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NOTE FOR RECORD

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 - Mr Coleby
 - Mr Dawkins
 - Mr Flemming
 - Mr George
 - Mr Goodhart
 - Mr Walker
 - Mr Quinn

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*The Governor called on
the Chancellor*

TEA n 3 10 80

The meeting provisionally arranged between the Governor and the Chancellor of the Exchequer for 6.00 pm this evening will not take place. Instead, the Governor will call on the Chancellor tomorrow (Saturday) morning at 10.30 am at No.11. The Deputy Governor will also attend.

Governor's Office HO-P
10 October 1980
T E Allen (4121)

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Re Deputy Governor
Mr [unclear]
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NOTE OF A MEETING HELD AT NO.11 DOWNING STREET ON SATURDAY,
11 OCTOBER, 1980 AT 10.45 A.M.

Present:

Chancellor of the Exchequer
Financial Secretary
Sir Douglas Wass
Mr. P. Middleton

Governor of the Bank of England
Deputy Governor

Mr Coleby
Mr Douglas
Mr Fleming
Mr Geary
Mr Goodhart
Mr Waller
Mr Quinn

The meeting was held to review a number of aspects of monetary policy in preparation for the meeting which the Prime Minister was to hold on that subject on Monday, 13 October. In addition to the papers which the Chancellor had submitted to the Prime Minister, details of which were given in the Chancellor's covering minute of 10 October to the Prime Minister, the Governor's letter of 10 October to the Prime Minister, setting out the Bank's views on the issues, was relevant.

Monetary Control

2. The Chancellor, opening the meeting, thanked the Governor and Deputy Governor for giving up their Saturday mornings at short notice to discuss these issues. The Chancellor said that there seemed to be two sets of questions: firstly, those relating to the prospects for the current PSBR and monetary growth, together with the question of the roll-over of the monetary target; and, secondly, questions about the suitability of present methods of monetary control. He would prefer to start at Monday's meeting with this second set of issues. He started from the premise that the present system, when judged against the objective of controlling monetary growth, had not worked very well. He was keen to consider proposals for improvements. As he understood it, Monetary Base Control (MBC) was not being advocated as a means of solving present problems but as one way in which our capacity to deal with



disturbances affecting the money supply. There were a number of steps, falling short of MBC, which could secure such improvements.

3. The Governor thought that in a period of considerable tensions the present system had achieved much. He doubted whether changes in technique, in particular a move to MBC, would in any way solve fundamental problems. He would therefore prefer to consider these problems before questions about control techniques. He was clear that adoption of the new techniques proposed, with the automaticity which they implied, would lead to higher and more fluctuating interest rates. If these were not acceptable there was little point in considering the case for changes further. On MBC, he did not think that such a system would have solved the problems of the last two years. The Chancellor, however, thought that MBC could well have resulted in some of the problems being avoided. He was interested in trying to reduce the degree to which monetary policy, in particular decisions about changes in MLR, had been politicised. The Governor shared this view.

4. Sir Douglas Wass thought that the problem of monetary control could usefully be considered in terms of the banks' management of their assets: he thought that deliberate actions by the authorities to influence the banks' reserve assets could improve monetary control. The Governor said that consultations following the Green Paper on Monetary Control had revealed little enthusiasm for such a system. Sir Douglas Wass noted that Harold Rose and others had thought that such a system might work. The Governor said that a lender of the last resort facility would need to be retained in order to stop a major bank collapsing. It was therefore likely that it would



be the price rather than the quantity of money which would take most of the strain. Mr. Middleton recognised that much of the strain would be taken on price, but the present system placed no constraints on banks' balance sheets. Under an MBC system, for example, banks might charge a commitment fee on overdrafts, though he thought that there would be some effect on bank behaviour and on the quantity of credit extended.

5. The Chancellor said that the Treasury papers fully recognised that changing to some form of MBC would involve substantial institutional changes: on this there was no difference with the Bank. The upheavals which these implied were bound to make one cautious. However, the criticisms of the present techniques of monetary control, as set out in the second paragraph of the summary of the papers on monetary control, were indeed formidable. The Governor agreed that, in relation to monetary control over a reasonable time scale, the present techniques of funding could be criticised, though in terms of the sheer quantity of debt sold the techniques had been successful. Against this background, there was obviously a case for improvements in techniques, including more funding through national savings. If however what was being suggested was matching the profile of funding with that of borrowing a number of substantial problems existed. Even if the uncertainty inherent in forecasting could be dealt with, the skew in the profile of the PSBR would result in feasts and famines of funding, which would result in the authorities getting a worse bargain in the markets, thus increasing the cost of funding. It would, of course, also require different institutional arrangements. He cited the Swiss as having regarded MBC as a medium-term system.

