; and during a cyclical upturn, the increased velocity of circulation will mean that monetary policy is less restrictive anyway.

But I have difficulty in relating that to what is actually happening. We have not been able to control the money supply in any precise way; and the Civil Service strike has meant that we have not even been sure how fast it has been growing. You say that we can control the monetary base, and that in doing so we would not be choking back the recovery. But, at the moment, we are not controlling the monetary base: so surely what the Bank of England was doing in the markets at the beginning of last week was choking back the recovery. (Incidentally, I see that, since I wrote my earlier minute, my concern has received some respectable support in the shape of the FT on 20 November - "to sacrifice the whole recovery to a set of confusing statistics would be unforgivable"; and in the Economist this week - "the Bank of England has stopped the fall in the short term rates in its tracks. And the recovery too?")

Surely the message we want to try and put across at the moment is that recovery does not just mean a temporary increase in output. Any Government could manage that; and it is about to happen cyclically anyway. What we mean by recovery is sustainable growth, which means growth at a much lower rate of inflation than we at present have.

J.M.M. VEREKER

23 November 1981

CONFIDENTIAL

MR. WALTERS

c.c. Mr. Hoskyns
Mr. Ingham
Mr. Duguid
Mr. Scholar

Monetary Targets and the Recovery

My attention has been drawn by a colleague in the CPRS to the attached exchange between Terry Burns and Alan Bailey, which I think you also should see - if you have not already. Among the issues addressed, the one with which I am most concerned is raised by paragraph 12 of Terry Burns' minute of 17 September, which says that:-

"Adherence to monetary targets ...... is not always a policy which restricts the growth of real output. When inflation is reduced below the growth rate of money incomes implied by the monetary policy, the difference will be reflected in a higher growth of output."

Conversely, as Alan Bailey has pointed out, and as Terry Burns confirmed in his letter of 11 November, the amount of recovery the authorities will allow depends on the extent to which inflation is falling below the growth rate of money GDP. As Terry Burns puts it explicitly:-

"We welcome signs of an upturn in economic activity if, and only if, they go with a continued trend reduction in inflation."

It is of course a familiar message of this Government that, within the monetary constraints the Government has established, output and employment can grow faster to the extent that wage increases are growing slower. But I am distinctly uneasy at the development of an explicit policy to choke off the recovery in output on the grounds that the underlying rate of inflation still exceeds the growth rate of money GDP. That would provide gratuitous ammunition for the Government's opponents to say that not only has the Government's attachment to monetarism deepened the recession

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(which I think we are prepared to acknowledge as part of the transitional cost of moving to lower inflation), but that it is also now being used to deny the British people the fruits of the recovery. I do not, for example, believe that pay behaviour will respond at all helpfully to the argument that recovery depends on the difference between some abstract monetary concept and the rate of inflation.

I should therefore welcome your comments on this aspect of the debate. In particular, how far is the Government prepared to go to choke back the recovery; to what extent was the Government's intervention on interest rates at the end of last week part of that; and what are the implications for employment of any restriction in the recovery?

I think this issue is potentially of sufficient importance to involve the Prime Minister, either in Question Time or in speeches, so I am sending a copy of this minute to Michael Scholar and Bernard Ingham, although I am sparing them the enclosures.

J. M. M. VEREKER

19 November, 1981.

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C. SECRET

TELEPHONE 01-601 4444

2 new papers.

Commented

BANK OF ENGLAND
LONDON EC2R 8AH

13 November 1981

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CH/EXCHEQUER
REC. 13 NOV 1981
ACTION Mr Lavelle 13/11
COPIES TO CST, FST, EST, Sir D Wass, Sir K Couzens, Mr Burns, Mr Ryrie, Mr Hancock, Mr Middleton, Mrs Hedley-Miller, Mr Kemp, Mr Monck, Mr Britton, Mrs Lomax, Mr Peretz, Mr Ridley

The Rt Hon Sir Geoffrey Howe QC MP
HM Treasury
Parliament Street
London
SW1P 3AG

My dear Geoffrey

1 I undertook to let you have a note on the EMS.

2 Perhaps an appropriate starting point is your minute of 18 September addressed to the Prime Minister, which I have read with great interest. I note your conclusion that, though you still see the disadvantages as outweighing the benefits, you believe the balance of argument has shifted and may shift further. Let me elaborate my own position, taking as my starting point the view the Bank took in 1978 and early 1979 when the EMS was being set up.

3 We then argued that we should join the System but delay our adherence to the intervention arrangements until we judged the combination of external and internal circumstances more propitious. This is essentially the stance of current policy. Doubtless it would be difficult to find a constellation of exchange rates which would generally be regarded as ideal for the UK in all respects, but the present pattern perhaps strikes a tolerable balance in producing a sterling rate which is helpful to counter-inflationary policy without being excessively damaging to the competitiveness of industry. In this sense one might therefore judge the "external" circumstances as now being consonant with entry.

4 Moreover, the key factor, so far as "internal" circumstances are concerned, was then, and remains now, the UK's rate of inflation compared with that of our EC partners. The progress we have made - and the deterioration in some European countries - now puts the UK near the middle of the Community's inflation band.

5 Of course things will not stay as they are and we need to consider the direction of likely pressures on sterling. It is extremely difficult to predict the course of exchange rates with any confidence but among the main factors to be taken into account are the following:

(a) As regards the prospects for the current balance, I fear that, when the recovery in the UK economy which we all hope for comes about, the necessary restocking is likely to put considerable strain on the current account.

(b) Furthermore, any tendency for the exchange rate to deteriorate may lead to some acceleration of capital outflows, which may in any case be expected to be stimulated on political grounds as the next General Election approaches. Such trends and anticipations can all too easily become reinforcing and self-fulfilling.

(c) Thirdly, there are the 'petro-currency' effects which can, of course, be a very potent influence on sterling. Here it may be that slack world demand will keep oil prices stable or even slightly falling. On the other hand, there is always the possibility of a new shock in the Middle East or a greater than expected pick-up in demand, giving a fillip to oil prices and hence to sterling. Because of the extreme unpredictability of the petro-currency effect, it is perhaps wisest to assume on balance a neutral effect on the pound. (In addition to any petro-currency effects on the trend for sterling, there is, as you stress, the volatility which they produce. I return to that in paragraph 17.)

6 In the light of these factors the balance of probability, in my view, is that sterling will continue to be rather vulnerable.

Present policy dilemmas may thus be heightened. Any further substantial overall depreciation would pose a serious threat to the Government's anti-inflationary policy, which would be intensified to the extent that further efforts (ie, in addition to those already taken on interest rates) were not made to check or reverse sterling's fall.

7 If, against my present expectations, events unfolded in such a way that the tendency was for sterling to appreciate again there would also be difficulties. An appreciation would naturally be helpful in the fight against inflation, but the effects of the recession on the real economy have been such that it is perhaps hard to believe that we could be indifferent to its consequences for the convalescent competitiveness of our industry. Indeed, as I argued in my Stanford speech, it is stability of the exchange rate that we need, particularly from the point of view of encouraging investment and trade.

8 A major disturbance in either direction of the present "tolerable balance" is thus likely to be harmful to the economy. This means that from now on the exchange rate will in any case be an important policy consideration.

9 The difficulties we have had in controlling and interpreting the £M3 target (quite apart from particular problems such as the removal of the corset and the Civil Service strike) have already led us to look for additional outward and visible expressions of the Government's determination to fight inflation. Ever since your Budget speech you have been making it increasingly clear that the exchange rate is a factor that must be taken into consideration in assessing the stance of monetary policy. Circumstances now perhaps suggest that confidence in that determination might be reinforced by commitment to a more stable exchange rate.

10 Your minute deals with potential difficulties arising from seeking to adhere both to a monetary and to an exchange rate objective. Clearly if the pressures on the exchange rate are downwards the two are likely to be compatible. Indeed, in such circumstances, an

...ange rate objective is likely to be the harsher disciplinarian, because it is immediately clear when it is under threat and policy choices have to be faced without the luxury (permitted in the case of a purely domestic objective) of waiting to perceive a trend. But even if exchange pressures were to be upwards and the potential policy conflicts materialised, the state of the real economy is such that they would have to be faced, whether or not we had adopted an exchange rate objective. In this respect our position is fundamentally different from what it was in 1978 or 1979.

11 The question still remains, however, whether, if the Government were to adopt an exchange rate objective, basing ourselves on an effective rate index would not make better economic sense than joining EMS. Stability against EMS currencies, when the whole snake can fluctuate against the dollar, could not guarantee a stable effective rate, although this probably matters less now than in 1978, given that the proportion of our trade with EEC countries has increased so significantly.

12 There are two answers to this question. The first is that in my judgment the announcement of an exchange rate objective expressed in terms of the effective rate would carry less conviction with the markets than taking on the obligations, but also the rights, of full EMS membership. Acting alone might well prove more difficult than acting in concert with our European partners, supported by the full institutional framework of the EMS.

13 The second answer is part of the very much wider issue of how long we can continue to be wholeheartedly committed to membership of the European Community whilst at the same time standing aside from its major monetary achievement. In particular it would seem hard to square that commitment with the deliberate adoption of an exchange rate objective which bore no relation to the EMS.

14 These seem to me the factors that must be considered before reaching any final decision. In my view, joining the exchange rate mechanism of EMS would help to underpin the level and stability of sterling. At the same time I believe entry would enhance rather than undermine the anti-inflationary stance of Government policy at

a time when £M3 has become an unreliable guide to policy. We have always recognised the risk of entering the EMS and soon finding ourselves forced to realign because of irresistible downward pressure on sterling. I would not wish to pretend that such a risk does not still exist. It should be fully weighed, but in my view it is not sufficiently large to determine against entry.

15 There are two other important questions to consider: that of timing, and that of the width of the margins, 6% or $2\frac{1}{4}$%.

16 So far as timing is concerned, the immediate future may be opportune. The United Kingdom has the Presidency until the end of the year; the present constellation of exchange rates is broadly acceptable to us; and in the wake of the recent realignment there is relative stability among the European exchange rates.

17 So far as the exchange rate margins are concerned, the difference between 6% and $2\frac{1}{4}$% goes beyond mere technical detail, because it makes a real difference to the degree of constraint which membership of the System would put on us. There is a dilemma here. To the extent that we see entry into the EMS as reinforcing the counter-inflationary strategy, the tighter the constraint the better. On the other hand the petro-currency effects on sterling, whose unpredictability I know causes you particular concern, do distinguish us from all our European partners (with the possible exception of the Dutch, who are not large enough to matter); and they reinforce the peculiar vulnerability of sterling compared with other EMS currencies to short-term capital flows. My own feeling is that, if we were to decide to join, it would be regarded both by our partners and by the markets as a sign of prudence to opt for the wider margins. A 6% margin plus the well-demonstrated capacity of the system to accommodate realignments when they are necessary should allay many of the fears that we might not be able to maintain our position in the system. This would not preclude us from imposing on ourselves the self-discipline of intra-marginal intervention to keep within a narrower band, as the Italians and others have done from time to time.

Yours ever

Gordon.

Prime Minister

(2)

CONFIDENTIAL

cc Mr. Wolfson MCS 11/4
Mr. Hoskyns
Mr. Duguid
Mr. Vereker
Mr. Scholar

Top Copy. European Policy. June 79, EMS

PRIME MINISTER

MONETARY REFORM AND THE EMS

1. At a meeting between Terry Burns, Peter Middleton and myself today, there emerged a very wide measure of agreement, amounting almost to unanimity, on what should be done in the next stages of monetary reform and for the development of the general financial strategy. The main elements were those which I mentioned in my memorandum of 30 October 1981.

2. We could see no good reason at all for entering the EMS. You may be interested in the views expressed in the Bundesbank Monthly Report. The Bundesbank suggests that the EMS has been a failure in promoting monetary stability. I entirely agree with this assessment by the Bundesbank.

AW

11 November 1981

ALAN WALTERS

CONFIDENTIAL

Advance copy of the article

New measures of monetary policy

which will appear in the
Monthly Report
of the Deutsche Bundesbank
Vol. 33, No. 10, October 1981

New measures of monetary policy

Exchange rates in the European Monetary System (EMS) were realigned with effect from October 5; against the Danish krone, the Belgian and Luxembourg franc and the Irish pound (as measured by the bilateral central rates)

- the Deutsche Mark and the Netherlands guilder were revalued by 5.5 %, and

- the French franc and the Italian lira were devalued by 3.0 %.

For the Deutsche Mark this resulted in a revaluation of 8 3/4 % against the French franc and the Italian lira.

The realignment of exchange rates in the EMS had become necessary because the price discrepancies and external disequilibria among the various partner countries had grown steadily over time.

Stability of exchange rates is an important goal within the EMS, but in view of the varying price and cost trends, the differing economic structures and the partly diverging economic policy approaches of the partner countries, the possibility of adjusting the central rates between the partner currencies, as and when required, had been envisaged from the outset. Central rate adjustments, such as the latest realignment, are therefore not at variance with the aim of exchange rate stability; indeed, they are necessary in order to preserve the system.

From the very beginning, however, the objectives of the EMS went beyond the establishment of stable (but adjustable) exchange rate relationships; the ultimate goal was the creation within the European Communities of a "zone of stability" which included monetary stability. In fact, no major successes have been achieved in this respect since the EMS was formed. Price rises in the Netherlands and Belgium have come more into line with those in Germany, but at the same time the differential in relation to countries with higher inflation rates like Ireland, Italy and France has increased. In August 1981, for instance, consumer prices in Italy were 19.5 % higher than a year before, and those in France were up by 13.6 %, while in Germany the inflation rate came to 6.0 % and in the Netherlands to 6.4 %. Since the EMS was established (in March 1979) such price rises have amounted to 54 % in Italy and 36 % in France, but to only 16 % in the Netherlands and 14 % in Germany. Given such divergent trends in general price and cost levels under a system of basically fixed exchange rates (the rates can move only within relatively narrow margins), the competitive position of the countries with higher inflation rates deteriorated in trade with member countries, while the countries with relatively stable prices registered competitive advantages, but also an increase in imported inflation. The latest exchange rate realignment was designed to rectify the accumulated price discrepancies. However, the exchange rate adjustments also owed something to other factors, such as the state of a country's balance of payments, the interest rate dif-

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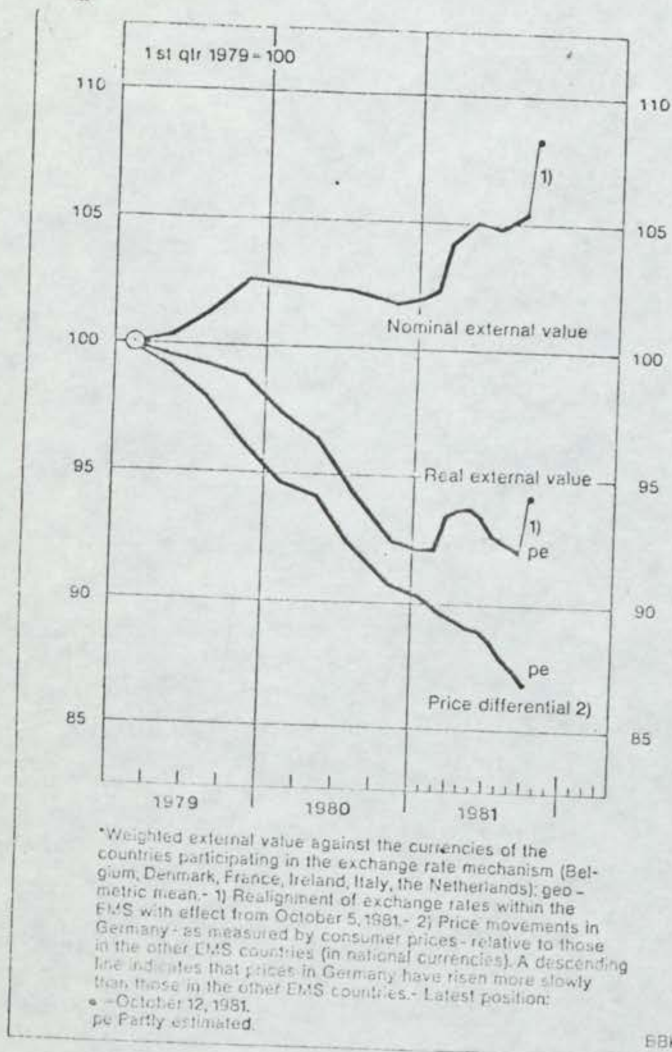
External value
of the Deutsche Mark in the EMS*



*Weighted external value against the currencies of the countries participating in the exchange rate mechanism (Belgium, Denmark, France, Ireland, Italy, the Netherlands); geometric mean.– 1) Realignment of exchange rates within the EMS with effect from October 5, 1981.– 2) Price movements in Germany – as measured by consumer prices – relative to those in the other EMS countries (in national currencies). A descending line indicates that prices in Germany have risen more slowly than those in the other EMS countries.– Latest position: • – October 12, 1981.
pe Partly estimated.

ferential and its impact on capital movements, and specific national objectives (e.g. due consideration of the index-linking of wages).

The exchange rates were realigned by first fixing the bilateral central rates anew, as already mentioned. In the aggregate, these central rate adjustments resulted in an average revaluation of the Deutsche Mark against the other EMS currencies of 5 ½ %.[1] After taking account of the depreciation of the pound sterling in the market since the last realignment, the new parity grid also gave rise to new central rates vis-à-vis the European Currency Unit (ECU).

