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THE GOVERNOR has seen.

— need JB 8/2

MEETING WITH THE CHANCELLOR: 5.~~00~~ 15 P.M. 7TH FEBRUARY

The meeting has been set up to enable you to speak about the forthcoming Basle (and ECOFIN) meetings - the European Monetary Fund and EMS in particular - papers to be found just after market reports. Other points are:

1. Markets - usual briefing attached plus DAHB's note of 6th February on dollar intervention.

2. Monetary policy - the consultative document. - MPN 03

3. ?The Bank's forecast - JCRD's note of 6th February attached.

4. ?The Budget /you were thinking of the timing for a Bank submission/.

5. ?The banks' profits.

6. Steel dispute; BL.

7. NEDC/CFI /Chandler calls on you tomorrow/.

8. Stock exchange/OFT; ?CSI generally.

9. ?Building societies.

10. ?Exchange Control Act /meeting arranged for Thursday, 14th February/.

11. ?TUC Lending Facility/Wilson Report.

J.S.Beverly (4121),
Governors' Office.

7th February 1980.

S E C R E T

cc: Chief Secretary
Financial Secretary
Sir Douglas Wass
Sir Kenneth Couzens
Mr. Hancock
Mr. Middleton
Mr. Bridgeman
Mr. Britton
Mr. Lavelle
Mr. Riley
Mrs. Lomax
Mr. Gill

Governor/Bank of England

has another copy

Copies to the Deputy Gov's
Mr Fforde
Mr McMahon
Mr Dow
Mr Blunden
Mr George
Mr Goodhart
Mr Balfour - paras 8/10.

11/2

NOTE FOR THE RECORD

MONETARY AFFAIRS

The Chancellor discussed monetary affairs with the Governor and Sir Douglas Wass at 5.30 p.m. on 7th February.

2. The Governor commented on the reasons for the weakness of the US dollar in international markets. There was now considerable worry in the US whether the Federal Reserve could maintain control over the domestic monetary situation; there were inhibitions against further increases in interest rates, while an increasing number of banks were leaving the Federal Reserve system. The US bond market was going through a very difficult period, and capital values had fallen by more than 10 per cent in recent weeks. Meanwhile sterling remained relatively strong, with the firm commitment of the Government to monetary control, and the security of North Sea oil contributing to this situation.

3. In UK domestic financial markets current developments were relatively favourable. Equity and gilt prices were firm, and interest rates up to three months had turned down a little. A Treasury Bill tender on 8th February would either be maintained at the same level as on 1st February, or a somewhat higher price would be offered. Generally the money markets were left tight, although the Bank had continued to give assistance. However, the problem of the February make-up day remained; and £423 million was due shortly in part payment for gilts already sold. There was a real prospect that the authorities might need to take further action to avoid tight markets leading to renewed upward pressure on interest rates; the Governor had in mind the possibility of offering to the banking system generally a sale and re-purchase

facility for gilts, although in practice transactions would be restricted to the clearers.

4. Since a full analysis of the monetary prospect was not yet available, the Governor had not finally made up his mind. But he thought it more likely than not that action of this kind would be needed if an increase in base rates were to be avoided. If the authorities did nothing, and the banks failed to raise base rates, there was a danger of "hard arbitrage", as companies drew on their overdraft facilities and redeposited the proceeds in the money markets. On the other hand, if the banks found themselves obliged to raise base rates, they would be able to blame the authorities for failing to give assistance, while at the same time still further increasing their profits.

5. If the Government were to take action to avoid an increase in base rates, it was recognised that this would be tantamount to an announcement by the Government that, in their judgement, interest rates were already at a level sufficient to achieve the necessary measure of control over sterling M3 within an appropriate time-scale. The Governor's preference was to give the necessary measure of assistance, unless the evidence suggested that such a course would be thoroughly inappropriate. Sir Douglas Wass was inclined to agree, although he made the point that the authorities might be criticised for helping the banks to cope with a problem of their own making. The Chancellor acknowledged that the Government's supporters would find an increase in MLR in advance of the Budget difficult to accept; and there was general agreement that it was absolutely essential to maintain the credibility of monetary policy, even if this required further uncomfortable action.

6. It was noted that, despite the difficult position of the clearing banks under the corset, there was no sign that they were taking advantage of the abolition of exchange control to exploit the euro-sterling leak.

7. The Governor reported that he had spoken to Lord Armstrong about the problem of bank profits, which had been discussed at the Chancellor's meeting earlier in the week. He had suggested that the banks emphasise changes in real profits, and the need to avoid an erosion of their capital base; at the same time it was very important that they should avoid high pay settlements. The banks needed to embark on a campaign of public education comparable with that they had previously undertaken in opposition to nationalisation. The Governor had floated the idea of a profit equalisation reserve, which Lord Armstrong said he would consider.

8. The remainder of the discussion concerned external monetary policy. The Governor reported that the European Commission had been working on a document about the co-ordination of monetary policies, which might be on the agenda for the March Finance Ministers' Council. The Commission were urging that Community member countries should commit themselves to prior consultation before making changes in interest rates. The Governor thought such an arrangement impracticable and probably dangerous - there should indeed be consultation about the level of monetary targets, but the various national authorities should then be left to pursue those targets by whatever means they found necessary. It was noted that the Germans had shown themselves very unwilling to reduce domestic interest rates for external reasons.

9. The next European Council would have before it papers by the Commission and the Committee of Central Bank Governors on the development of the European Monetary Co-operation Fund (EMCF). The Governor found it hard to assess what other countries really wanted in this field. The arrangements for credits and the formal calling of reserves were already in operation; but significant further developments would sooner or later require some surrender of sovereignty which could only be achieved by amendment of the European Treaties which would in turn require legislation by each of the countries concerned. We should have to decide whether we

wanted to work towards a sort of IMF for Europe, or towards a European currency board which would have some operational powers. The Governor thought other member countries would favour relatively slow evolution rather than an immediate radical step; but sooner or later the sovereignty issue would have to be tackled.

10. As the EMCF developed, a particular problem could arise if some member countries in the Community were outside the EMS. It was possible that the UK would be accused, however unjustifiably, of obstructing progress towards greater monetary co-operation by staying outside the EMS; and there was some prospect that we might extract some concessions from the Germans and Dutch on the UK contribution to the Community Budget as the price of joining the EMS.

MW

(A.J. WIGGINS)
11th February 1980