6. The Financial Secretary said that doubts about the present methods of monetary control and proposals to improve



them needed to be considered against the background of Ministers' determination to achieve the MTFS. There were a number of uncertainties. Firstly, whether banks would change their behaviour so as to make a system of closer control of monetary aggregates feasible; secondly, whether the politicisation of the generation of interest rates could be reduced; and thirdly, whether funding techniques could be improved. He had some confidence on all these. One deficiency of the existing system was that whilst funding depended on the belief that interest rates would fall, the corporate sector would only turn to the capital markets, as it must if bank lending were to be substantially reduced, if it believed that interest rates would fall no further. The Governor said that the experience over the years had been that high levels of debt sales required some prospect of falling interest rates and that funding might become difficult. He did not however share the Financial Secretary's fundamental doubts about the nature of the present system. In the past the present system had funded large PSBRs and if the almost irreconcilable pressures of current policy could be reduced he was confident that the present system would continue to work successfully. The Financial Secretary reiterated the point that the present system had not enabled monetary targets to be achieved.

7. It was agreed that, in view of the imbalance between the personal and corporate sectors, it was necessary to fund more Government borrowing with savings from the personal sector. In the immediate past, national savings had not been large, partly because of concern about the mortgage rate. It was agreed that from now on priority should be given to tapping the personal sector. The Governor asked, in relation to MBC, whether it was desirable for the whole of an external shock to be taken at once by interest rates and the real economy, rather than allowing some easing of monetary policy. Sir Douglas Wass said that the reality of the present situation was that some slack already existed, i.e. monetary policy was



already taking most of the shock. What was being suggested was that debt sales should be more closely related to flows of funds than at present. He thought this could be achieved in part by increasing the range of marketable instruments, and in part by tailoring debt sales to fluctuations in the flow of funds. He recognised, however, that forecasts of flows of funds were subject to a wide margin of error.

8. The Deputy Governor thought that the experience of floating exchange rates had been that they had not stabilised current accounts. This left him unconvinced that freer interest rates would wholly even out the development of monetary aggregates in domestic markets. Treasury representatives noted that floating exchange rates had been tested during a period of great stress, associated with oil price shocks, and the capital account need to be brought into the reckoning.

9. The Governor said that it had to be recognised that if shocks had been allowed to be transmitted more directly to the real economy interest rates would have been higher. Would it for example have been right to allow interest rates to rise in the first half of 1980/81 to reflect the skewed profile of the PSBR, rather than extending relief to the money markets, thus placing further pressure on the corporate sector.

10. Mr. Middleton noted that the fundamental problem of accommodating shocks, for example from the PSBR, was that it was hard to claw back the monetary accommodation. This pointed towards allowing interest rates to rise more and then fall back later. The Governor questioned whether in those circumstances rates would have in fact fallen back. The Financial Secretary



said that it was not clear that by allowing more of an external shock to fall on interest rates, rates would over a period be higher. Indeed, he thought that industry would prefer such a system. The Governor agreed that if the system were operating properly there was no reason why it should lead to higher rates over a period; in reality, however, distortions could well have this effect. Sir Douglas Wass and the Deputy Governor thought that there could be a balance between total accommodation of shocks on the one hand and no accommodation at all on the other. Sir Douglas thought that what was needed was to move more of the burden of adjustment on to interest rates. The Governor doubted whether it would be sensible for the "shock" represented by the substantial difference between current money wage settlements and the monetary target to be taken through the system of monetary control. The burden which this would place upon the corporate sector would be simply too great. If the proposition about improving methods of control amounted to moving over to a non-mandatory system of MBC, he doubted whether such a change would represent a major improvement.

11. Mr. Middleton noted that the present system worked off a medium-term control, directed towards £M3. A move to a mandatory MBC would probably require a new aggregate in addition to £M3 or PSL1. The Governor agreed that £M3, which was controlled through interest rates and funding, was uncontrollable in the short-term; more precise control pointed towards M1 as the target. However £M3 had its own attractions: it could be analysed in terms of its credit counterparts and could be linked directly to the PSBR.