However, the actual exchange rates of the EMS currencies do not correspond to the bilateral central rates, because the market rates may fluctuate within fixed margins of normally 2.25 % on either side of the bilateral central rate.[2] Experience shows that, when the central rates are adjusted significantly, the exchange rate formed in the market does not change to the same extent. Immediately after the latest realignment the Deutsche Mark stood at a higher level than before, but it remained within the lower half of the new margins of fluctuation and at times reached the lower intervention point vis-à-vis the French franc. Thus the result of the realignment was the same as usual in the initial phase: within the EMS the previously strong Deutsche Mark became a "weak" currency, and the devalued currencies appeared to be "strong". When this Report went to press (October 13), the actual appreciation of the Deutsche Mark against the other EMS currencies, relative to the market rates immediately prior to the realignment, consequently amounted to only 2 ½ %, compared with – as noted – a revaluation of 5 ½ % on the basis of the central rates. Only if the Deutsche Mark were to take up, within the present margins of fluctuation, a position similar to the one it had occupied before the realignment (i.e. close to the upper intervention point) and if other currencies were to approach the lower intervention point, would the market rates appreciate to the same extent as the central rates, viz. by 5 ½ %. Hence the exchange rate adjustments are currently imposing a smaller burden on German exports to the EMS countries than had widely been feared when the central rate changes were announced, especially since the pressure on import prices due to the revaluation is at the same time bringing relief to enterprises.

No less significant than the exchange rate shifts among the EMS currencies in the wake of the realignment is the resultant increase in the room for manoeuvre of the Deutsche Mark vis-à-vis the U.S. dollar. In connection with the realignment the Deutsche Mark has become somewhat stronger against the dollar, too, partly perhaps because it has now been freed from certain adverse influences relative to the dollar which affect it when exchange rates in the EMS are unrealistic. But the fact that the Deutsche Mark has appreciated against the dollar since October 2 must also be attributed to another factor which may have been even more important, namely a general improvement in the international standing of the Deutsche Mark. After the realignment the Deutsche Mark strengthened perceptibly, not only against the dollar but also vis-à-vis other major third currencies; between October 2 and the time this Report went to press it appreciated by 2.3 % against the weighted average of the currencies of 23 of Germany's principal trading partners. More than half of this overall appreciation was accounted for by exchange rate movements in the EMS. The weighted external value of the Deutsche Mark is now 3.7 % higher than at the end of 1980, and thus back at the level of end-1979. At least for the time being this development is curbing the importation of inflation into Germany, which up to recently was accentuated by the tendency of the Deutsche Mark to depreciate.

However, a reservation must be made in this connection inasmuch as the restraining effect of the slight appreciation of the Deutsche Mark does not apply to some of the prices of agricultural imports, or to the prices of agricultural exports. In the case of market organisation prod-

1 Weighted average in accordance with the shares in Germany's foreign trade between [illegible] and 1977.
2 In the case of Italy the margins amount to [illegible] %. the United Kingdom is not participating in the exchange rate mechanism.

Changes in the central rates and market rates of the Deutsche Mark against the EMS currencies after the realignment of October 4, 1981

Currency	Bilateral central rates: DM per currency unit, previously	Bilateral central rates: DM per currency unit, as from Oct. 5, 1981	Revaluation of the DM in %
French franc (100)	42.4505	39.0302	+ 8.76
Netherlands guilder (100)	90.4673	90.4673	0
Belgian/Luxembourg franc (100)	6.23800	5.91280	+ 5.50
Italian lira (1,000)	2.01518	1.85281	+ 8.76
Danish krone (100)	32.1373	30.4619	+ 5.50
Irish pound	3.71457	3.52090	+ 5.50
Average of the EMS currencies 1	—	—	+ 5.54

Currency	Market rates: DM per currency unit, Oct. 2, 1981	Market rates: DM per currency unit, Oct. 13, 1981	Appreciation/Depreciation of the DM in %
French franc (100)	41.630	39.880	+ 4.4
Netherlands guilder (100)	89.925	90.660	— 0.8
Belgian/Luxembourg franc (100)	6.103	5.948	+ 2.6
Italian lira (1,000)	1.950	1.874	+ 4.1
Danish krone (100)	31.680	31.110	+ 1.8
Irish pound	3.643	3.549	+ 2.6
Average of the EMS currencies 1	—	—	+ 2.4

1 Weighted with German shares in foreign trade between 1975 and 1977.

Changes in central rates and in monetary compensation for agricultural imports and exports after the realignment of October 4, 1981

Country	Revaluation (+) or devaluation (—) against the ECU in % 1	Change in monetary compensation in percentage points	Memorandum item Monetary compensation 2: before the realignment	Memorandum item Monetary compensation 2: after the realignment
Germany	+ 5.6	+ 5.1	+ 3.2	+ 8.3
Netherlands	+ 5.5	+ 4.3	0	+ 4.3
Belgium/Luxembourg	+ 0.1	0	0	0
Ireland	+ 0.1	0	0	0
Denmark	+ 0.1	0	0	0
France	— 2.9	0	0	0
Italy 4	— 2.9	— 2.2	— 1.7	— 3.9
Memorandum item United Kingdom 4	5 (— 9.8)	+ 1.6	+ 1.9	+ 3.5

Note: Next to France's "after" value, the table prints the footnote mark 3 before the 0.

1 On the basis of central rates. — 2 Deviation of "green parity" from central rates in % (after deduction of franchise). +: monetary compensatory amounts are charged on imports (import levies) and refunded on exports (export refunds). —: monetary compensatory amounts are refunded on imports (import subsidies) and charged on exports (export levies). — 3 Monetary compensation is unnecessary as the "green parity" was also devalued (by 1.5 %). — 4 Monetary compensation is adjusted weekly to exchange rate movements. — 5 Computed devaluation of the pound sterling against the ECU.

ucts, the revaluation of the ECU central rate of the Deutsche Mark in the EMS is offset by increasing the "monetary compensatory amounts" (MCAs) for imports of agricultural goods into and exports of agricultural goods out of Germany. In accordance with the Federal Government's wishes, the EEC Commission raised the MCAs for Germany to the same extent as the Deutsche Mark was revalued, in order to preclude repercussions on the level of intervention prices. Other countries did not proceed in precisely the same manner; for them the positive or negative MCAs went up – in line with the current regulations – slightly less than would have been consistent with the change in central rates (see the adjacent table). France adjusted the agricultural conversion rate to the change in central rates (albeit likewise only in part). An additional factor in Germany's case is that, while the MCAs were raised in accordance with the central rates, the Deutsche Mark has so far not appreciated nearly so strongly in terms of the actual exchange rates, as noted.

In connection with the firmer position of the Deutsche Mark in the international exchange markets, long-term interest rates in Germany have fallen sharply since mid-September. In the money market, too, the time money rates have decreased slightly, while the day-to-day money rate has remained unchanged. At first this process took place independently of the movement of U.S. security yields, which continued to rise until the end of September. More recently, however, the fall in interest rates in Germany has been fostered by declining bond yields in the United States. The reduction in long-term interest rates in Germany due to market factors, which has now spread to bank lending rates as well, no doubt reflects the fact that fears of a further depreciation of the Deutsche Mark have disappeared – and if anything given way to expectations of an appreciation – as a result of the improvement in the current account and the strengthening of the Deutsche Mark against the U.S. dollar and other major currencies.

The Bundesbank took due account of the changed situation in the financial and foreign exchange markets and lowered the special lombard rate from 12 % to 11 % with effect from October 9. This correspondingly reduced the cost to the banks of raising funds by pledging securities at the central bank, which has averaged about DM 3 billion during the past few months. Money market rates have also fallen to about the same extent. The Bundesbank was able to exploit the resultant scope for interest rate policy because the importation of inflation has been slowed down by the appreciation of the Deutsche Mark against major partner currencies. Nevertheless, price rises in Germany, which are largely "home-made", continue to be strong. Even though the situation in the external field is somewhat easier, the monetary room for manoeuvre can be utilised only with caution, especially since international interest rate developments remain complex and subject to sharp fluctuations. The adjustment of the German economy to external conditions, which have been radically different for more than two years now, has made some progress but, as the monthly current account deficits show, it has not yet gone far enough. Moreover, it must be further supported by government fiscal policy and the incomes policy of management and labour, not least in order to avert adverse consequences for employment.

MR. HOSKYNS

c. Mr. Walters

Medium Term Financial Strategy

Thank you for your minute of 4 November about the medium term financial strategy. I had read David Blake's article in The Times, and thought that it was generally quite good, except that it fell into the usual trap of assuming that the MTFS was a much more rigid affair than it was ever conceived to be. This, as I see it, is a plain misreading of what we have said on a number of occasions about the MTFS. It is also rather extraordinary in view of the Prime Minister's remarks on this subject in the censure debate speech last week (as Geoffrey Rippon pointed out yesterday, the word "flexible" appears some five times in a very few paragraphs in Hansard).

I think the moment for injecting the kind of thinking you are suggesting - the rolling forward each year of the previous year's MTFS/plan - is either now or will soon be here. As I understand it, the Treasury are embarking on a review of the monetary arrangements. It may be that this at present concentrates on the areas Alan Walters has mentioned - the possibility of widening the interest rate bands, and of moving to a different target aggregate or group of aggregates. But there is no reason why this review should not be widened. I assume that Alan Walters will be in on the act, and will ensure that the Treasury's review covers the right points.

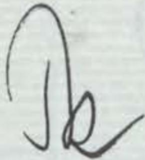
M. C. SCHOLAR

5 November 1981

4 November 1981

MR SCHOLAR

As I did not copy to you my original note to Alan Walters, which prompted his minute about the medium-term financial strategy, I now enclose it. The sort of argument we are trying to dispose of is well illustrated in David Blake's article in the Times of 3 November. It is encapsulated in the sentence: "The world is too uncertain a place to be able to set such things (ie the MTFS component objectives) years in advance". But that is not what any sensible planner would propose. The plans would be revised and rolled forward each year, as we should in fact have done last spring. It is the fact that the world is an uncertain place that makes having a plan better than having no plans. It is interesting that other things David Blake says reveal that he is probably much more "planning minded" than most monetarists, but in the more deterministic and less indicative sense of the word "planning".



JOHN HOSKYNS

SECRET

CHANCELLOR

cc Chief Secretary
Financial Secretary
MST(C)
Sir D Wass
Mr Ryrie
Mr Burns
Mr Middleton
Mr Britton
Mr Kemp
Mr Monck o.r.
Mr Sedgwick
Mr Riley
Mr Turnbull
Mr Pickford
Miss Roach
Mr Crook
Mr Guy

Mr Scholar - No. 10 —

Prime Minister

This is cheering (up to a point). The reduction in the 3-month rates suggests the market saw it coming.

MCS 30/10

OCTOBER MONEY SUPPLY: FIRST GUESS

I attach the Bank of England's first estimate of the growth of £M3 in banking October. Recorded growth was 1.3%, as against a forecast of 1.8%. This takes growth in the target period at an annual rate down slightly to 18.7%. This of course double counts the strike effect. 'Underlying' growth is estimated at an annual rate of just under 12 per cent.

2. The major source of the improvement on the forecast is the CGBR. We have known for some days that it was likely to be lower than was at first feared. Inflows to Inland Revenue and Customs have been higher than expected and the net outflow from Customs has been lower. Of the £1,500 million difference between the forecast and preliminary outturn £1,000 million is thought to be attributable to faster than predicted recovery from the strike i.e. the total strike effect was an addition to the CGBR of £1 billion rather than £2 billion. Of the rest, about £300 million appears to be accounted for by lower onlending to the local authorities and public corporations and correspondingly higher market borrowing by them. Bank lending is £450 million higher. Assuming that the difference in strike effect is £1,000 million this is explained by the lower CGBR and does not alter our view of the underlying trend.

SECRET

3. In the last few days the market has started to talk about an October £M3 figure substantially lower than implied by our earlier briefing. This is primarily because tightness in the money markets at the end of the month seemed to suggest that back tax payments were coming in ahead of schedule. There have been estimates as low as ½ per cent, but 1.3 per cent, if the figure is confirmed next week, would be somewhere in the middle of the range of market estimates.

Howard Davies

H J DAVIES
30 October 1981

SECRET 30/10/81

MONTHLY AGGREGATES IN BANKING OCTOBER - A FIRST ESTIMATE

£ millions, seasonally adjusted

Figures provided by the weekly reporting banks suggest that £M3 rose by 971 (+1.3%) in Banking October, a more modest rise than the 1.8% predicted at the monthly forecast. On the basis of this figure the annual rate of growth in £M3 since February 1981 would be 18.7%.

M1 is estimated to have fallen by 121 (-0.4%) in October, indicati an annual rate of growth since February of 10.4%. Wide monetary base fell in October, by 195 (-1.6%). Increases in PSL1 and PSL2 over the month are tentatively put at +0.8% and +0.7% respectively; the lower growth in PSL1 compared with £M3 is mainly due to growth in public sector deposits and a fall in holdings of CTDs and bank acceptances.

The attached table compares changes in the counterparts and £M3 with the forecast. The CGBR at +907, was 1,459 better than forec although this was partly offset by the other public sector contribution which, at +412 was 300 larger than expected. Net purchases of CG debt by the private sector totalled 1,212, very much as expected. Of this, gilts raised 1,062, and National Savi 261. There were net surrenders of 28 Treasury bills and of 83 CTDs etc.

Sterling lending to the private sector rose by 636, compared with a forecast of 180. Part of this is accounted for by the forecast being based on a much larger CGBR. (Issue Department's take-up of commercial bills contributed 132 to the rise.) An estimated fall in the bill leak may have contributed another 150.

The net residual over the month rose by 228, with identified external items up by 234, of which sterling lending to overseas rose by 193.

SECRET

£ millions
Seasonally adjusted

		"First Estimate" (a)		Forecast (b)	
CGBR			+ 907		+2,366
CG Debt:	Gilts	-1,062		-1,045	
	Treasury Bills	+ 28		- 15	
	National Savings	- 261		- 250	
	CTDs etc	+ 83		+ 200	
			-1,212		-1,110
Other public sector:	LA	..			
	PC	..			
			+ 412		+ 107
Bank lending to:					
Private sector (inc Issue Bills)			+ 636		+ 180
SUB TOTAL			+ 743		+1,543
External and foreign currency finance Non-deposit liabilities			+ 228		- 160
STERLING M3			+ 971		+1,383
			(+1.3%)		(+1.85%)
Notes and coin			- 21		
Private sector sight deposits			- 100		
M1			- 121		
			(-0.4%)		

(a) Including some transactions which could not be attributed to individual weeks in Table 3W/1.

10 DOWNING STREET

Prime Minister

My contacts in the Treasury make me doubtful about the proposition that opinion there is becoming more enamoured with M1 or M0 [targets]; they (Terry Burns in particular) are bent more on exploring the idea of a target rate of growth for nominal GDP.

Content for Alan to open up discussions with them?

MLS 30/10

Yes but Mr. Heath was on M1 in 1973 nor.

30 October 1981

ALAN WALTERS Econ Pol

PRIME MINISTER

NEW FINANCIAL ARRANGEMENTS AND MEDIUM-TERM FINANCIAL STRATEGY

1. I believe we are now at a state where it would be wise to move forward in the next stage of the new financial arrangements. And I would like your permission to proceed, with Middleton and Burns, to plan the next stages.

2. We can claim that the new financial arrangements have been successful. During the course of the last two months we have had to deal with sharp changes in world interest rates. I think we may claim that the new arrangement enabled the markets to move interest rates quite rapidly. There was very little evidence of the delay which has caused such problems in the past.

3. One of the next steps is to set up a programme for widening the bands. There are also a number of technical issues in dealing tactics - but these are minor matters.

4. One of the big issues that was left in limbo in our July meeting was the appropriate targeting for the centre of the interest rate bands. As you know, I have always been of the opinion that sterling M_3 was an appropriate target for the long-run, or strictly medium-term target, but was misleading for indicating the degree of monetary stringency. M_3 is largely a credit magnitude and does not closely respond to the measure of money, as a means of payment, (see attached note for the distinction between money and credit). Opinion in the City (such as Gordon Pepper and Tim Congdon), and in academe (Patrick Minford and possibly Brian Griffiths), and in the Treasury is now becoming much more enamoured of a "means of payment" aggregate such as M_1 or M_0. These would be much more sensitive to movements in interest rates than is sterling M_3.

5. There are many problems of reconciliation. The new targets must be broadly consistent with MTFS sterling M_3 targets. I suspect that this can be achieved mainly be defining appropriate time periods for the targets. But this needs a great deal more thought.

/6. The appropriate

6. The appropriate time for these discussions is before we start the intensive exercises in the run-up to the Budget. And as far as we can see during the next two or three months we shall have no severe pressure problems of funding a large borrowing requirement. There is also every hope that American interest rates will begin to subside so that pressure at the short end of the yield curve will subside.

30 October 1981

ALAN WALTERS

cc Mr. Wolfson
Mr. Hoskyns
Mr. Duguid
Mr. Vereker
Mr. Scholar

THE DIFFERENCE BETWEEN MONEY AND CREDIT - THE CONSIDERATION OF CREDIT CONTROLS

1. Inflation, Money and Credit

It is often argued that credit controls will contain inflation. In order to show that the argument is false, we need to distinguish carefully between money and credit.

In essence, money is the means of payment, whereas credit is the deferment of a payment. Credit allows the purchaser to postpone payment. When payment is made it is with money.

Some credit instruments act as money because they are normally accepted as a means of payment. But most credit instruments do not act as means of payment, and do not circulate as does money. They have to be "encashed" before the purchasing power which they embody can be spent. The key distinction is that money circulates. Credit does not.

It is readily acknowledged that those credit instruments that form a sub-set of the circulating media, change from time to time. But such changes are relatively slow. There is normally a well defined set of money assets which act as means of payment and which circulate from one holder to another in the discharge of obligations.

2. An expansion of the volume of credit is neither a necessary nor sufficient condition for inflation

An expansion of credit is clearly not a necessary condition. If the Bank of England printed 50 million £100 notes and sent them to every person in the country gratis, then there would undoubtedly be some considerable inflationary pressure. But there would be no increase in the quantity of credit whatsoever.

It is obviously also not a sufficient condition. The lender must finance the credit. If there is no change in the stock of money, the lender can only finance the credit by reducing his own purchases by the amount of the loan. Or, alternatively, the

/lender can run down

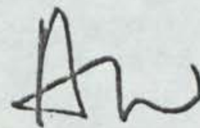
lender can run down his own money balances. But in the latter case all this does is increase the velocity of circulation of money. And we know that there is a definite limit to an increase in velocity. It cannot sustain a continuing inflation.

The only way in which we can plausibly argue that an expansion of credit causes a persistent inflation is if, by some means, we increase the quantity of money to "validate" the expansion of credit. But this amounts to no more than saying the inflation is generated by an increase in the rate of growth of the money supply.

3. Credit Controls

Apart from the fact that credit controls are not necessary or even useful in controlling inflation, they are unlikely even to achieve the proximate objective of controlling the growth of credit.

The first reason is that there are likely to be substantial leaks. They are difficult to police and the elaborate complexity of credit arrangements are such that attempting full policing would be prohibitively expensive. A second reason is that credit controls cannot conceivably cover all lending institutions. If we control banks, it is likely banking business will move out of the banking system. A very costly distortion of normal arrangements.



18 September 1981

ALAN WALTERS

cc Mr. Wolfson
Mr. Hoskyns
Mr. Duguid
Mr. Scholar

10 DOWNING STREET

29 October 1981

Dear Peter

I read with great interest the paper on the Medium-Term Financial Strategy which you sent to me. I think its time we took up again the problems of both re-casting the medium-term financial strategy and the continuing financial reforms of the debt market. There is a good argument for considering these problems while we are under no great pressure to sell debt, so that we are not distracted by contemporaneous pressures. As you know, I think the new financial arrangements have bedded down quite well. There is some flexibility which enabled us to ride the very difficult periods over the last six or seven weeks without the trauma which would have normally accompanied the old-type movements of MLR. Should we allow a longer period for it to bed down? I am inclined to think that it should run on in this way for the rest of this year at least, but we ought already to be thinking about what revisions we should be making next year. I would be inclined to widen the interest rate band in 1982. That is a matter I think we need to discuss.

The really important point is the problem of targeting and ensuring that the new arrangements can be explained in at least broad consistency with the medium-term financial strategy.

We talked about this in a somewhat desultory way when we met with Terry Burns about three weeks ago. However, we were under a shadow of market strains on the one hand, and Blackpool's Tower on the other. Certainly I felt that we need another session to put our ideas together and see whether we can come up with a package of proposals that we can float to the Bank and to Ministers.

I did not realise that the Tuesday Club was a refuge primarily for unreconstructed Keynesians. But I enjoyed the argy-bargy. It was quite fun.

Best wishes.

Ever
Alan

P.E. Middleton, Esq.,
HM Treasury.

cc Mr. Wolfson
Mr. Duguid
Mr. Scholar

MR. HOSKYNS

MEDIUM-TERM FINANCIAL STRATEGY

As you can see from the letter I wrote to Middleton, we have already started thinking about this. I am hoping that over the next month or so we can settle down to some calm reflection on the prospects before us, rather than panic reaction to contemporaneous markets.

In a sense what you are suggesting is what the medium-term financial strategy should be. It should both explain and educate at the same time. Indeed, if it doesn't do the latter its no use.

My general predisposition is, as it always has been, to get away from being hung for monthly, quarterly or even annual swings in M_3. I think we have to get a formula such that we can direct people's attention to M_3 over a three year period or so. Meanwhile it seems to me that we should push ahead with freeing up interest rates even more. I think it is quite reasonable to claim that the new financial arrangements are quite successful. In the most difficult period any of us can recall, when American interest rates were shooting through the roof, we made adjustments here in London with none of the enormous political trauma and delay which accompanied such movements in the past. Even so, interest rates were unduly constrained in the early days and probably should have gone up earlier. I believe there is a good opportunity to move forward to widening the bands by another ½% notch.

Then the nettle has to be grasped about what are our target variables. I still remain unrepentant and quite convinced that the best target variable is a "means of payment" figure rather than the mixture of means of payment and credit magnitude which appears in M_3. I believe now that the Treasury are gradually coming round to this point of view. But it means going back on a lot of what they have said in the past, so it all takes a bit of time. When I last saw Terry Burns he asked me what sort of M_1 target I would be using. After protesting that I would rather use a target somewhat different from M_1, I however said that some 6% seems to me to be

/appropriate

appropriate and would be a good enough guide for our purposes. This answer was off the top of my head, but I think its the sort of ordered magnitude we should be looking to.

29 October 1981

ALAN WALTERS

29 October 1981

MR WALTERS

cc Mr Duguid

MEDIUM-TERM FINANCIAL STRATEGY

Do we need to do any thinking on how the MTFS should be recast, based on money GDP or whatever, rolled forward a year or two etc?

I feel that there is an infantile tendency amongst those not fully in favour of such a strategy, and particularly amongst wet critics, to abandon the strategy as a fiasco simply because it was not "right" in its first formulation and we have not succeeded in meeting it. (The real objection, as we said in our review of Government strategy last Christmas, is that it was never a strategy at all - simply a set of perfectly valid objectives with no supporting strategy.) The tendency in Westminster, Whitehall, Fleet Street, seems to be "If at first you don't succeed - quit". No company's corporate strategy would ever survive on such a basis. I feel someone needs to do some work on both internal education against such an idiotic view, and external explanation!

What do you think?

JOHN HOSKYNS

To Trevor on 19/10

Econ Pol.

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

29 October 1981

Michael Scholar, Esq.,
Private Secretary,
No.10 Downing Street

Dear Michael,

In your letter of 13 October, you requested a draft letter for the Prime Minister to send in reply to Mr. Walter Goldsmith's letter to her of 9 October. The Chancellor has seen and approved this. I am sorry not to have met your deadline of 27 October.

Inevitably, given the large number of subjects covered by Mr. Goldsmith and the length of his letter, the draft reply is on the long side, though even so we have not attempted to deal in detail with every point he raises. You should know that on privatisation the Chancellor has already been in correspondence with Mr. Goldsmith - I attach a copy of his most recent letter.

Yours ever,

Peter

P.S. JENKINS

GR

M type for PM

DRAFT LETTER FOR THE PRIME MINISTER TO SEND TO:

Walter Goldsmith, Esq.,
Director General,
Institute of Directors,
116, Pall Mall,
LONDON. SW1Y 5ED

Thank you for your letter of 9 October.

The Government welcomes the continuing support of your members for its strategy and the emphasis we place on securing a lasting reduction in inflation as a precondition for economic growth. As you say, it is important to explain to the country at large the benefits of greater stability of prices, particularly in terms of the increased employment opportunities that will follow as the climate for investment improves and we compete more effectively in world markets.

I was interested to see that your members express a cautious optimism about the immediate prospects for their businesses. This ties in with other indications we have had, and, most recently, the encouraging figures on manufacturing production. The financial position of industrial and commercial companies has also improved in the first half of this year. These first indications of recovery do not do full justice to the underlying changes of the last two years. Most importantly, there seems to have been a big change in industrial attitudes, which has contributed to the reduction in the level of wage settlements over the past year and, vitally, to an increase in productivity. Taken together these developments mean that UK unit labour costs in manufacturing did not increase at all in the first half of this year. This is only a beginning. A lot remains to be done - not least in further reducing the level of wage settlements in the coming year - but I think there is enough here to justify the view of your members.

Of course there are still difficulties including in particular perhaps the high level of interest rates. These reflect in part, as you indicate, the deficits run for many years by Western Governments. But we must do everything we can to constrain our own public borrowing and so do what we can to ease the upward pressure on interest charges. In this context the effective restraint of public expenditure is vital. The Government recognises the burdens the recession has imposed on industry, and are concerned at the way the private sector has borne more of this than has the public sector. This is something we must change. There are three areas in particular where we are taking action.

We have set ourselves a target of 10 per cent reduction in Civil Service manpower by 1984, to the smallest Civil Service since the Second World War. Already the number of civil servants has been reduced by over 50,000. This represents real progress towards a more efficient and cost-conscious public service. Additionally, the Government has announced that 4 per cent is the general allowance which it is prepared to make to accommodate public service pay increases next year. This represents an assessment of what the taxpayer can afford and more generally what the economy requires if there is to be a chance of restoring the competitiveness and jobs lost by recent excessive wage increases.

On local authorities, we have announced our intention to introduce early legislation to increase the electoral accountability of high-spending authorities and to shield the non-domestic ratepayer from the consequences of excessive spending. And, as you say, we intend to publish soon a consultative document on rates. The Government will continue to exert its influence to restrain local authority spending; but in the last analysis the responsibility lies with the authorities themselves. Pressure from public opinion can do much to create the right climate as for example the recent report from the CBI has shown. Your own members have an important part to play here.

I very much agree with the thrust of your comments about nationalised industries. Nationalised industry price increases have I know been a continuing source of concern. To some extent this has been the delayed

result of the lifting of the last Government's artificial and distorting price restraints. But there is a deeper problem here too, in that the performance of many of the industries - especially in terms of efficiency and labour practices - has been disappointing. This is particularly serious in those industries not fully open to competition. There are public expenditure consequences here, as well as implications for service to consumers.

Our belief is that the most promising means of improving performance lies with privatisation. I am grateful to you and your Institute for your continued interest and support on this. As you know, the Secretary of State for Energy announced on 10 October proposals for a number of privatisation measures in the energy field, including the transfer to the private sector of BNOC's entire oil producing business, and the privatisation of BGC's offshore oil interests. We shall also be introducing powers to abolish the BGC's statutory rights over the purchase of gas and its sale to industry. In the same week we announced that we would be accepting the bid for the National Freight Corporation which has been made by a management-led consortium, and we offered for sale just under half the equity in Cable and Wireless. There is still much to be done, and we shall need especially to give thought to the most promising ways in which we can introduce private sector disciplines into the large monopoly industries.

On fiscal policy it remains our objective to secure a further improvement in incentives by reducing the burden of personal taxation. But our ability to take the 1979 reductions further has been affected by the effects of the recession on our borrowing needs. Even so, thresholds for those paying the highest rates of tax are today higher in real terms than when we took office. Further progress in reducing personal taxation depends on containing public expenditure and even then we shall need to assess the priorities we attach to action in this area as against, say, some reduction in the burdens on companies whether via taxation or via interest rates being lower than they would otherwise be.

The Institute's proposals regarding the taxation of Schedule D income of new businesses will be examined. As you know we have taken a number of measures to help the small firm sector. New businesses will perhaps

benefit most from the overall improvement in the economic environment which our policies to reduce inflation are designed to achieve.

On the wider legal issues surrounding industrial relations, I agree that the balance of power has swung too far in favour of trade unions. We have already acted, through the 1980 Employment Act, to restrict the closed shop, to establish guidelines for picketing and to curb secondary action - an important first step in correcting that imbalance. We are currently considering the responses we have had - including the package recommended in your own submission - to January's Green Paper on trade union immunities, and will be announcing our ideas shortly.

Finally you suggest a new look at company law. As you know we have commissioned Professor Gower to put forward proposals for a new legislative framework of protection for investors in securities and other forms of property. He has been given wide terms of reference which will make possible a review of all Companies Act legislation, and it is hoped that a discussion paper will be circulated by around Christmas. Meanwhile we have no intention of introducing further Companies Acts during this Parliament, and we shall continue to join in EC harmonisation discussions to ensure that these do not prejudice the interests of our businessmen.

You wrote me a long letter, and I fear this is a long reply. But the matters we cover are vital to the future. I accept that your members - and others in our society, including in particular those who are unemployed - face problems as we seek to make the changes which are so necessary. And I share their disappointment that progress is not faster. But we intend to carry on with the measures to which we are committed, and which you support, towards, in your words, a better and freer future.

PUS

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

With the Compliments
of the
Chancellor of the Exchequer's
Private Secretary

11 August 1981

Esq.,

ectors,

ry Chambers,
ment Street.

Thank you for your letter of 8 July and for the enclosed paper outlining some of your thoughts on privatisation following the seminar I held at the end of June. It was good of you to take the trouble to set down your conclusions so comprehensively.

As you know, I endorse many of the sentiments in your paper, and in particular your general emphasis on the need to make progress with the privatisation programme. In view of the considerable legal and technical obstacles we have encountered I think the progress we have made so far - especially in preparing the legislative groundwork for future sales of assets - is rather more significant than you imply; but I accept that we need to do everything we can to keep up the momentum. My speech to the Selsdon Group on 1 July outlined some of our current thinking on the main questions.

Investigations are at present under way into many of the issues you cover in your paper. The Treasury and Civil Service Select Committee will be reporting shortly on 12 August, which will direct some attention - partly critically, partly constructively I expect - at some of the industries' complaints about EFLs; that report may merit some attention. Nearer home, the Treasury-chaired Working Group set up under the National Economic Development Council is looking into the various possibilities for financing nationalised industries, and will be reporting after the summer. Within the Government we are also considering the whole question of the Government's relationship with the nationalised industries on the basis of a helpful internal report by the Central Policy Review Staff. This will, I expect, be an important and continuing process. We do not intend to allow so fundamental an issue to be treated as a one-off project which can be "solved" quickly. I am most grateful to you for your contribution to these current debates. I have asked Adam Ridley to keep in touch with your office over the next few weeks while I am away, and I hope this will help fill in some of the background more fully.

GEOFFREY HOWE

Econ Pol

HL

13 October 1981

I am writing on behalf of the Prime Minister to thank you for your letter of 9 October. I will place your letter before the Prime Minister and a reply will be sent to you as soon as possible.

MICHAEL SCHOLAR

Walter Goldsmith, Esq.

HL

27/10

W. GOLDSMITH

13 October 1981

I attach a letter from Walter Goldsmith to the Prime Minister dated 9 October about a wide range of economic issues.

I should be grateful for a draft reply for the Prime Minister's signature by Tuesday 27 October.

MICHAEL SCHOLAR

Peter Jenkins, Esq.,
H.M. Treasury.

CONFIDENTIAL

Econ Pol

Prime Minister

To note.

MCS 9/10

Subject filed on Nat. Ind: Pt 5 Gas & Elec. Pricing Policy

PRIME MINISTER

INDUSTRIAL ENERGY PRICES AND THE EXCHANGE RATE

Econ Pol: Pt 9 Domestic Monetary Policy

The minutes of Cabinet on 15 September (CC(81)31st Meeting) invited me to report on comparative costs of energy to industrial users in the UK in the light of recent exchange rate movements.

The NEDC task force report prepared earlier in the year by Government, CBI, TUC and fuel industry representatives found that fuel prices to the majority of UK industrial consumers were in line with those in Europe. There were, however, disparities for large consumers of gas (up to 20%) and for large, high load factor users of electricity (up to 35%). Since January sterling has depreciated about 10% against the Deutschmark and 7% against the French franc, most of this in the past few weeks. This helps energy price comparisons correspondingly. The attached table, which shows January electricity tariffs to large consumers at the January exchange rates and at current exchange rates, illustrates the improvement. Depreciation so far, however, has not fully offset the considerable strengthening of sterling against European currencies which took place during 1980 (20% or more) and which contributed significantly to the disparities.

The earlier NEDC comparison is now being updated. In addition to exchange rate movements, this new comparison will take account of price increases this year, both in other countries and (mitigated by the Budget concessions) in the UK. I cannot anticipate the outcome. But on the basis of available data and at present exchange rates, it seems likely that:-

CONFIDENTIAL

(a) the disparities for large, high load factor electricity consumers will have narrowed. These will not, however, have been eliminated at the highest load factors against Germany and could still reach 25% against France (where the growing nuclear power contribution is also a factor).

(b) some disparities will also remain for large consumers of firm gas. Under the influence both of oil prices and higher prices for Dutch gas, prices in Europe have now generally moved up to the mid 20s in pence/therm. But average prices in the UK have also increased, within the renewal price ceilings set in the Budget, from about 22p/therm to 25p/therm for interruptible gas and 25p/therm to 29p/therm for firm gas.

Realignment of currencies in Europe may help comparisons further in relation to Germany and Holland. But the effects on sterling parities and fuel price comparisons with other European countries are less certain.

I am copying this minute to the members of Cabinet, Sir Robert Armstrong and Mr Ibbs.

NL.

SECRETARY OF STATE FOR ENERGY
8 October 1981

ELECTRICITY TARIFFS FOR LARGE CONSUMERS APPLYING IN JANUARY 1981

pence per Kilowatt/hour

Demand (Megawatts)	Load Factor (%) (1)	England & Wales (2)	France (3)		Germany (4)	
			Jan exchange rates	Oct exchange rates	Jan exchange rates	Oct exchange rates
4	40	2.91	2.25	2.40	2.82	3.11
	60	2.75	2.04	2.17	2.31	2.55
	80	2.67	1.89	2.01	1.99	2.20
10	40	2.87	2.22	2.36	2.74	3.02
	60	2.72	2.03	2.16	2.26	2.50
	80	2.64	1.87	1.99	1.95	2.15
40	40	2.74	1.87	1.99	2.70	2.98
	60	2.60	1.73	1.84	2.23	2.46
	80	2.53	1.61	1.71	1.94	2.14

(1) Actual consumption expressed as a percentage of what it would be if the consumer's maximum demand were sustained throughout the year.

(2) Yorkshire and North Western electricity board tariffs.

(3) Electricite de France "tarif vert".

(4) Rheinisch-Westfälisches Elektrizitätswerk (RWE), the largest of the German utilities which serves the Ruhr. Tariff L 120.

source: Table 15 of NEDC Energy Task Force Report, February 1981.

exchange rates: DM 4.702 on 2 January and DM 4.26 on 1 October; FF.10.866 on 2 January and FF 10.2 on 1 October.

MES
Mr Scholar
No 10 D.S

D E D I P SECRET

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FM FCO Ø52ØØ7Z OCT 81

TO IMMEDIATE UKDEL MELBOURNE

TELEGRAM NUMBER 2Ø9 OF 5 OCTOBER

FOLLOWING PERSONAL FOR PRIME MINISTER FROM CHANCELLOR OF THE EXCHEQUER.