12. The Deputy Governor wondered whether there might not be some limit on how far the Government would be prepared to see interest rates, and thus possibly the exchange rate, to rise. The Chancellor agreed that any system of monetary control would in practice need to provide for override, as did the Swiss and US systems. The Financial Secretary thought that a system of



monetary control which relied more heavily on interest rates would adjust more quickly and this would probably reduce a Government's inhibitions about high interest and exchange rates.

13. The Governor thought that a system of MBC would be scarcely compatible with membership of the European Monetary System (EMS), and he believed that the UK would in due course join. Membership, at the same time as MBC, would imply dual objectives. He observed that the Germans, with a much more disciplined attitude towards inflation, had not been able to make MBC work. Sir Douglas Wass noted that membership of EMS could be made consistent with MBC through varying the path of "Mo". Against this, the Deputy Governor doubted whether the transitional costs of moving to MBC would be worthwhile if, in the event, "Mo" were to be allowed to vary. The Chancellor thought that EMS was not a decisive argument against MBC. The Financial Secretary noted that the time to join EMS would be when the UK's inflation rate stood comparison with those of other members, at which time these dual policies could be operated without setting up unsustainable strains.

14. Responding to the Chancellor's invitation to summarise the problem as he saw it, Mr. Middleton said that the present system was not succeeding in reducing monetary growth. Too much of any shock was being taken through monetary growth. Achieving monetary targets was at the heart of the Government's policy for dealing with inflation; this implied that there were great risks in letting the money supply depart too far from target in the short and medium term. More automaticity in the generation of interest rates should help domestically in the same way as the floating exchange rate reduced external shock. At present precise targets existed but the Government had no sure means of achieving them over what seemed an acceptable timescale. This seemed to be the worst of all worlds. The question really was whether to go for a less precisely defined monetary policy over a longer timescale or whether to strengthen instruments so as to improve the chance of achieving the sort of targets which were currently being set.



15. The Chancellor endorsed this summary and said that, notwithstanding the institutional changes implied by and costs associated with moving to MBC, he would favour a move in this direction if it held out the prospect of easing present problems of control. He hoped that at the meeting with the Prime Minister on Monday there would be recognition of the need for improving present techniques and identification of areas in which this could be done. He believed that there were a substantial number of issues about which the Treasury and the Bank agreed. These included increasing the role played by interest rates in monetary control; decreasing the political nature of MLR decisions, though he recognised that this could not wholly be eliminated; encouraging the banks to work more closely with the authorities in effecting monetary control; reducing the extent to which the authorities needed to influence expectations in order to fund; the need to smooth the path of the PSBR; and, finally, the need to increase the amount of Government borrowing funded directly from the personal sector.

16. The meeting considered the merits of the different options identified in the summary note on monetary control. Sir Douglas Wass noted that option (c) involved only limited institutional change, though the banks would have to examine their base rates more often. Mr. Middleton thought that in some ways moves in the direction of option (b) were more attractive. The danger of disintermediation, which would be present in any mandatory system, could be dealt with in part by paying interest on banks' required reserves with the Bank.

The Governor noted that a time when substantial volumes of debt sales were required the scope for radical change was limited. One possibility might be to experiment with nationalised industry stock. Sir Douglas Wass pointed out that backed as they were by Government guarantee such instruments were in effect indistinguishable from gilts. Mr. Middleton said that in addition to removing the existing reserve asset ratio, which was a matter of urgency, he would favour tightening the operation of the lender of the last resort facility and



seeking to influence long rates directly.

Current Situation

17. The Governor said that the Bank's forecast showed growth of 12 per cent in £M3 over the current target period. This assumed a PSBR for 1980-81 of £10½ million; unchanged interest rates and a slowdown in bank lending. The Treasury's view was similar. He added that this forecast was critically dependent on the PSBR which was itself very uncertain, particularly because the dip which would bring the PSBR back to its forecast outturn would not come until the last quarter of the financial year. Some slippage could be hauled back by funding. The Chancellor noted that such a forecast, if realised, would not be inconsistent with returning to the MTFS. The Deputy Governor added that the forecast showed the banks' liquidity getting worse. This reinforced the need to make changes to the reserve assets ratio.

18. It was noted that the tone and substance of the Mansion House speeches would affect the markets. The Financial Secretary noted that the markets had had much bad news to take of late and had behaved well. Sir Douglas Wass thought that there might be the danger of overconfidence in the markets. The Governor thought that the markets' behaviour indicated that they were not taking the Government's targets seriously, though this did not mean that they did not recognise the Government's determination. Against this background, he thought that by sticking with the existing target the Government would be making things unnecessarily difficult for itself. He would prefer applying the target over a long period. If the target looked too tight it might well be self-defeating, as markets might think that interest rates would have to rise to achieve it.