1. YOU MAY LIKE A FURTHER REPORT ON EVENTS IN FINANCIAL MARKETS.

2. IN ONE OF MY MESSAGES TO YOU FROM WASHINGTON LAST WEEK I MENTIONED THAT IT MIGHT WELL BE NECESSARY TO ALLOW INTEREST RATES TO RISE FURTHER DURING THE COURSE OF THE WEEK, IN THE FACE OF CONTINUED MARKET PRESSURE. HIGH US RATES GAVE US LITTLE OPTION. IN THE EVENT THE BANK OF ENGLAND, IN RELIEVING A LARGE MARKET SHORTAGE ON WEDNESDAY, SUPPLIED FUNDS TO THE MARKET THROUGH BUYING BILLS IN THE RANGE 14 AND THREE QUARTERS - 15 AND THREE QUARTERS PER CENT. THIS BROADLY CONFIRMED THE EXISTING PATTERN OF RATES AND THE OPERATION PASSED OFF QUIETLY, IN LINE WITH THE OBJECTIVES OF THE NEW MONETARY CONTROL ARRANGEMENTS. THE MOVE WAS RECOGNIZED AS A RESPONSE TO WORLDWIDE INTEREST RATE DEVELOPMENTS, AND WAS NOT SEEN AS A DELIBERATE MOVE BY THE GOVERNMENT TO ENGINEER HIGHER INTEREST RATES.

3. ON THURSDAY MORNING THE CLEARING BANKS RESPONDED BY RAISING BASE RATES BY 2 POINTS AND A NEW STRUCTURE OF INTEREST RATES BEGAN TO EMERGE, WITH OVERNIGHT MONEY AT 16 PERCENT AND THREE MONTHS AT CLOSE TO 17 PERCENT, JUST CONSISTENT WITH BASE RATES AT 16 PERCENT. SINCE THEN WE HAVE SEEN THREE DAYS OF RATHER NERVOUS TRADING IN THE MONEY MARKETS, AND IT IS TO EARLY TO SAY WHETHER THE NEW STRUCTURE HAS YET BEEN CONSOLIDATED, THOUGH TODAY'S DEVELOPMENTS, WHEN RATES EASED SLIGHTLY IN BOTH NEW YORK AND LONDON, WERE MARGINALLY ENCOURAGING.

4. THE STOCK MARKET, WHICH WAS PRACTICALLY UNCHANGED ON THURSDAY AND FRIDAY, ROSE BY 14 POINTS TODAY. THERE WERE SOME HOPEFUL SIGNS, TOO, IN THE GILT-EDGED MARKET, WHERE WE WERE ABLE TO SELL SIZEABLE AMOUNTS OF STOCK (POUNDS 315 MILLION IN TOTAL) FOR THE FIRST TIME FOR SOME WEEKS. MOST OF THE STOCK SOLD WAS AT THE SHORT END, BUT THERE WAS ALSO REASONABLE DEMAND FOR MEDIUMS AND LONGS. LATER IN THE WEEK WE SHALL BE MAKING A DECISION ON THE NEXT STOCK TO BRING TO MARKET, WITH THE AIM OFF ACHIEVING SUBSTANTIAL FURTHER SALES IN BANKING OCTOBER.

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/5.

SECRET

5. TUESDAY SEES THE PUBLICATION OF THE SEPTEMBER MONEY SUPPLY FIGURES, ABOUT WHICH YOU WILL BE RECEIVING SEPARATE BRIEFING. ALTHOUGH THE POUNDS M3 NUMBER IS LARGE AT 2 PERCENT, THE MARKETS HAVE BEEN LED TO EXPECT A HIGH FIGURE SO IT SHOULD NOT HAVE SERIOUS ADVERSE EFFECTS. (IT WILL OF COURSE BE SEEN AS FURTHER JUSTIFICATION FOR LAST WEEK'S INTEREST RATE MOVE.) THE BUILDING SOCIETIES HAVE NOT YET MADE THEIR DECISION: THEY MEET ON FRIDAY, AND ONE MUST EXPECT THEM TO PUT UP MORTGAGE RATES.

6. THE FOREIGN EXCHANGE MARKETS WERE UNCERTAIN THIS MORNING IN THE WAKE OF THE EMS REALIGNMENT (WHICH WE NEGOTIATED IN BRUSSELS YESTERDAY) BUT HAD SETTLED DOWN BY LUNCHTIME. THERE WERE NO LARGE MOVEMENTS: AND NO HEAVY OFFICIAL INTERVENTION. THE MAIN FEATURES HAVE BEEN:-

(A) SOME WEAKENING OF THE DOLLAR, ON EXPECTATIONS OF FALLING DOLLAR INTEREST RATES. (SEVERAL US BANKS HAVE CUT PRIME LENDING RATES BY HALF PERCENT TO 19 PERCENT) STERLING CLOSED IN LONDON AT DOLLARS 1.8512, A GAIN OF 2 AND ONE HALF CENTS SINCE CLOSE ON FRIDAY.

(B) THE REALIGNMENT ITSELF SEEMS TO HAVE RESULTED IN A SMALL RISE IN THE DEUTSCHEMARK AGAINST NON-EMS CURRENCIES SUCH AS THE DOLLAR AND POUND, WITH MORE OF THE REALIGNMENT SHOWING UP AS A FALL BY THE WEAKER EMS CURRENCIES.

(C) THE DEUTSCHEMARK IS NOW AT THE BOTTOM OF THE 2 AND ONE QUARTER PERCENT EMS BAND, WITH THE FRENCH FRANC AT OR NEAR THE TOP - SO THAT SINCE FRIDAY THE FRANC HAS ONLY FALLEN, SO FAR, BY ABOUT 4-5 PERCENT AGAINST THE DEUTSCHEMARK, ALTHOUGH THE REALIGNMENT PROVIDED FOR A 8 PERCENT FALL.

WITH STERLING ONLY FALLING MARGINALLY AGAINST THE DEUTSCHEMARK AND RISING AGAINST OTHER CURRENCIES, THE STERLING EFFECTIVE INDEX AT THE CLOSE TONIGHT WAS 88.05 - WELL UP FROM 87.3 ON FRIDAY NIGHT. IN SHORT, THE RECENT TURMOIL SEEMS TO HAVE DIED DOWN.

7. THE RISE IN INTEREST RATES IS OF COURSE A BLOW, BUT NOT ONE THAT WE COULD HAVE AVOIDED. INTIL THE AMERICANS ARE SEEN TO BE TAKING CREDIBLE STEPS TO REDUCE THEIR DEFICIT, RATES WORLDWIDE ARE LIKELY TO STAY HIGH.

CARRINGTON

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COPIES TO
PPS/CHANCELLOR)
PS/FST)
PS/MST(C))
SIR D WASS) TREASURY
MR RYRIE)
MR MIDDLETON)
MR HANCOCK)
MR SCHOLAR NO 10 DOWNING STREET

SECRET

Econ/Pol

BY ALAN WALTERS

SPEECH FOR THE INSTITUTE OF DIRECTORS' ANNUAL MEETING
TO BE HELD ON 5 OCTOBER 1981 AT 7.00PM

I much appreciate the privilege of giving this annual address. As you well know, as indeed I have never tried to hide, I am an economist. To confess that one is a professional economist nowadays, invites mixtures of scepticism, cynicism or derision. To invite an economist to your dinner shows that the Institute is generous. To invite him to speak, however, implies a magnanimity of spirit and tolerance of tedium that invokes wonder. But for the next twenty minutes or so I ask you to stifle your entirely natural propensity to nod off. What I would like to do is to provide you with an understanding of the basic ideas of the broad policies which have in recent years been given the inelegant term "monetarist".

Unfortunately the terms "monetarism" and "monetarist" have been distorted and debased. Monetarism is said to be merely a new recipe for a slump. Of course this is all quite wrong. Only the label is new: the ideas are as old as history. However, it really grew into a systematic way of thinking when those two great Scotsmen David Hume and Adam Smith, produced their works of the most surpassing genius which laid the foundations of virtually all we know about money and its effects. Monetarism indeed was the guiding principle of British economic thought during the great hayday of the British industrial miracle. It was the very fibre of Gladstone's rectitude.

The basic principle of monetarism is a very simple one which even its worst enemies find it difficult to deny. It is a principle that every businessman knows. If there is an increase in the quantity of a commodity on the market then it is likely that the price of that commodity will go down. Strawberries cost less in summer than in winter. Similarly, this must obviously apply to money because money was just another commodity for many years, when we traded sovereigns and silver coin, and one would expect it to behave just like any other commodity. So it means then that if there is an increase in the quantity of money then the price of money will fall. That is to say the price of goods in terms of money will rise. This is the essence of the proposition that inflation is caused by

/"too much money

"too much money chasing too few goods". There are many instructive and some amusing examples of the manifestation of this law. For example, when during the United States Civil War the Union forces overran and captured the Mint of the Confederate States, the great inflation which had been going on in the Confederate States was markedly reduced for a while. But, of course, the Confederate Government soon re-established the Mint on safer, Confederate territory, and the inflation in the Southern States got under way once more.

This very example illustrates the temptations of modern monetary economies. Instead of money being a commodity such as gold or silver, it is now merely token pieces of paper issued by Government. Often it appears simply as a stroke in a ledger. Sometimes merely a charge on a tape. There is no precious metal which, so to speak, "backs" the currency. It is all faith.

And once faith is there, of course, it is a great temptation for Government to trade on it. "Print the notes to buy the votes." Yet printing press finance has <u>not</u> been a conspicuous feature of our peacetime history except in the last few decades. The price level in the 1930s was indeed below the price level at the end of the Napoleonic wars in 1815. For more than a century there had been broad stability of the price level.

I trust I need not go into the sorry story of accelerating inflation which we have all seen since the end of World War II. It is no accident that the erosion of the ideas of monetary management, the widespread embrace of the principles of planning and post-Keynesian policies have all been associated with the most persistent peacetime inflation in our monetary history.

The widespread observation that something had gone wrong and that inflation was accelerating dawned slowly in Britain. I believe the final evidence was the fact that the Keynesian methods had failed to maintain full employment. It was at last realised that even the most rampant inflation could not ensure either full employment or growth. On the contrary, it appeared

/that inflation

that inflation was in fact associated with unemployment and indeed, through the general atmosphere of uncertainty produced by very high and variable inflation rates, unemployment was generated.

In retrospect this should have come as no surprise to any observer who kept his eyes open. Economies such as Germany, Swizterland and Japan had managed to maintain very full employment indeed yet had had very low rates of inflation. Of course Germany in its reforms in 1948 positively rejected Keynesianism and planning in favour of a free market economy, called by Erhard the social market economy. Similarly, Japan had founded its social market economic system on the basis of advice it received from a solid mid-West banker who abhorred budget deficits and Keynesian practices. The Swiss, of course, have always cherished stability of the Swiss franc above many of their other virtues. Similarly, even more wide-ranging economists would have noticed that those countries in Latin America which had vigorously pursued inflationary finance for many years, such as Chile, andArgentina, had hardly enjoyed rapid growth. In fact Argentina had once enjoyed a standard of material wealth greater than the United States. But with its massive inflations had virtually marked time since the early 30s. Inflation certainly did not appear to have brought growth.

This then was the atmosphere in which the old verities of the theory of money was reassessed beginning in the 1950s.

So it emerged that the lessons of history gave additional potency to the proposition that inflations were due to too much money: one will not have any substantial inflation if one controls the quantity of money and allows it to grow only slowly. (I should say that although 364 plus economists have denied this proposition, they did not reveal the basis for their sweeping claim. Perhaps we'd better leave their proposition in decent obscurity until they come up with a better story.)

/How are we to ensure

How are we to ensure that the quantity of money is controlled? Money does not grow on trees. Nor is it a plague born on the winds of change from some foreign shore. Money is largely in the hands of Government.

And as we all know, money is used as one way of financing Government spending. Governments like any other entity must balance their books. They must pay for the goods they receive. There are three ways of discharging these obligations. First, <u>taxation can be raised now</u>. Second, loans can be incurred now. But that means <u>taxes must be raised later</u> to finance the loans. Thirdly, money can be <u>"printed" now</u>. But (you guessed it) printing money is a form of tax - an inflation tax. It increases prices and so reduces the value of notes and deposits already in the hands of the public. All of us pay the tax proportionately to your holdings of sterling*.

There is no escape. You either pay "ordinary" or "fiscal" <u>taxes</u> <u>now</u> or <u>later</u>, or alternatively you pay the <u>inflation tax</u> as the value of money is eroded through time.

There is a crucial constitutional difference between raising ordinary or fiscal taxes and the inflation tax. Fiscal taxes have to be approved by Parliament and receive the Royal Assent. Inflation taxes, on the other hand, are imposed without legislative or royal assent. They are a form of taxation without representation. No wonder our great statesmen of the past condemned inflationary finance as a fraud by spineless government.

The rectitude of Gladstone must cause us all to wince - after all in his time Britain never got hooked on inflation. Today most of us find it difficult to recall the days when there was anything like a stable price level. We have been living with it - albeit trying to evade its consequences - for almost a generation. We do not know any better.

/For these good reasons

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*This takes some time to appear and is therefore attractive to meretricious politicians.

For these good reasons then, the adjustment to a stable price level must be slow. We are now hooked. Too fast a deceleration would invite painful withdrawal symptoms (such as financial hallucinations).

To control inflation, what we must do is to ensure that the quantity of money is controlled over a fairly long period of time. Reducing inflation cannot be done "at a stroke". It requires a programme that persists for at least three years and probably five. The main reason is that it takes a considerable time for people to adjust, both in their expectations and in their behaviour to a new monetary environment. The policy must also carry conviction . The experience of British governments since the War has been that, although they have pursued a policy of restraint for some time, no-one has expected that it would last for more than a year or two. And in general people have been correct. For example, the squeeze which Mr. Jenkins imposed in 1968 was foregone in 1969, and the reduction in the money supply pursued by Mr. Healey in 1977 was reversed by the end of 1978. What is required, however, to reduce the rate of inflation is a persistence and a consistency in policy which reduces progressively the rate of growth of the money supply and then holds it at a suitably low level, say about 3-5% per annum. Belief is all.

This is the policy that was inaugurated with the medium-term financial strategy.

I believe this long run, that is 3-5 years, role of money in providing the stability in the general price level is the most important task for Government in monetary policy. When everyone realises that the Government is maintaining a firm long-run control over the emission of money, then it will create a firm set of expectations that inflation will not run away and frustrate our long-term planning.

This is about all monetarism can do. It cannot ensure lasting prosperity or perpetual growth. It will not ban the bomb or cure cancer. It will not banish poverty. It will not make the mad sane, nor will it even make sinners repent,

make sinners repent. Alas, all we monetarists can offer is long-run stability in the general level of prices. To many of us this evening, though, that is no trivial matter.

Furthermore, most of us in this room would have very firm ideas on how best to implement this monetary discipline - by reducing Government expenditure and so the deficit. But monetary management is not the only reason - perhaps not even the main reason - for reducing Government spending. There is overwhelming evidence that at present government performs many functions which could be much better carried out by the private sector. Yet the Government is being urged to increase government spending and monetary expansion to "solve" all the problems that beset us.

The commonsense of monetarism is to use monetary policy only solving monetary problems. We should not attempt to deal with real problems by manipulating monetary conditions. In this very real sense, as Sir Keith Joseph put it many years ago, "monetarism is not enough".

Many of the abiding problems of Britain are real, not monetary problems. As such they require real solutions.

Of course, it is a great temptation to provide some monetary gimmick to deal with a real problem. And it is not only the economics profession who are guilty of this. Many a businessman has come along with a system for cheap credit which is designed to promote industrial health. But we've had enough of these quack cures. We know that you cannot increase growth, reduce unemployment, eliminate poverty, etc by monetary expansion.

Yet such policies, futile though they may be, have enormous emotional, intellectual and political appeal. Such proposals are demonstrably designed to "do good". They are put forward with a crystal clear conscience and with perhaps just a tinge of hubris. There is always a ready audience for the latest fad. Man is fundamentally a romantic animal and prefers fiction rather than fact. A firm recognition of reality and a shunning of romantic

/myth is the

myth is the most admirable characteristic of all great statesmen. One of the reasons I came back from the United States to become Mrs. Thatcher's adviser, was my conviction that at last Britain had a Government that was facing squarely the facts and the hard decisions that needed to be made. I was not disappointed. I am not disappointed and I will not be disappointed.

C/f

Econ Pol

2 October 1981

I enclose the papers you kindly lent me on monetary policy. I hope that they are all there (I know that one paper is missing - that is the Green Paper on Monetary Policy, which I will return separately when I have tracked it down).

I have taken copies of bits of these papers. Thanks very much for all your help on this.

MICHAEL SCHOLAR

Andrew Turnbull, Esq.,
H.M. Treasury.

File No.

Department

Drafted by (Block Capitals)

Tel. Extn.

OUTWARD TELEGRAM

Security Classification: SECRET

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[TEXT]

Following is a personal message for Whitmore, Prime Minister's Party from Lankester 10 Downing Street.

BEGINS:

I sent you a telegram on Monday evening saying that Treasury Ministers had decided in principle to raise the interest rate band from 13-15% to 14-16%. I also said that it was unlikely that the Bank would have to operate in the money market before Thursday or Friday, so that the new band was unlikely to become obvious before then. In the event, a substantial shortage has emerged in the money markets this morning, and the Bank and the Treasury have decided that they have no option but to provide some assistance to the market. They will be doing so at about 15% or possibly a shade higher. There is bound to be comment in the press that we are validating the higher interest rates, although as I explained earlier, we have little alternative. The move

/ may

may also trigger an early increase in base rates: The Bank think that they will go up by 1½ to 2 per cent tomorrow.

The Bank will be dealing at the higher interest rate at 1215 our time. By the time you receive this message, you may have already seen what has happened from the tapes. But I thought you would want to have the background.

ENDS

R.

GR 240

SECRET

PS/NO 10 Downing Street

R
has copy

SECRET

FM WASHINGTON 290200Z SEP 81

TO IMMEDIATE UKDEL MELBOURNE

TELEGRAM NUMBER 001 OF 28 SEPTEMBER

INFO IMMEDIATE F C O (PERSONAL FOR CHIEF SECRETARY, WASS, RYRIE, JENKINS, MIDDLETON (TREASURY) AND LANKESTER (NO.10)

FOLLOWING PERSONAL FOR PRIME MINISTER FROM CHANCELLOR OF THE EXCHEQUER.

1. MY ASSESSMENT OF THE U.S. SCENE, AND ITS SIGNIFICANCE FOR US, REMAINS AS IN MY REPORT OF 27 SEPTEMBER (WASHINGTON TELNO.2 TO KUWAIT), THOUGH I HAVE SINCE HAD TALKS WITH REGAN AND VOLCKER.

2. YOU WILL HAVE HEARD THAT THE LONDON EQUITY MARKET FELL A FURTHER 17 POINTS TODAY (MONDAY) AND THAT THERE WERE FALLS ALSO IN NEW YORK, TORONTO AND PARIS. IN NEW YORK, HOWEVER, THE SHARP FALL WAS MORE THAN RECOVERED DURING THE DAY, AND IN LONDON THE POSITION WAS SLIGHTLY BETTER BY THE CLOSE. INTEREST RATES IN LONDON MOVED UP A LITTLE IN THE MARKETS, WITH 3-MONTH RATES RISING 3/8 TO 16 5/8 AND 7-DAY MONEY CLOSING AT 14 7/8.

3. I HAVE HAD DISCUSSIONS WITH LEON BRITTAN IN LONDON AND WITH THE GOVERNOR, WHO IS SIMILARLY IN CLOSE TOUCH WITH HIS PEOPLE AT HOME. IN THE LIGHT OF THE MOVEMENTS IN THE MARKET, I AGREED TO MOVE THE LIMITS, WITH WHICH YOU ARE FAMILIAR, UP BY ONE POINT. THIS GIVES THE BANK THE NECESSARY ROOM FOR THEIR OPERATIONS. IN THE PRESENT CIRCUMSTANCES NONE OF US SAW SCOPE FOR RESISTING THE MARKET MOVEMENTS.

4. ON THE EXCHANGES WE STARTED THE DAY IN LONDON AT 85.9 EFFECTIVE AND ENDED AT 86.4. I HAVE AUTHORISED THE BANK TO CONTINUE OPERATING IN CASE OF NEED IN THE EXCHANGE MARKETS AT A SCALE BROUGHT IN LINE WITH WHAT WE HAVE AGREED IN THE PAST.

5. THE TURMOIL IN THE LONDON MARKETS IS WORRYING. BUT THE SLIDE HAS BEEN WORLD-WIDE, WITH ITS PRINCIPAL CAUSES, AND POTENTIAL REMEDIES, LYING ON THIS SIDE OF THE ATLANTIC. THE UNDERLYING PROSPECTS FOR THE RECOVERY OF THE UK ECONOMY HAVE NOT CHANGED. NOR OF COURSE SHOULD OUR POLICY COURSE: WE MUST HOLD TO IT, AND BE SEEN TO DO SO.

6. I AM KEEPING CLOSELY IN TOUCH WITH THE SITUATION AND EXPECT TO BE BACK IN LONDON LATE ON WEDNESDAY EVENING.

HENDERSON

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HD/ESID

COPIES TO:-

(PERSONAL FOR) PS/NO 10 DOWNING ST. ✓
CHIEF SECRETARY
SIR D WASS
MR W S RYRIE
MR JENKINS
MR MIDDLETON
} H M TREASURY
MR LANKESTER NO 10 DOWNING ST.

SECRET

MR SCHOLAR
PA.

10 DOWNING STREET

24 September 1981

Dear Peter,

Before I go off to Washington I thought I would let you know my opinion about recent monetary events. I discussed these with the Minister of State yesterday and I guess he will mention many of my views to you.

The first problem is, of course, the unusually large increase in the borrowing requirement in September and October. Since this is very much a transitory problem and the borrowing requirement looks fair for the rest of the year, one's first instinct is to simply let it appear in the monetary statistics. I would be against this, however. The main reason is that the markets are likely to be very tentative and hesitant, especially with Wall Street in its present state. Even though we warn the markets that this is a very big and transitory borrowing, I am afraid it will still be taken with a pinch of salt. I think we have to fund quite a lot of it.

I gather that the opinion is that not much could be done through additional Treasury bills, at least not without greatly disturbing the short end of the market. Similarly, unless there is some considerable break in Wall Street, I cannot see any joy in issuing conventional gilts. I doubt very much whether we could get away with less than 16½% or 17%, which would have very serious repercussions. I am on balance therefore in favour of making a first issue of unrestricted indexed gilts.

I should expect these to have a very considerable appeal to the personal sector. The tax advantages, relative to ordinary gilts, would be very considerable. I should not have thought that they would have appealed much to foreign holders. If they can get conventional gilts with a 16% yield, and pay no tax on that yield, then I cannot see how they could find a 1½%-2% yield on indexed gilts at all attractive. But even if they are very attractive to foreign holders, competition among them will so increase the issue price that the rate of return will be very low. I think we can claim then that we are certainly not giving anything away! There are very many more issues on which I think I differ with the analysis presented in your paper, but I do not think that the differences are substantial.

/The second problem

The second problem is the interpretation of the rise in lending by banks to the personal sector. As you know, with the sort of analysis I do, I do not regard the extension of credit as being inflationary per se. It is only inflationary in so far as it generates an additional quantity of money. I suspect that most of the lending to the personal sector is simply bank credit substituting for other forms of credit. I doubt very much whether there is any inflationary pressure at all in such bank credit expansion. The narrow monetary aggregates are still low and do not exhibit any tendency to take off.* Furthermore, the sort of assets which one would expect to be purchased by such credit expansions are not exhibiting any increase in price. On the contrary, it seems as though the house market is if anything on the decline. And the Stock Market certainly has gone down with a bump. Credit was not fuelling either house prices or the Stock Market. Perhaps it has flowed into foreign assets. I am therefore inclined to view any expansion of M_3 which is due to the effects of the expansion of credit to the personal sector as being not of any great concern. If, however, it results in a bigger demand for money proper, and an expansion of the narrow aggregates, then I would think we should be clearly much more concerned.

At the very least we should be careful to interpret movements in M_3 in an appropriate way. I know there is very little data on which this can be confidently done, but I am at present anxious to avoid drawing hasty and, what may turn out to be erroneous, conclusions.

Yours [illegible]

Alan

* Except for M_1 where there [illegible] can [illegible] adjustments strike effect. M_0 remains [illegible].

Peter Middleton, Esq.,
HM Treasury.

CONFIDENTIAL

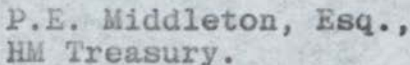
jfh

23 September 1981

Thank you for your letter of 23 September with the papers on derestricting the indexed gilt.

I have discussed these with the Prime Minister, and she is content for the final decision to be taken by the Chancellor in consultation with the Governor.

TPL


P.E. Middleton, Esq.,
HM Treasury.

CONFIDENTIAL jfh

cc to Econ Pol
CAP
Pt 8.

23 September 1981

A BF for meeting on Econ Pol June 79 EMS

We spoke on the telephone earlier today about the possible decision to issue a derestricted indexed gilt.

I have drawn the Prime Minister's attention to some of the wider implications of this decision, on the lines we discussed; but she has decided that, in view of all her other immediate preoccupations, she will leave the final decision on this to the Chancellor and the Governor.

I have also drawn the Prime Minister's attention to the Bank's interest in the C Chancellor's minute of 18 September on EMS, and I am sure she will want the Bank to be represented when she discusses the issue with the Chancellor in due course. This will probably not be before she returns from Cancun towards the end of October.

TPL

C.W. McMahon, Esq.

CONFIDENTIAL

H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-233 3000
Direct Dialling 01-233 5627

P E Middleton
Deputy Secretary

23 September 1981

T Lankester Esq
10 Downing Street
WHITEHALL

Dear Tim,

We spoke about the funding programme following your letter of 21 September to Peter Jenkins. As we agreed I attach the papers on derestricting the indexed gilt.

The issues are summarised in my minute of 11 September. The two key areas of concern are the overseas political problems (paras 17-24 of the main paper) and the tax problems (paras 28-38 of the paper), and you may wish to direct the Prime Minister's attention to these. There are also the general problems associated with any extension of indexation with which the Prime Minister is familiar but which are brought out in Mr Ryrie's minute. These difficulties have to be set against the problems of issuing conventional, long-dated stock at present yields and its implications for the Government's confidence in its own strategy, and the advantages of indexed gilts in terms of the immediate cost to the PSBR. These points were made in my minute of 16 September to the Chancellor.

You will see from that minute that we are very well aware of the urgency of the situation. The Chancellor has taken the papers with him so that he and the Governor can settle the question in Washington if necessary. Meanwhile we have been going over the arguments with the Minister of State and he will have a further meeting with Treasury and Bank officials later this week so that we can make final recommendations on the funding programme. We want to be in a position to take the best opportunity which the market affords to get on with the funding programme, so I hope that the Prime Minister will feel able to leave the decision to the Chancellor. If however there are points which the Prime Minister wishes to discuss further I hope we can try to resolve them before she leaves.

Perhaps I could also deal briefly with the other point in your letter - preparation of the markets for the high CGBR's expected in September and October. You will see from this morning's papers that we have already started doing this - rather successfully I think because we managed to pin the news to some positive action to mop

CONFIDENTIAL

up a possible money market surplus, and get it out in calm market conditions. I think we can continue to get the message over without frightening the markets in advance of a funding operation which everyone can see coming.

Yours ever

Peter

P E MIDDLETON

Encs

Chancellor of the Exchequer

cc Financial Secretary
Minister of State (C)
Sir Douglas Wass
Sir Kenneth Couzens
Mr Ryrie
Mr Burns
Mr Hancock
Mr Monck
Mr Lavelle
Mr Britton
Mr Turnbull
Mrs Lomax
Mr Peretz
Mr H Davies
Miss O'Mara

Mr Fforde)
Mr George) B/Eng
Mr Plenderleith)

Mr Green) IR
Mr Ware)

INDEXED GILTS

1. As you know, we were due to discuss the question of derestricting the indexed gilt, together with some related issues with Mr Lawson.

2. We face severe funding problems particularly in banking October. A new issue of stock of some description is clearly going to be essential. It does not have to be long dated, but we may have to tap this part of the market. Yet following the change in short term interest rates on Monday, yields on conventional longs are currently in excess of 16%.

3. We must therefore be in a position to compare this very high nominal yield - and very high real yield on our price expectations - with the alternatives among which the indexed gilt is a front runner. The attached short piece from this morning's Lex puts the point in a nutshell.

4. The original intention was that the Financial Secretary (Mr Lawson) would sort through the arguements concerning derestriction before letting you have his recommendation, in the hope that we could get a decision in principle before you left at the end of this week. Given the change in interest rates however we can

first attempt to dispose of the stock which is on the Bank's books - which will give us a feel for the conventional end of the market. This should allow time for whichever of the new Ministers you decide should take responsibility for these issues to discuss the question with us and have a submission ready for your return. On this timetable we should still be in time to get subscriptions from an IG in banking October if it was decided to go ahead.

5. However, we cannot be absolutely sure on timing. So, as a precaution, I am sending the papers to you and to the Minister of State (C) - my submission to the Financial Secretary of 11 September, together with a minute from Mr Ryrie. These provide the background to a decision. If you can ready them and keep them by you when you go overseas, we shall be in the best position to take a quick decision if necessary.

P E MIDDLETON
16 September 1981

Encs

FT: Wednesday 16 September 1981.

THE LEX COLUMN

A credibility gap 12 points wide

Yesterday long-dated gilt-edged yields moved above 16 per cent, and despite a late rally this return was still available on a few stocks at the close. A few miles further west, the Treasury was blithely announcing a 4 per cent target for growth in public sector wage costs in the next financial year. The Government's credibility gap can rarely be calculated so precisely.

There is little chance that the gilt-edged market will get the traditional signal, in the form of a slightly cheap issue of high coupon long-dated stock, that the authorities consider yields to be high enough. Expensive funding would hardly square with the Treasury's 4 per cent. On the other hand, another index-linked stock must be a possibility, although a further issue restricted to the pension funds would go down like a lead balloon.

FINANCIAL SECRETARY

cc Sir Douglas Wass
Sir Kenneth Couzens
Mr Burns
Mr Middleton
Mr Hancock
Mr Monck
Mr Lavelle
Mr Britton
Mrs Lomax
Mr Peretz
Mr H Davies
Miss O'Mara

Mr McMahon - B/E

INDEXED GILTS

I am sorry that I shall be out of the office on Wednesday and therefore unable to attend your meeting at which you will be discussing the HF paper which Mr Middleton submitted on Friday. But I should like to make a few comments.

2. I think the paper is excellent on the points which it covers. But there are some wider issues. The proposal to de-restrict obliges us to face again the general questions involved in the issuance of public indexed debt. I do not think Mr Middleton is quite right in saying that the restriction was imposed primarily because we did not wish to risk further immediate upward pressure on the exchange rate. It was also because there were doubts about the principle of general indexed debt, and these were felt to have less force when one was considering debt available to pension funds only.

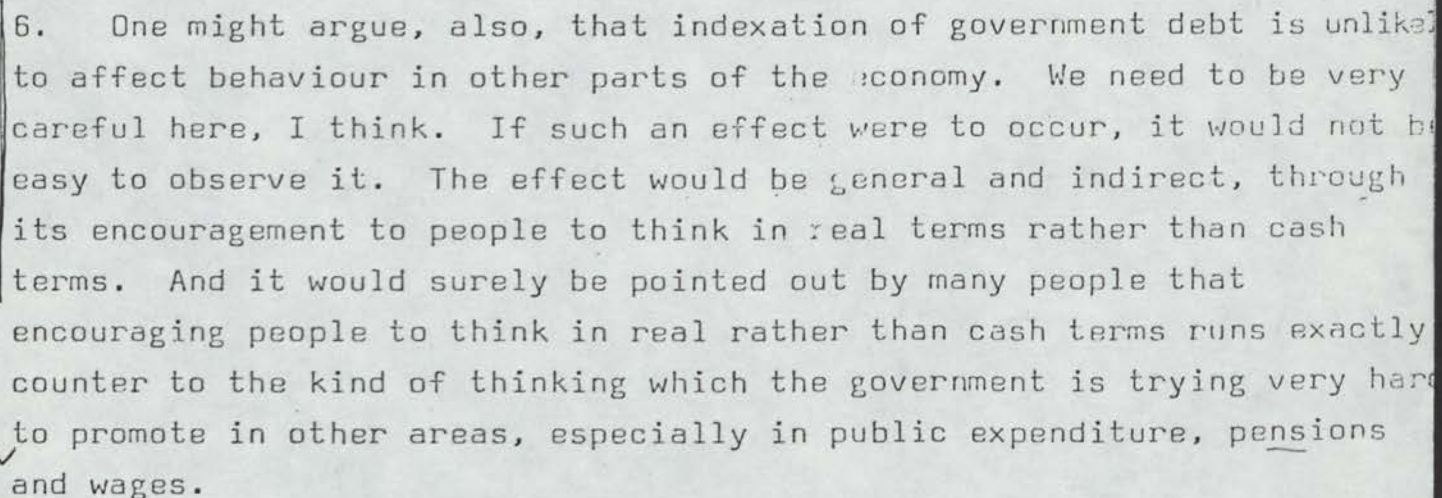
3. Admittedly, at that time, granny bonds were available only to people of granny-like age and one could argue that de-restricting indexed gilts is simply the parallel step to making granny bonds available to everyone. One could also argue that the apparent lack of any adverse effect on the equity market and the lack of serious objections from other borrowers suggests that there is no reason why we should not take the further step.

4. But the wider questions are still there. They are expressed in this paper mainly in terms of the opposition we would be likely to

367/9

encounter from overseas. It is pointed out that most other governments still have rooted objections in principle to the idea. The interesting question is: why is this so and should the objections which are felt abroad apply to us?

5. I suspect that foreign opposition is based mainly on a general and rooted objection to "indexa t ion" to price movements in any form - a generalised fear that this encourages inflation and an inflationary mentality. One might dispute this by arguing that indexation has different effects in different areas. The kind of indexation which does damage is indexation of wages, social security benefits, pensions and government expenditure generally. To reduce inflation, governments must often try to ensure that increases in all these things are less than the current rate of inflation; but it is often right at the same time to have interest rates which are above the rate of inflation. In this sense, there is no necessary parallel between the remuneration of capital and many other expenditures in the economy. But this argument does not, in itself, make the case for indexation - it makes a case for positive interest rates. No one would argue that indexation is the only or best means of achieving that.



6. One might argue, also, that indexation of government debt is unlikely to affect behaviour in other parts of the economy. We need to be very careful here, I think. If such an effect were to occur, it would not be easy to observe it. The effect would be general and indirect, through its encouragement to people to think in real terms rather than cash terms. And it would surely be pointed out by many people that encouraging people to think in real rather than cash terms runs exactly counter to the kind of thinking which the government is trying very hard to promote in other areas, especially in public expenditure, pensions and wages.

7. It is also impossible to escape the question of cost: a question I would prefer to put in terms of the risk the government would be running in terms of future cost of servicing debt. What is at issue, of course is not the determination of the present government to beat inflation, but whether some future government will behave in a highly irresponsible way. The effect of only one year of hyper-inflation would be to make the cost of all indexed debt then outstanding much greater than the cost of conventional debt issued at the same time. And if this were

defended on the grounds that there would be no "real" additional burden that would merely seem to confirm that we were abandoning the psychology of cash which we are otherwise trying to promote.

8. Sir Kenneth Couzens may have comments on what the paper says about the likely reaction of overseas governments. I have always had an uneasy feeling that we might have done well to do a deal with OPEC on oil prices and indexation of their investments. One argument against general indexation now, however, is that we should be giving OPEC what they want (and perhaps obliging other countries to follow us in doing so) without any quid pro quo.