19. There was discussion of when a decision on the roll-over of the monetary target should be taken and announced. There



would be no detailed discussion at the Prime Minister's meeting on Monday. Logic pointed towards saying something about the consultations on the Green Paper on Monetary Control and the monetary target at the same time. The October banking figures might well narrow the options. The Chancellor favoured an early announcement, which should be made to Parliament, possibly to the Treasury Select Committee. It would be desirable to establish a provisional view by 27 October.

20. The meeting then considered the background to the current monetary target. The Governor saw a dilemma between the severity of the squeeze on the corporate sector and the prospect of it tightening, on the one hand, and the constraint of the target, on the other. But for the target, he would advocate a reduction in interest rates and the exchange rate. The pressure on the corporate sector to adjust was undoubtedly sufficient. The Bank's forecast showed the trade balance becoming the principal depressing factor. Wage behaviour was changing. The question was how to prevent pressure intensifying. The Chancellor recognised these factors but stressed the overriding importance of keeping policy consistent with the MTFS. Policy actions which implied a departure from the MTFS would destroy the credibility of the strategy and provide a further twist to inflation as the economy emerged from recession. In turn, this would be setting the stage for the next round of decline in the British economy. He hoped that the imbalance between companies and persons and between the private and public sectors could be eased through fiscal policy, including restraining public sector wages and increasing the take from the oil sector. The Financial Secretary said that contacts had suggested to him that interest rates should be held until the pay round was well under way. He noted that the pessimism of the Bank's forecast turned much on wages, where the performance might be more encouraging than the forecast assumed.



21. The Governor said that he feared another step change in the next few months, similar to that in April, in the level of economic activity. He noted that the numbers in the MTFS had been illustrative, except for the final year. If the economy was adjusting, and the private sector was, the path of monetary targets could be varied, in order to avoid excessive strain, without credibility being lost. The Chancellor said that given that monetary growth over the previous three years had averaged 14 to 15 per cent he was very reluctant to relax the monetary targets. The Financial Secretary noted that whilst the MTFS target for 1981-82 of 6 to 10 per cent might look very tight it would, probably at best, follow an outturn of 12 per cent over the current target period, which was more like 13 to 14 per cent at an annual rate. The Chancellor added that what was desirable was to increase the pressure on the public sector within a given monetary stance, rather than relax that stance because the corporate sector was under pressure. He believed that the pressure on the corporate sector could and should be maintained in order to encourage adjustment.

22. The Governor questioned whether more pressure could in fact be placed upon the corporate sector. The Deputy Governor wondered whether continuing pressure on the present scale might not lead to involuntary public expenditure, in the form of assistance to companies, thus making the task of restraining public expenditure even more difficult. The Financial Secretary thought that there were some good signs. Stock adjustment was well under way and a better wage round was in prospect, though the effects of this on the exchange rate were uncertain.

23. The Chancellor said, summarising this part of the discussion, that the Bank and the Treasury seemed to be in agreement on a number of points. They both recognised the current pressures on the corporate sector; would like to see an abatement of interest rates; were doubtful about the possibilities of reducing the exchange rate; agreed that it was essential to



increase the funding of Government borrowing directly from persons on a scale beyond that already agreed, and, if necessary, at the expense of mortgage rates; and finally that the PSBR needed to be contained, particularly through restraint on public sector wages. Where there seemed to be difference was on whether the balance between different sectors of the economy could be improved within the overall framework of keeping monetary policy consistent with the MTF5.

Interest Rates

24. The Governor wondered, in view of the severity of the recession which the Bank were forecasting, whether interest rates could be kept at their current levels until about February, as the Bank's forecast suggested they would need to be if their forecast of monetary growth was to be realised. The Financial Secretary thought that interest rates might decline but then need to be increased reflecting the path of monetary growth. Sir Douglas Wass thought that whilst a reduction in interest rates before the Budget should not be entirely ruled out, the Government should wait for firm evidence of $\$M3$ being on target before acting. A premature reduction could well reduce the credibility of monetary policy and it might be politically very difficult to raise interest rates again. The Governor agreed with this last point.

R.I.T.

(R.I. TOLKIEN)
14 October 1980

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