Patricia E. James

pp W S RYRIE

14th September 1981

Financial Secretary

cc Sir Douglas Wass
Sir Kenneth Couzens
Mr Ryrie
Mr Burns
Mr Hancock
Mr Monck
Mr Lavelle
Mr Britton
Mr Turnbull
Mrs Lomax
Mr Peretz
Mr H Davies
Miss O'Mara

Mr Fforde)
Mr George) B/Eng
Mr Plenderleith)

Mr Green) IR
Mr Ware)

INDEXED GILTS AND FOREIGN CURRENCY BONDS

1. I attach a note, prepared in HF with the assistance of other parts of the Treasury, the Bank of England and Inland Revenue. It sets out the factors to be taken into account in arriving at a decision on whether to remove the eligibility restrictions on indexed gilts.

2. Perhaps I could point up the issue as follows:

a. Indexed gilts are intended to improve the effectiveness of our funding programme. The restricted market has proved to be thin. There is a clear presumption on funding grounds that the market needs to be widened if the IG is to fulfil the role which was originally envisaged.

b. Our immediate funding problems are serious; another issue of IGs is an obvious possibility, and could prove to be the best option. But I doubt if we could risk another restricted issue hard on the heels of the last one. Removing the restriction would be a way of giving a once and for all boost to the market.

c. If this line of argument is followed, the obvious course on tax is the simplest - extend the existing CGT exemption on gilts to the IG. This would widen the market to the greatest

extent. It would also help counter suggestions that the only objective of derestriction would be to attract overseas lenders.

d. The restriction was imposed primarily because we did not want to risk further immediate upward pressure on the exchange rate. It was always an open question as to which market the main adjustment would take place in if there was substantial overseas demand - the foreign exchange market or the domestic interest rate market. But we concluded that the immediate effect was likely to be upward pressure on the exchange rate and downward pressure on interest rates. In present circumstances this would be welcome.

e. It is difficult to imagine that there could be particular resource risks for the UK in extending the IG to overseas buyers. The real sterling resource costs are fixed and known in advance. Whether an IG or a conventional or present rates of interest is the better bet depends on the future rate of inflation. If extending eligibility reduces the price - as it should if there is a lot of interest - an IG seems preferable to offering conventional debt at yields in excess of 15%. Of course, there are risks in increasing our net liabilities to foreigners, however we do it; expensive mistakes cannot be recouped through the tax system. An IG is a less risky way of borrowing abroad than a conventional overseas issue (see para 3 below).

f. But the other OF objections (set out in paras 17-24 of the paper) remain - and are reinforced because the imposition of the restriction in the first place means that its removal will direct attention to the overseas implications.

g. The obvious tax course is still not an easy one in any other than a technical sense, as is brought out in paras 28-38 of the note. Extending distortions in this way is contrary to Ministers' general stand on taxation and my own inclinations. But I rather doubt whether there would be much of an outcry if we did it. The equity market has managed to live quite successfully with the present IG and I doubt whether there would

be much company interest in indexed bonds. And - perhaps regrettably - as the existing gilts exemption has become well established, we may manage without much fuss. This of course assumes that there is no change in the existing exemption for gilts, on which you will have seen the paper attached to Mr Green's minute of 4 September.

3. We are also considering another proposal which would tap overseas savings to finance the PSBR. I attach a submission by Miss O'Mara on the case for a foreign currency denominated bond. From most points of view a destricted IG looks a better bet. Unlike a foreign currency bond, the real resources costs are not affected by changes in the real exchange rate. And an IG is likely to be more effective in raising money at acceptable interest rates than a foreign currency bond. A dollar denominated bond would be unattractively expensive at present rates. If it were subscribed in dollars it would only affect the exchange rate and the money supply to the extent that it was coupled with intervention. Subscription in sterling would be possible, and would avoid the need for overt intervention, but it would be a new departure and would involve additional costs. We think it unlikely that a foreign currency bond would do much to mop up residents foreign currency deposits. Destricting the IG has a more obvious justification in terms of the funding programme.

4. Perhaps we could have an early discussion with you on these issues.

P E MIDDLETON
11 September 1981

Enc

INDEXED GILTS : DERESTRICTION

Introduction

We decided in July 1980 that if Indexed Gilts were to be issued they should be available only to gross funds in the UK. Since the decision to go ahead was taken in January of this year we have issued two £1 billion stocks, with eligibility to hold them restricted to pension funds, and to life offices and friendly societies in respect of their UK pension business only. Two factors have caused us to wish to look again at the eligibility restrictions. In the first place, we have conceded a higher real yield on the IGs than was expected. There have certainly been important factors other than the eligibility restrictions at work. Real interest rates are at dramatically high levels in the US and elsewhere. But a number of commentators have argued that we have rigged the market against ourselves in restricting eligibility to the long-term institutions. The second element of the equation which has changed considerably is of course the exchange rate. The effective rate was around 95 last July, and even higher in January when the final decision to issue IGs was taken. It is now around 90. The dollar rate has fallen more sharply, from around 2.35 to about 1.80. In these circumstances we may be less concerned to avoid the risk of encouraging potentially large-scale inflows into sterling, which was cited in the Budget speech as the main motivation for the existing eligibility restrictions.

2. This paper accordingly attempts to assess the likely consequences of derestriction of indexed gilts for this yield and marketability, and re-examines the implications for the exchange rate, relations with our EC and OECD partners, the tax system, and other borrowers.

The Case for Derestriction

3. Although our experience with indexed gilts so far has not been unsatisfactory - they have helped us to maintain momentum in the funding programme at times of great uncertainty in domestic and overseas markets - there is no doubt that the prices, particularly of IGII on issue, have been lower than many had predicted. Real interest rates have clearly risen everywhere, and some of the forecasts of prices well over par, or even of negative real yields, were always unrealsitic, but it is hard to avoid the conclusion that restricting eligibility to hold the stock has cost us something. The investment behaviour of the eligible institutions is heavily influenced by the advice of a relatively small number of actuaries, who tend to look for a 3 per cent real return on their total portfolios, and assume that this or something like it should be explicitly available on IGs. This is not to say that HMG has been the victim of a price-fixing ring; our analysis of the bids received for the two stocks does not lend support to such a conclusion. But it seems likely that persons in the UK

and overseas investors would be willing to hold such stock at a lower real yield. It is also demonstrable that the existing stocks have not been actively traded. The volume of deals has been very small, and the Bank has on occasion intervened to hold quite large quantities of stock. This lack of marketability (although it is perhaps to be expected that many investors would want to hold the stock for long periods) is also an adverse factor as far as the price is concerned.

4. It may be argued, therefore, that the eligibility restructions are seriously hampering the development of the strong and deep market in indexed stocks which is essential if they are to play the major funding role which was envisaged for them. Although we were able to dispose of the whole £1 billion of IGII on the first day of trading there was evidence of considerable reluctance on the part of the institutions to enter the initial auction. When the economic case for indexed gilts was made it was argued that they would be saleable at time of uncertainty about future inflation, and would therefore allow us to fund at times when we are otherwise vulnerable to bearish market sentiment and have difficulty selling conventional stock. We also maintained that the reduction in uncertainty about future real rates of return which is a consequence of the indexation provision would ultimately result in lower interest rates for a given level of gilt sales. But both these potential advantages are put at risk if the market in IGs remains thin. The assurance of debt sales is much reduced, and the lack of marketability will certainly contribute to higher yields than would otherwise be the case. If IGs are to help us meet our monetary objectives with greater accuracy we must try to ensure that market conditions are as favourable as possible.

5. It is difficult to quantify the likely impact of derestriction on the yield. That there will be an improvement in marketability is not in doubt, but the extent to which currently ineligible investors will be prepared to bid up the price is uncertain, and will depend to a large extent on the tax treatment chosen. With CGT exemption it is clear that an unrestricted IG would be attractive to persons, and particularly to higher rate taxpayers. Some indication of the price at which they might find the stock attractive is given by the experience with index-linked National Savings certificates. Over the last few years persons have been prepared to take up quite substantial amounts of second issue certificates which offer a negligible real rate of return (taking account of the bonus). The table at Annex B shows real rates of return on an illustrative 20 year IG, with and without CGT exemption, and on the savings certificates. At present the price paid by gross funds for such a stock might be around £90 to yield 2.65 per cent. At this price the real yield for a 75 per cent taxpayer would be only 1.06 per cent, but this would be considerably higher than the real return available on the certificates. (The timing of any moves to derestrict would need to take into account the possible impact of National Savings). The table also sheds some light on the question of the impact of CGT, though this is not entirely straightforward. Small

investors would be able to take advantage of the £3,000 a year threshold on capital gains: the figures make no allowance for this. Even those investors who would be fully liable to the tax might wish, as a hedge, to lock part of their assets into a negative yield so long as it seemed likely to be not far short of the rate of inflation - but there must be doubts as to whether they would want to do this over a long period.

6. The take up by persons, and indeed non-residents, will also be affected by the maturity of the stocks on offer. It may well be that they will not be keen to buy long-dated stocks, particularly in the light of the likely sensitivity of the market price to variations in real interest rates. And some competition for IGs will also come from the unrestricted second index-linked certificate given its five year maturity and capital certainty.

7. In spite of these uncertainties about the precise nature of the effects of derestriction there can be little doubt that the marketability of the stock will be improved, and the price pushed up. Our experience so far suggests that the costs of the eligibility restriction (there are administrative problems, too, and they are hard to police) are higher than was initially expected. In these circumstances it seems appropriate to re-examine the case for restriction, to decide whether it remains necessary for other reasons to rein back the development of the market for indexed debt.

8. When we looked at this in 1980 our principal concerns were the effect on inflows and on the exchange rate, potential political difficulties with OECD and the EC, and taxation (in allowing only gross funds to buy IGs we side-stepped the difficult question of whether nominal gains made on indexed stock should or should not be subject to CGT) and the effect on other borrowers, particularly in the equity market.

(i) Inflows and the Exchange Rate

9. In 1980 we concluded that the risks of encouraging potentially large inflows into sterling, at a time when the rate was thought to be uncomfortably high, were unacceptable. In fact, simulations on the Treasury model showed relatively low inflows and modest exchange rate effects, but these simulations were based on some fairly arbitrary assumptions. In particular the attitude of non-residents is a major imponderable; given the volume of funds at their disposal and the fact that demand for this new type of paper may not be particularly price-sensitive, there is always the risk that inflows could be much larger than assumed, even if the stock is CGT-exempt, which was the assumed tax treatment.

10. We see no particular reason to adopt different assumptions now, so that our assessment of the practical consequences remains the same. One might argue that high real rates available elsewhere on fixed interest debt make UK IGs look relatively less attractive. But

of course the calculation depends primarily on expectations about future real rates, and the market's assessment of the likelihood that the monetary policy currently dominating the US economy will be sustained. On the other hand one might claim that UK assets are now more attractive since the correction of what was widely perceived as an overshoot in the value of sterling earlier this year. A longer term view would be that there has been no fundamental change in the condition of the UK economy such as to alter market perceptions of sterling assets.

11. It also remains the case that we are the only major country issuing government indexed financial assets - so there is no change in scarcity value. IGs would represent a form of insurance against inflation risk not available elsewhere, and if OPEC investors were to decide to invest only a tiny proportion of their portfolios on IGs, inflows could be much larger. Overseas investors would have no direct protection against exchange risk: real exchange rates do change. Annex A shows that there have been significant swings and secular trends in real exchange rates in recent years. But the chances are still that overseas investors would see attraction in adding at least a modest amount of this new asset to their portfolios.

12. On balance, therefore, we still think a likely outcome of CGT-exempt derestriction would be to attract significant but not massive inflows from overseas. The impact on the exchange rate would probably be modest. At present with attention in the foreign exchange market now focussed more on the dollar, the chances of a larger confidence effect, which worried us last year, are possibly rather less. To the extent to which the exchange rate did rise it would be likely to be against all currencies, not just the dollar. If IGs were issued without CGT exemption, the position might change quite significantly. If CGT were payable IGs would be less attractive to persons in the UK. Since CGT cannot be deducted at source in effect foreigners are not liable. IGs would therefore be most attractive to gross funds in the UK (the existing clientele for restricted IGs and others) and overseas residents. It seems likely that although some higher rate UK taxpayers would still find the stock attractive the proportion of take-up by overseas investors would probably be larger. How much larger it is impossible to say.

13. Although the analysis of the size of the effect on the exchange rate is little changed from the summer of 1980, the weakening in the exchange rate over past months provides a different background to the possibility of inflows. The competitive pressures on industry have abated over the last few months, though in fact the overall cost competitiveness of British industry is about the same as it was in July 1980. This might suggest that we could be more relaxed for the time being about the risk that overseas purchases might give a boost to the rate. However it is not clear that UK industry would take this view. Nor is there any

certainty about the future prospect: if sterling strengthened this could encourage overseas purchasers of past as well as new issues. At the same time there is a danger that restriction would be regarded as having been undertaken for exchange rate reasons, so bringing the whole question of an exchange rate policy back into the political arena.

14. We also need to consider the longer-term risk involved in derestriction. There is the possibility, at least, that the initial overseas take-up of indexed gilts would be very large, and it would certainly build up over time. There may be circumstances in which large indexed liabilities could be unwelcome.

15. It could be argued, for instance, that offering indexed debt to foreigners carries with it a greater risk of resource transfer overseas than do other forms of borrowing. If the UK inflation rate rises, and the exchange rate does not adjust, then the resource costs of indexed borrowing would be high, and the circumstances in which they would be greatest - an unexpected rise in inflation - would probably be those in which we could least afford the balance of payments loss, and in which to reschedule outstanding overseas debt would be most expensive. It is also perhaps worth noting that if the borrowing were very long-term - and of course the major resource transfer could occur at maturity -then it could occur at an unfavourable time as North Sea oil production runs down.

16. But of course there are risks inherent in all kinds of overseas borrowing. Conventional debt held overseas will prove expensive in real terms if the rate of inflation turns out to be lower than expected. The real cost of foreign currency denominated borrowing is affected by unexpected developments in overseas rates of inflation and by changes in the real exchange rate. For example a fall in the real value of sterling (as in 1976) increases the real sterling value of overseas debt repayments at the same time as the economy is hit by an increase in the cost of imports. (This is not the case with indexed debt since the real <u>sterling</u> value of these repayments is fixed by definition). In the case of indexed debt the risk of changes in the real exchange rate is borne by the overseas investor; with conventional foreign currency debt it is borne by the UK government.

17. These resource cost arguments are essentially the same as the economic arguments for indexed gilts generally. Because indexation removes uncertainty about the rate of inflation, overseas investors should in principle be willing to accept a lower average real rate of return on these securities than they are on conventional ones. This risk premium would depend upon how uncertain they were about future inflationary developments in the UK and hence the counter inflation policy stance adopted by the authorities. The larger the initial inflow, the lower the rate of return would tend to be, tending to minimise the risk of large debt repayment transfers overseas. Moreover overseas holdings of these assets should be less

prone to changes in inflationary expectations than other sterling balances. Thus although there are risks, as explained above, we believe that removing uncertainty about the effects of changes in the UK inflation rate should allow the UK to borrow abroad more cheaply than otherwise, even if inflation turns out as expected by the market.

(ii) International Implications

18. In OF's view the announcement by HMG of a decision to permit non-residents to buy indexed gilts would be likely to arouse considerable interest, concern and criticism overseas. There are three main reasons for this:-

(i) The long history of international discussion about indexing the financial assets of the OPEC surplus states.

(ii) The difficulties experienced by a number of industrial countries, including Germany as well as smaller Community countries, in financing their current account deficits following the second oil price shock.

(iii) The damaging effect of indexation arrangements on the economies of some industrial countries, notably Italy and Belgium within the European Community.

19. OPEC interest in indexation was a constant feature of the years 1976-78 when, following the first massive oil price increase of 1973-74, the real oil price fell again. During this time the dollar was weak and real interest rates paid on OPEC financial investments were for the most part negative. The surplus OPEC countries protested at the erosion of the value of their investments and threatened to keep their oil - which they described as their 'sole national asset' - in the ground rather than exchange it for depreciating assets. Their campaign for the indexation of financial assets played a large part in the Conference on International Economic Cooperation in Paris in 1976-77. Even at that time, however, there was reason to believe that the surplus OPEC countries, and particularly perhaps Saudi Arabia, were mainly concerned to establish and to pursue a grievance for political, rather than for expressly economic or financial, ends. Since that time, less has been heard of this proposal, no doubt for three main reasons: the new surge in the real oil price in 1979-80; the emergence of a strong dollar; and the increase in interest rates earned on dollar, yen and deutschemark investments which are now significantly positive in real terms.

20. As a result of the OPEC campaign, it was argued from time to time in discussion among industrial countries that it might be in our interest to grant indexation to OPEC countries in order to provide them with an incentive to produce oil, and not to keep it in the ground. It has also been suggested - most recently by Mr Heath in a memorandum on the "North/South Summit" at Cancun - that such an arrangement could take the form of a formal 'bargain' between consumers and producers of oil.

21. The United Kingdom has been at one with the industrial partners in resisting any agreement to index OPEC assets. There are good reasons for this - in particular, the potential cost; the removal of a constraint upon the price-fixing policy of the producers (whose assets would be insulated from its effects); and the precedent, not only for producers of other commodities, but also for the use of indexation more generally within the economies of the industrialised countries. Like others, we have never believed that it would be possible to strike a 'bargain' by which OPEC would commit themselves to produce specific quantities of oil; or that it would be worth paying for such a commitment because in practice OPEC could not be held to it.

22. Against this background the OECD countries might well criticise the UK for weakening the agreed line on indexation if we permitted non-residents to buy indexed gilts. It is true that the indexed gilt would be denominated in sterling and would not completely protect the creditor from exchange risks. It is also true that the issue of indexed securities denominated in sterling to all potential buyers without discrimination is different from an undertaking to index OPEC's financial assets. The purpose of the indexed gilt would be to fund the UK's domestic public expenditure, and still more different from an indexation scheme arrived at as part of a bargain on oil prices. Nevertheless it would be argued that the principle of providing protection had been conceded, at least in some degree, despite the agreed objections.

23. Criticism in OECD fora might have no direct consequences. But this disquiet would spill over into the strong criticism which we would be likely to encounter among the partner countries in the European Community where much more would be at stake. Many Community countries are having to count on inflows, or to borrow, in order to finance their current account deficits. The United Kingdom is not in this position. We are unique among the major industrial countries in having sufficient domestically produced oil to meet our needs. We have been running a very big current account surplus and, so far as we know without trade figures, the current account is still in surplus. If the indexed gilt proved attractive to OPEC investors, it is likely that the funds would have been drawn into sterling in preference to the mark, the franc and other Community currencies. Moreover it is not only the smaller Community countries who are now relying on overseas market borrowing. France and even Germany are at present anxious to borrow overseas. The Danes are particularly heavily dependent on borrowing. They, the Irish and perhaps even the French, might wish to come to the sterling market (see paragraphs 41 and 42 below). They might well find that they had to offer an indexed asset if they were to make any headway against the indexed gilt.

24. This would be a matter of great concern within the Community. It is not only that the Germans have extremely strong views about the unwisdom of indexation. The effect of

indexation procedures on economic management is currently a lively issue in the Community. The Commission is running a campaign within the Community designed to encourage the Italian and Belgian Governments to remove or at least adjust the indexation arrangements for wage determination in their countries. It certainly would not be regarded as helpful if the UK took action running counter to this campaign. (Though the Wass report on indexation last year argued that the indexation of Government securities is a quite separate issue from the indexation of earnings and other costs).

25. The issues touch all the Community partner countries in one way or another, and in a greater or lesser degree. The bad feeling would provide an unhelpful and damaging background to the forthcoming negotiations with the partner countries about the UK's contribution to the Community Budget, where very large sums are at stake. The difference between a good and bad settlement could be over £500 millions. The UK faces an uphill struggle in any case. The indexation question could only intensify the difficulties.

(iii) Tax Implications

26. When we examined the possibility of issuing unrestricted indexed gilts last year the tax implications were reviewed but no conclusions were reached. In the event it was not necessary to decide on the CGT treatment since we concluded for other reason that it would be preferable to issue IGs restricted to gross funds in the UK. The current position in regard to existing IGs is that the stock is not described, as are other gilts, as a Government Stock to which the usual CGT exemption applies. In theory, therefore, if a holder of the stock were to become liable for tax, both CGT and Income Tax would be payable.

27. The problem identified last year concerned the treatment of the IG for CGT purposes. There are two possibilities. We could apply the same regime as for other gilts. There would be no liability provided the stock was held for more than 12 months. To do this we would need to revise future and amend existing prospectuses to specify the stock under paragraph 1 of Schedule 2 of the Capital Gains Tax Act 1979 as a gilt edged security. Alternatively, by doing nothing we could deny CGT exemption.

28. The decision we reach on IGs is of course related to work on the future of the existing CGT exemption for conventional gilts. An Inland Revenue paper on Stamp Duty and CGT on all gilts is in preparation in parallel with this note and will be considered alongside it. That paper sets out the arguments for and against the existing exemption. If it were decided that the exemption should be removed, then it would be inconsistent to exempt IGs. But if not, the IG decision is freestanding.

(a) Granting CGT Exemption

29. If the existing treatment of gilts is not changed then we could defend granting exemption on the basis that it followed the usual practice for gilts. But we would be open to

criticism. It would be argued that CGT does in general apply to nominal gains on other securities, even though they may reflect no more than movement in the price index. The existing CGT exemption was first introduced in 1969 to facilitate switching between stocks, so as to help maintain an active secondary market and thereby enhance liquidity. It does affect the price of gilts to an extent. The Wilson Committee Report estimated the redemption yield advantage of gilts over local authority bonds deriving from this exemption at ¼ per cent. (It is difficult to produce hard evidence for this or any other figure but there is undoubtedly some yield advantage.) We have of course also taken advantage of the exemption in issuing low coupon stocks. Other borrowers are unable to do this. But for the most part we issue stocks with coupons fairly close to the expected yield, and over the life of a stock the net gains are limited to the discount, if any, from the redemption price at which the security is offered. This bears no simple relation to the going inflation rate.

30. In the case of an IG the expected capital gains over the life of the stock amount to the expected inflation rate - plus the size of the discount on issue (in the present case unfortunately quite large). The arguments against the tax concession would be considerably stronger. We could expect complaints from other borrowers unless they were treated in the same way.

31. The Inland Revenue argue that to grant exemption would add a new factor to the debate on indexation for CGT; and would make it harder to hold the line elsewhere.

(b) Refusing Exemption

32. The other possibility is to leave the prospectuses as they are, extend eligibility, but make no special provision for CGT exemption. It can be argued that the indexation provision makes the stock quite different from other gilts. CGT is charged on other nominal gains and it would be unreasonable to exempt IGs from this general charge. It can be maintained, too, that the high coupon interest payments on conventionals represent, in part, early capital repayment, and are taxed as income. The treatment of indexed gilts and conventionals would therefore be more 'equal' if the capital uplift were taxed.

33. But there are two difficulties. In the first place the Government would be overtly imposing CGT on a gain that, by definition, was a paper rather than a real one. Over the whole life of the stock there is no possibility of real capital gains or losses, beyond the extent of any discount on issue. Also, if we did not grant exemption it is likely that demand from UK taxpayers would be very low. There would be additional demand from overseas investors who do not pay CGT, but the price of the stock maintained by the demand from non taxpayers (overseas and the existing eligible institutions) might be such as to make it entirely unattractive to investors paying CGT. The wider market in the stock which it is our

objective to generate might well not be forthcoming, and there could be complaints from UK residents about the way the terms of the stock had apparently been set so as to exclude them, though our assessment is that some high taxpayers would still find them attractive

34. In 1980 the Inland Revenue concluded that on balance they saw CGT exemption, by analogy with existing conventional gilts, as the easier of the two alternatives (though ideally they would prefer no exemptions at all). It also seems likely to maximise the market appeal of the stock, and would stimulate the wider secondary market which we see as important. But it is also the solution which would provide the greater opposition from other borrowers, who would see it as a further example of the Government giving itself an unfair advantage in the market. Corporate sector borrowers contemplating the issue of indexed debt would be particularly aggrieved (see below).

(c) Stamp Duty

35. The stock is also not yet specifically exempt from stamp duty, again because only non-taxpayers are eligible to hold it. The existing stamp duty exemption goes wider than that for CGT. It extends to local authority stock, Treasury guaranteed stock, corporate fixed interest stock and - a new extension in the current Finance Bill - index-linked corporate stock. This latest exemption for index-linked stock in the private sector really leaves no option, unless the Government is to discriminate against its own stock, but to allow the exemption from stamp duty for all Government stocks to run for IGs. This would be the position if no legislative steps were taken to prevent the exemption from running. Of course, if the whole of the stamp duty exemption in this area - gilts and the rest, including the latest index-linked exemption - were to go (a possibility which the Inland Revenue paper discusses) then IGs would clearly be subject to transfer duty at whatever rate was applied to gilts generally.

(d) The Tax Treatment of Other Indexed Borrowing

36. In late 1980 we were told that a number of companies were looking seriously at the prospect of issuing index-linked debt. We and the Bank concluded that we saw no objection. But there were two obstacles in the way, which it seemed sensible to remove. In the first place if indexed borrowing took a form in which the principal was indexed, the premium or "uplift" payable at the end of the loan would not be deductible. Secondly, stamp duty would be payable on transfers. We considered with the Inland Revenue whether the uplift could be made deductible for corporation tax but (quite apart from the objection in principle of deducting what is clearly a capital payment) the consequence would be that it would then have to be treated as income in the lender's hands. Exempt funds would be indifferent to the tax treatment of the return on an indexed bond but other lenders would not. An individual

receiving a lump sum counted as income could be pushed up by it into a high marginal rate of tax. Moreover the company might not have sufficient taxable profits to use the relief.

37. In fact in spite of the precedent set by central government there has recently been a marked slackening of interest in such borrowing and we are not currently aware of any companies ready or preparing to come to market. But we promoted a clause in the Finance Act 1981 to extend stamp duty exemption to index-linked corporate stock. And the Inland Revenue have drawn attention to the possibility of devising forms of indexed borrowing which preserve deductibility. It may be possible, for example, for companies to determine a rate of interest at a level which reflects compensation for inflation, but deferring payment of some or all of their interest until redemption (the Rothschild scheme). Particularly in view of the absence of active interest from companies in indexed debt issue the current position is broadly satisfactory, but there could be complaints about anomalous treatment if the Government brought forward a tax-exempt IG.

(iv) The effects on Other Borrowers

(a) The equity market

38. To some extent the reaction of other borrowers to a government decision to issue unrestricted IGs would depend on decisions on the taxation aspects set out above. But it was thought last year that there was a significant danger of adverse implications for the equity market if the government issued indexed gilts on a large scale. It was argued that the closest substitute for such debt was company equity and that significant switching by the institutions might be induced, with an adverse effect on equity prices. Since then, and particularly in the last few months, the equity market has been remarkably buoyant. No adverse reaction was identified after the issue of the first two restricted IGs.

39. It might be argued that unrestricted IGs posed a more serious threat to the equity market, in attracting a wider range of lenders into indexed debt. But it is the quantity of IGs on issue, rather than their eligibility characteristics, which will principally affect other borrowers. Although removing the eligibility restrictions might allow us to expand our IG issues the decision to derestrict does not in itself carry any implications for the equity market. In fact, if derestriction attracted inflows from overseas such as to depress the yield on IGs, then it might be thought to help the equity market. But in general the arguments remain as for restricted IGs. When the effect on other borrowers was considered last year we considered on balance that the overall impact would not be adverse. There might be some switching out of equities, but in the long run other borrowers would benefit from the reduction in interest rates in the whole economy which we saw as one of the potential gains from use of IGs.

(b) Local Authorities

40. Although we have seen no firm proposals, there are indications that some lc[illegible] authorities may be interested in issuing index-linked debt. If indexed gilts remain available only in restricted form then it is relatively easy to prevent Local Authorities from doing so, if we wish. Although Control of Borrowing Orders could still be used derestriction would make it difficult to prevent LAs from issuing indexed obligations of their own.

(c) Indexed Bulldogs

41. After the first IG issue the Bank was approached by a number of banks and brokers asking about the authorities' attitude to indexed bulldog bonds. Ireland was mentioned as a possible issuer. We agreed with the Bank that our attitude should be discouraging. We thought we should wait and see how the market in IGs developed, and saw possible dangers in the issue of indexed bulldogs in competition with our own debt. There was also the question of whether bulldogs should carry the same eligibility restrictions and, if they did not, the pressure that this would put on us to lift our own restrictions. There was also the risk of international criticism for allowing foreign borrowers to use our capital markets to issue indexed debt. Indexed bulldogs, if allowed unrestricted distribution, were seen either as depressing the exchange rate less than an ordinary bulldog or, if the proceeds were not converted out of sterling by the borrower, as putting direct upward pressure on the rate.

42. If our own IGs were derestricted these arguments would lose much of their force. The increased supply of funds available for investment in indexed debt would reduce the possibility (probably not very great in any case) that indexed bulldogs would damage IGs. If a flood of such issues should threaten we have the power the control it through the exercise of timing consent. (In practice we are not aware of any recent interest in this type of paper). As for international criticism, and the potential exchange rate effect, the significance of indexed bulldogs would probably be swamped by the general imapct of derestriction itself. It is perhaps unlikely, therefore, that we would wish to resist issues of indexed bulldogs. But we should recognise that derestriction of our own IG would make it more difficult to do so, if it were thought desirable.

(v) Partial Derestriction

43. We have briefly considered the possibility of partial derestriction, in other words issuing both restricted and derestricted stock from time to time. The prospectuses of the two existing IGs provide for restrospective changes in the eligibility restrictions, and we have tended to assume that the issue of an unrestricted stock would be accompanied by the derestriction of those already in the market. But we would not have to do this, and to do so would be to grant existing holders a potentially sizeable capital gain. But the Bank see

considerable difficulties in the way of running a restricted and an unrestricted market in IGs side-by-side. It would be confusing for investors and would cause administrative problems . the Registrar's Department. More importantly, to run two markets side by side would be inconsistent with the overall objective of improving the marketability of the IG so as to push up the price.

Conclusion

44. The above discussion implies that the main obstacles to derestriction are the possible impact on our relations with OECD and EC countries, and the effects on the tax system. The exchange rate case seems now to be of lesser importance, and the resource cost arguments do not point unequivocally one way or the other. If the Government issued very large quantities of indexed debt there could be adverse effects on other borrowers; but this depends on the quantity of debt issued, rather than on its eligibility characteristics.

ANNEX A

MOVEMENTS IN REAL EXCHANGE RATES

IGs will only offer inflation protection to foreigners to the extent that nominal exchange rates adjust to take account of differential inflation rates. In recent years nominal rates have not responded in any very accurate way to inflation differentials and there have been significant swings and similar trends in real exchange rates. This is illustrated in the following table, which compares for a number of currencies the average rates of change per annum of their effective exchange rates, and real effective exchange rates as represented by relative nomalised unit labour costs in the economy concerned, between 1973 and 1980. It is apparent from this that the changes in real exchange rates over this period, far from being negligible, were in five of the eight currencies larger than the nominal changes:

% per annum	Effective Exchange Rate	Real Effective Exchange Rate
Japan	+1.6	-3.6
Canada	-2.8	-2.6
US	-0.8	-1.4
Netherlands	+4.1	-1.1
Germany	+5.0	+0.5
France	0.0	+0.9
Norway	+1.2	+1.6
UK	-2.5	+6.2

ANNEX B

INDEXED GILTS: REAL RATES OF RETURN*

% per annum

Income tax %	No CGT	CGT at 30%; inflation averaging: 8%	9%	10%	11%	12%
1. Price of £100						
0	2.00	0.92	0.87	0.82	0.78	0.75
30	1.40	0.25	0.19	0.14	0.10	0.06
45	1.10	-0.09	-0.15	-0.20	-0.24	-0.28
60	0.80	-0.43	-0.49	-0.54	-0,59	-0.62
75	0.50	-0.77	-0.83	-0.89	-0.93	-0.97
2. Price of £95						
0	2.31	1.22	1.17	1.12	1.09	1.06
30	1.70	0.53	0.47	0.42	0.38	0.35
45	1.39	0.18	0.12	0.07	0.03	0.00
60	1.08	-0.17	-0.23	-0.28	-0.32	-0.36
75	0.77	-0.52	-0.58	-0.63	-0.68	-0.71
3. Price of £90						
0	2.65	1.54	1.49	1.45	1.42	1.39
30	2.02	0.83	0.77	0.73	0.69	0.66
45	1.70	0.47	0.41	0.36	0.33	0.29
60	1.38	0.11	0.05	0.00	-0.04	-0.07
75	1.06	-0.25	-0.31	-0.36	-0.41	-0.44

*The figures show illustrative real yields to redemption at various prices on a 20-year stock with a 2 per cent coupon. For simplicity it is assumed that interest is paid annually.

NB Real return on 2nd Index-linked Certificate % per annum

	8%	9%	10%	11%	12%
	0.54	0.51	0.49	0.47	0.45

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cc Mr. Duguid

Econ Pol 1

Prime Minister

I think it would be useful if I sent the Treasury a letter based on this, and in particular making the point about funding at X below. Agree?

TL 18/9

Yes please. I hope the relevant press briefing will be clear

MR. LANKESTER

MONETARY AND FUNDING CONDITIONS

Although the public sector borrowing requirement seems so far to be even below the target and likely to be either on target or under-shoot by the end of the year, there are great difficulties with the time profile. In particular, it looks as though October will be a very difficult month indeed, following an awkward September. However, for the rest of the financial year there is likely to be little or no requirement for public sector borrowing. Although there remains the possibility of over-funding to offset private borrowing.

The main difficulties in September and October arise because of the Civil Service strike. In particular in October there is likely to be a net requirement of nearly £2 billion in order to pay off VAT refunds. These payments are being made before calling in the overdue VAT receipts. A second difficulty arises because borrowing by the private sector has been considerably augmented by the banks switching into the personal loan and particularly into mortgage loan business. To some extent this is simply the switch from other institutions, such as building societies, but some of it is undoubtedly a net increase.

The increase in demand for loans from the public sector and private sector comes at a particularly difficult time. All eyes are focused on the United States and the likelihood of rates of interest, particularly on long bonds, declining. Even though long term interest rates in the UK market are as high as 16%, there has been no funding going on for some time. The situation is, however, quite brittle. It may change dramatically if suddenly there is convincing evidence by the Reagan administration that they intend to bring down the budget deficit.

Whatever happens, however, we have a very difficult corner in October.

The actions that might be taken to ease our way round this corner are:

/To make it clear to

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1. To make it clear to the markets that there are very unusual but transitory items, such as the £2 billion VAT repayments, which will be offset by in-flows later. If we can tell a convincing story about these movements, then it is likely the markets will not read the blip in the borrowing requirements as a permanent shift.

2. It may well be necessary to prepare the markets for an unduly large M_3 figure. This can again largely be attributed to strike effects.

3. It is important to get funding moving again. There are a number of ways this might be done. Probably best is to bring forward the plans for a non-restricted indexed gilt. This would have the effect of soaking up a lot of the liquidity, and hopefully bank balances etc, from the personal sector. It might also ease the present stickiness in the long term conventional gilt market. But, realistically, the best hope for the conventional gilt market lies in a break in the United States conditions.

It seems to me very doubtful whether anything more should be done to discourage private sector lending. The 2% rise in short term rates and probably in base rates will give rise to some restraint later on in the year. This is not going to help for the period when the difficulties are greatest, namely, October. And in any case there is no sign of any take-off in house prices, they remain fairly stagnant. The construction industry is still very much in the doldrums.

All the evidence is consistent with the fact that our basic monetary conditions are healthy. I am concerned that appearances in banking September and October, may be deceptive. We should do as much as we can to allay the fears that might be generated in the markets.

17 September 1981 ALAN WALTERS

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Cabinet / Cabinet Committee Document

The following document, which was enclosed on this file, has been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES.

Reference: CC(81) 31st Conclusions, Minute 3

Date: 15 September 1981

Signed OWayland Date 14 August 2012

PREM Records Team

cc Master

SECRET

Copy filed on Econ Pol May 49 Exchange Rate

4

cc Mr Walters

10 DOWNING STREET

From the Private Secretary

14 September 1981

Dear John.

As you know, the Chancellor and the Governor called on the Prime Minister late this morning to discuss interest rates and the exchange rate. They were accompanied by Sir Kenneth Couzens.

The Chancellor said that towards the end of the previous week he had become increasingly concerned about the fall in the exchange rate. It had continued to fall this morning; and at noon the effective rate was 86.6, which was below its level at the time of the General Election, and the DM rate was just over 4.21. These rates compared with 98.6 and 4.66 respectively on Budget Day. He and the Governor now believed it would be appropriate to raise the undisclosed interest rate band - probably by 1½% - with a view to bringing about a 2% rise in base rates. This was partly with a view to arresting the fall in the exchange rate; but it was also justified to some extent by the domestic monetary situation. The latest money supply figures and their medium prospects, and in particular the strength of bank lending to the personal sector, were a cause for concern.

The Governor explained that sterling had been weakening for several months, but the fall against the DM had accelerated over the last few days. One reason for the decline was the widening of the interest rate differential between sterling and the dollar; another was the weakening of oil prices, which particularly favoured the DM. He supported the Chancellor's view that, on both exchange rate and domestic monetary grounds, a 2% rise in base rates was required.

The Prime Minister said that, if interest rates were to be raised at all, the increase should be sufficient to achieve a steadying of the exchange rate. She therefore agreed with the proposal that the undisclosed band should be raised so as to bring about an increase in base rates of 2%; anything less would be likely to be insufficient. The Prime Minister went on to say that recent developments on the exchange rate front raised the question once again of whether the UK should join the EMS. She hoped that the Chancellor would reconsider the options. The Chancellor said that he was already looking at this question, and he hoped to be in a position to advise the Prime Minister further before he went away later in the week.

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

Yours ever,

Tim Lankester

John Kerr, Esq.,
H.M. Treasury.

SECRET

SECRET AND PERSONAL UNTIL 14.30 ON 8 SEPTEMBER
RESTRICTED THEREAFTER

cc Chief Secretary
Financial Secretary
Sir D Wass
Mr Ryrie
Mr Burns
Mr Middleton
Mr Kemp
Mr Monck
Mr Turnbull
Mrs Lomax
Mr Riley
Mr Britton
Mr H Davies
Miss Roach
Mr Crook
Mr Harrison
Mr Guy
Mr Lankester - No.10

MR PICKFORD

AUGUST MONEY SUPPLY: PROVISIONAL ESTIMATE

The Chancellor has seen your minute of 4 September on which Mr Britton minuted:-

> "The bank lending figure is worrying. There is no indication of a reversal in the first week of the new month, such as might have occured if round-tripping had taken place on a large scale".

2. The Chancellor agrees that the bank lending figure is indeed worrying. He has noted that personal lending continues to grow rapidly, and that about one half of such lending in banking August was for house purchase.

J O KERR
7 September 1981

JT

Prime Minister

SECRET AND PERSONAL UNTIL 14.30 ON 8 SEPTEMBER

Note at the end.

D.J.T. Colleague 4/9/81.

1. MR BRITTON
2. CHANCELLOR

cc Chief Secretary
Financial Secretary
Sir D Wass
Mr Ryrie
Mr Burns
Mr Middleton o/r
Mr Kemp o/r
Mr Monck o/r
Mr Turnbull o/r
Mrs Lomax
Mr Riley
Mr H Davies o/r
Miss Roach
Mr Crook
Mr Harrison
Mr Guy

Mr Lankester No. 10

MT

AUGUST MONEY SUPPLY: PROVISIONAL ESTIMATE

I attach the provisional money supply figures for banking August and the Bank's analysis together with the statistics on eligible liabilities, reserve assets, reserve ratios and special deposits.

2. The growth of £M3 will be announced as about 1 per cent. The provisional estimate of 1.1 per cent shown in the figures is higher than the first guess reported earlier this week (0.7 per cent). The principal changes since then have been in lower bank lending to the private sector (now +1467 rather than +1650), more than offset by a less negative contribution from external factors and non-deposit liabilities (now -223 as against -740). Recorded £M3 growth over the first six months of the current target period is now 16.9 per cent at an annual rate. The Bank's commentary points out that, although estimates of underlying growth are subject to a wide margin of error, it is less certain this month that money supply growth excluding strike effects still remains within the target range. Although we have not yet seen the Bank's draft Press announcement, we understand that the Bank intend to be non-committal on this question.

3. Although overall growth in £M3 is fairly close to the forecast level there are substantial differences in the counterparts. You are already aware that the CGBR improved much more quickly than was originally anticipated, both because the backlog of unprocessed checks was cleared more rapidly and because tax payers have been paying their tax liabilities more readily than expected. Although this CGBR improvement was expected to add to private sector bank lending, the growth in lending is still greater than anticipated. This may have been caused partly by round-tripping (hard arbitrage) over make-up day, although the Bank have not been able to detect this happening to a significant extent. Lending to persons continues to grow at a fast rate, accounting for about £400 million of the total; about one-half of personal lending was for house purchase.

4. External factors were much less contractionary than forecast because the overhang of demand for sterling by oil companies in respect of their PRT/SPD payments due on 1 September was less than expected. Oil companies appear to have met a much higher proportion of their tax bills through surrender of CTDs than is usual; this will tend to put upward pressure on money supply growth in banking September.

5. M1 fell sharply in banking August, by 2.4 per cent. The Bank attribute this fall partly to unwinding of strike effects and partly to reversal of the unexpectedly large rise last month. PSL1 and 2 grew by 1.3 per cent and 1.0 per cent respectively, but the monetary base only rose by 0.3 per cent.

Stephen Pickford

S J PICKFORD
4 September 1981

The bank lending figure is worrying. There is no indication of a reversal in the first week of the new month, such as might have occurred if round-tripping had ~~been~~ taken place on a large scale

AJWB

SECRET

PROVISIONAL MONETARY AGGREGATES FOR AUGUST

£ millions, seasonally adjusted

As usual at this stage all figures are subject to revision, particularly those affected by overseas holdings of gilts and others shown in brackets in the attached table.

1 Sterling M3 is provisionally estimated to have risen by 830 (1.1%) in banking August. Although this is in line with the forecast, the pattern of counterparts is very different (see table); the ending of the civil servants' dispute is the most important reason for this. The cumulative growth in the first six months of the current target period is 16.9% pa, and whilst there is a large distortion due to the civil servants' dispute still affecting the figures (the remaining distortion to the CGBR is about £4½ billion) it is more difficult this month to claim that the underlying growth is likely to have been below 10%, the top of the target range. For this to be true, and assuming no other distortions, at least 48% of the remaining CGBR distortion must be assumed to have inflated deposits (compared with 37% last month). But the rise this month may have been artificially inflated by arbitrage - see para 5 below. (It is always exceedingly difficult to quantify round tripping but, by way of example, if this were assumed to account for 350 of the August rise, and if only one-third of the outstanding strike effect is assumed to have inflated deposits, then the underlying growth of £M3 would be about 11%.)

2 M1 fell sharply, by 780 (2.4%). This almost certainly reflected some unwinding of strike distortions (M1 showed a large rise of nearly 5% in April, the first month seriously affected by the strike) but may also have included a reversal of erratic factors which contributed to the large (3.2%) rise in M1 last month. (NB if a large part of the M1 fall is attributed to the strike then explanation of the large rise in bank lending is that much more difficult since the total unwinding of the strike on the CGBR is estimated to be only some 775). PSL 1 and 2 grew by 1.3% and 1.0% and, at an annual rate, have grown by 16.5% and 15.0% respectively over the last six months. The wide monetary base rose by 0.3% in the month but its annual rate of growth since February remains low (2.0%).

3 UK residents' deposits in foreign currency increased by 480 of which 200 represented transactions and 280 valuation changes. M3 therefore rose by 1,310 (1.6%) and its annual rate over the last six months is 25.1%.

4 Turning to the counterparts, virtually all of the difference between the CGBR of 270 and its forecast reflected the ending of the strike. On-lending was low, much as expected, and the direct contribution of the other public sector was 240; altogether the LAs and PCs were some 150 less expansionary than expected. Purchases of central government debt by the non-bank private sector were again substantial at 930. Gilts accounted for 810, considerably more than forecast, helped by sales by banks and overseas. National Savings contributed 200 but there were net surrenders of 150 CTDs.

5 Lending in sterling to the private sector increased very sharply, by 1,470. In addition there was a rise of 100 in bills held outside the banking system, and lending in foreign currencies to the private sector rose by 440 - neither of these are included in the counterparts. Advances by the LCB accounted for 1,580 of the 1,470. There was a small fall in advances by other banks, a fall of 200 in market loans, and a fall of 1,160 in bills held by the banking sector largely offset by the rise of 910 in Issue Department holdings. With market rates, particularly one month and longer rates, persistently

above 13% during the month there appears to have been scope for arbitrage although the expectations that base rates were likely to rise may have discouraged longer-term round tripping. The structure of lending within the system certainly points to soft arbitrage. Evidence of hard arbitrage however is harder to find. The rise in advances by the clearers was well spread between industrial categories and the larger rises were mainly to categories where there had earlier been falls attributed to the strike. Categories that have in the past been suspected of round tripping (food, drink and tobacco and large retail chains) showed rises totalling some 200 where a small seasonal fall might have been expected. Lending to persons, which is unlikely to have included arbitrage or been affected by the strike, accounted for 400 of the (unadjusted) total. There seems little evidence in the figures of bill arbitrage such as occurred last March - total acceptances outstanding fell by 230 in the month.

6 External factors in total were modestly contractionary (-130). Within this total there was a very large rise in overseas sterling deposits of 660 but the banks switched out of sterling by 420. The main reason why external factors were much less contractionary than forecast appears to have been that the overhang of demand for sterling by oil companies to pay PRT/SPD was much less at the end of the month than had been expected.

SECRET

£ millions
seasonally adjusted

PROVISIONAL DCE, STERLING M3 ETC IN BANKING AUGUST 1981

	Preliminary*		Forecast**	
CGBR: own account	+ 290		+1,494	
on-lending to LAs	- 63		- 26	
on-lending to PCs	+ 46	+ 273	+ 87	+1,555
Net purchases of CG debt by non-bank private sector: (inc -)				
Gilts	- 809		- 415	
Treasury bills	- 70		- 75	
National Savings	- 199		- 270	
TSB claim on FBS	-		-	
Certificates of tax deposit etc	+ 145	- 933	+ 200	- 560
Other public sector: Local Authorities	+ 364		+ 100	
Public Corporations	- 120	+ 244	+ 215	+ 315
Sterling lending to the private sector:				
Bank lending to private sector	+ 557		+ 330	
Issue Department commercial bills	+ 910	+1,467		+ 330
Sterling lending to the overseas sector:				
Bank lending to overseas sector	+ 147	+ 147	+ 250	+ 250
External and foreign currency finance:				
Increase in reserves (inc +)	- 270		- 294	
Official borrowing (inc -)	+ 183		+ 194	
Overseas purchases (-) of: gilts	(+ 36)		)- 80	
treasury bills	(+ 49)		)- 10	
LA debt	(- 9)		) -	
Overseas sterling deposits (inc -)	- 658		- 220	
Banks' net currency deposits (inc -)	+ 422		- 350	
Seasonal adjustment	- 25	- 272	- 25	- 785
Non-deposit liabilities (inc -)		- 98		- 150
Sterling M3		+ 828		+ 955
		+ 1.18		+ 1.38
DCE		+1,198		+1,890

* Figures in brackets are more uncertain than other figures.
** As circulated in the Monetary Review of 13 August 1981.

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Secret 6: Subject to confirmation and therefore not for publication

Banking statistics

Eligible liabilities, reserve assets, reserve ratios and special deposits

(Quarterly Bulletin Table 4)

1 Banks

£ millions	Total	*of which interest-bearing*	British banks					Overseas banks			Consortium banks (a)
			London clearing banks	Scottish clearing banks	Northern Ireland banks	Accepting houses (a)	Other (a)	American	Japanese	Other (a)	
Eligible liabilities											
1980 Aug. 20	63,137	*45,987*	34,048	3,847	1,141	2,784	9,384	6,316	528	4,605	487
Nov. 19	66,014	*48,585*	33,533	4,015	1,164	3,272	10,166	7,013	763	5,542	546
Dec. 10	67,473	*49,482*	34,200	4,167	1,183	3,277	10,342	7,223	806	5,686	588
1981 Jan. 21	68,055	*50,475*	35,393	4,159	1,123	3,079	10,185	7,082	797	5,620	612
Feb. 18	68,318	*50,699*	35,036	4,169	1,107	3,147	10,280	7,363	765	5,765	685
Mar. 18	67,923	*50,447*	34,716	4,127	1,102	3,357	10,292	7,100	830	5,688	711
Apr. 15	70,012	*51,199*	34,795	4,083	1,078	3,514	11,299	7,526	934	6,026	757
May 20	71,280	*52,480*	35,396	4,183	1,068	3,507	11,305	7,687	1,021	6,253	858
June 17	72,260	*53,232*	35,396	4,237	1,066	3,506	11,698	7,864	1,137	6,506	848
July 15	74,563	*54,765*	37,422	4,407	1,041	3,443	11,776	7,819	1,170	6,631	853
Aug. 19	76,184	*57,276*	39,284	4,574	1,058	3,372	11,873	7,577	1,142	6,390	915
Reserve assets											
1980 Aug. 20	8,317	—	4,381	500	166	393	1,250	823	74	654	75
Nov. 19	8,960		4,470	535	169	454	1,365	964	104	800	98
Dec. 10	9,084		4,552	551	173	445	1,373	958	108	819	107
1981 Jan. 21	7,523		3,775	462	155	340	1,146	760	88	709	89
Feb. 18	7,602		3,827	448	155	347	1,138	788	86	706	106
Mar. 18	6,667		3,327	371	127	326	1,094	641	78	597	106
Apr. 15	6,806		3,285	365	122	340	1,193	681	86	626	108
May 20	7,790		3,854	440	133	382	1,223	804	110	725	121
June 17	8,287		3,936	458	133	435	1,372	899	123	800	129
July 15	8,231		4,031	479	130	388	1,287	852	133	814	119
Aug. 19	8,356		4,144	486	131	372	1,326	889	131	764	112
Ratio (per cent)											
1980 Aug. 20	13.2		12.9	13.0	14.6	14.1	13.3	13.0	14.1	14.2	15.4
Nov. 19	13.6		13.3	13.3	14.5	13.9	13.4	13.7	13.7	14.4	18.0
Dec. 10	13.5		13.3	13.2	14.6	13.6	13.3	13.3	13.4	14.4	18.1
1981 Jan. 21	11.1		10.7	11.1	13.7	11.0	11.3	10.7	11.0	12.6	14.6
Feb. 18	11.1		10.9	10.8	14.0	11.0	11.1	10.7	11.2	12.3	15.5
Mar. 18	9.8		9.6	9.0	11.5	9.7	10.6	9.0	9.4	10.5	14.9
Apr. 15	9.7		9.4	8.9	11.3	9.7	10.6	9.1	9.2	10.4	14.3
May 20	10.9		10.9	10.5	12.4	10.9	10.8	10.5	10.7	11.6	14.1
June 17	11.5		11.1	10.8	12.5	12.4	11.7	11.4	10.8	12.3	15.2
July 15	11.0		10.8	10.9	12.5	11.3	10.9	10.9	11.4	12.3	13.9
Aug. 19	11.0		10.5	10.6	12.4	11.0	11.2	11.7	11.5	12.0	12.3

Constitution of total reserve assets

	Total	Balances with Bank of England	Money at call		UK and Northern Ireland Treasury bills	Other bills		British government stocks up to 1 year	British government stocks over 1 year and up to 18 months
			Discount market	Other		Local authority	Commercial		
1980 Aug. 20	8,317	671	4,157	269	1,110	382	1,153	575	243
Nov. 19	8,960	575	4,342	312	1,301	534	1,210	687	233
Dec. 10	9,084	435	4,601	295	1,168	502	1,251	782	198
1981 Jan. 21	7,523	414	4,012	224	565	284	1,196	828	202
Feb. 18	7,602	596	4,138	250	416	272	1,094	836	227
Mar. 18	6,667	563	3,345	249	454	211	900	945	80
Apr. 15	6,806	452	3,690	256	305	244	1,001	858	182
May 20	7,790	430	4,577	244	301	279	1,206	754	255
June 17	8,287	513	4,388	255	725	423	1,241	742	244
July 15	8,231	604	4,166	256	699	406	1,278	823	188
Aug. 19	8,352	564	4,157	239	1,163	339	1,149	745	177

2 Finance houses

£ millions

	Eligible liabilities (b)	Reserve assets	Ratio (per cent)
1980 Aug. 20	466	48.4	10.4
Nov. 19	481	49.2	10.2
Dec. 10	466	49.3	10.6
1981 Jan. 21	444	46.4	10.5
Feb. 18	427	44.7	10.5
Mar. 18	406	36.9	9.1
Apr. 15	422	35.4	8.4
May 20	432	44.6	10.3
June 17	462	47.2	10.2
July 15	460	47.4	10.3
Aug. 19	473	50.2	10.6

3 Special deposits

£ millions

	Rates of call (per cent)	Special deposits: Banks	Special deposits: Finance houses
1980 Aug. 20	-	-	-
Nov. 19	-	-	-
Dec. 10	-	-	-
1981 Jan. 21	-	-	-
Feb. 18	-	-	-
Mar. 18	-	-	-
Apr. 15	-	-	-
May 20	-	-	-
June 17	-	-	-
July 15	-	-	-
Aug. 19	-	-	-

(a) There were transfers of contributors between groups in July 1980, November 1980, June and July 1981.

(b) Virtually all interest-bearing.

PART 8 ends:-

MAP to [illegible] 17/8

PART 9 begins:-

August Money Supply 4/9

KODAK Q-60 Color Input Target

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	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	
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