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## 10 DOWNING STREET

From the Private Secretary

20 November 1980

Dear Mr.

As you know, the Prime Minister held a further Monetary Seminar on Tuesday. The following were present: Chancellor of the Exchequer, Chief Secretary, Financial Secretary, Sir Douglas Wass, Mr. Burns and Mr. Middleton; the Governor and the Deputy Governor of the Bank of England, Mr. Goodhart and Mr. George; Sir Robert Armstrong and Mr. Ibbs. They had before them the papers described in your letter of 14 November, including the letter of the same date from the Governor.

Smoothing the PSBR

Referring to the recent Treasury paper on this subject (your letter of 5 November refers), Sir Douglas Wass said that some areas for smoothing the PSBR had been identified, mainly on the revenue side. But one should not exaggerate how much could be achieved, and some of the options would cause administrative difficulties and would be inconvenient for industry. He proposed that further work should be done to refine the possible options.

The Prime Minister said that the further work should be done as proposed.

Abolition of the Reserve Asset Ratio (RAR)

It was explained that the abolition of the RAR and its replacement by a new system of prudential control had already been announced in the Green Paper on Monetary Control. But a new system of control had not yet been fully worked out, and until it was, the RAR - or some variant of it - would have to continue in its place. The Bank had published a Consultation Document on the new prudential control system, but it had not been possible to carry the consultations with the banks forward, pending decisions on other monetary policy issues such as the Lender of Last Resort facility (see below). However, it was essential that the new prudential system should be in place by the next Budget.

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The Governor said that it would be desirable to make some early changes in the RAR so that, in its last few months of existence, it did not cause some of the difficulties which it had in the past. In particular, there was likely to be renewed pressure on the banks' liquidity in January, and it would be right to consider changing the definition of reserve assets before then so as to avoid - or at least reduce - the need for Bank assistance.

The Prime Minister said that it would be clearly undesirable to abolish the RAR before the new prudential system was in place. Even though the RAR was inadequate, to abandon it now would give the public the impression that the banks were being set free to "print money". But the new prudential system must be ready in time for the next Budget, and in the meantime it would be desirable to consider possible changes in the RAR on the lines suggested by the Governor.

#### Modification of Lender of Last Resort

It was explained that the Treasury and the Bank agreed on the need to move to a more flexible system of operations in the money market. This would include allowing short-term interest rates to be free to move within a predetermined (but unannounced) band, and the disappearance of MLR as such. Greater flexibility in interest rates could ease the political and technical tensions in our monetary operations. Moreover, the possibility of considerable fluctuation of short-term rates could encourage the banks to move towards more variable pricing for their lending, which would also be helpful for maintaining monetary control. The purpose of the band, rather than letting rates move completely freely, would be to avoid undue short-term volatility which might arise from technical factors and which might not be warranted by the underlying movement in the money supply. But it would be possible to change the band quickly if it appeared that the monetary target was not being achieved. The authorities would continue to intervene mainly by open market operations. The discount window would be used to relieve unexpected cash shortages, but this facility would be provided less predictably than at present and probably only at penal rates. The effect of changing over to a system on these lines, at least initially, should not be exaggerated. But it ought to be helpful in its own right, and it would be a move in the direction of a possible Monetary Base Control (MBC) system. It was proposed that the new method of operating should be announced by the Chancellor in general terms in next week's statement, and introduced in the next few months when the general guidelines for working it had been fully worked out.

In discussion, it was questioned whether it would be possible to keep the band secret. In response it was argued that the Bank could certainly resist pressure to publish on operational grounds; and although the market would get some idea of the band from the way the authorities intervened, it should still be possible to

maintain a considerable degree of uncertainty about it. This was the experience in the USA, where the Fed operated an interest rate band.

The Prime Minister said she was content with the proposal in general terms: it should be announced in the Chancellor's statement, and the Bank and the Treasury should immediately embark on discussions on the form of the new guidelines for short-term interest rates and how the new system would operate. Her one concern was that the proposal was not radical enough and that it would result in the banks still being able to obtain large-scale assistance from the authorities. She hoped that the Bank would veer in the direction of providing cash via the discount window and charging a penal rate so as to make it more likely that the clearers would restrain their lending. It was also essential, in her view, that the Bank and the Treasury should be prepared to change the band as and when monetary conditions required it.

#### Funding Methods

The Financial Secretary said that, following an intensive review, he had concluded that the introduction of a Restricted Indexed Gilt (RIG), aimed principally at the UK pension funds, would be desirable. The intention would be to issue perhaps £1 billion in the first place and at least £2 billion if the market reception was favourable. The value of the gilts would be linked to the RPI. The new gilt would be a considerable help to the Government's funding problem; it would reduce the cost of borrowing by cutting out uncertainty; and it would help bring down long-term interest rates and thus bring forward the reactivation of the Corporate Bond market. Although there were arguments against, on balance he thought it was right to go ahead with it.

In discussion, it was pointed out that RIGs would reduce the PSBR (because the index-link would not show up as interest rate in the Government's accounts). Their announcement now would also be of advantage for the Chancellor's statement next week. On the other hand, it was argued that the Government was already raising huge amounts of debt from the institutions without indexation, and it was doubtful whether offering them an indexed gilt was necessary. This would be a much greater departure than the issuing of "Granny Bonds" - because in the latter case it had been considered necessary to issue them in order to increase the Government's borrowing from the personal sector. There was a risk that if an RIG was announced, the institutions would hold off buying conventional stock and wait for a further RIG issue. More generally, an RIG issue would give the impression that the Government was extending indexation just when it was trying to reduce indexation in other fields, such as social security and public service pay. Finally, certain legal difficulties had been raised by the Department of Trade

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(Mr. Nott's letter of 17 November to the Financial Secretary refers), so that it was now doubtful whether it would be possible to go firm on an RIG issue in time for the Chancellor's statement.

As regards other methods of funding, the Financial Secretary said that the first day of the new "Granny Bond" issue seemed to have gone well. The Chancellor said that he would like to consider the possibility of announcing a further extension of "Granny Bonds" in the New Year in his statement.

As regards the possibility that the nationalised industries might borrow in their own name, Mr. George said that the industries had frequently argued for this; but in practice it seemed very unlikely that they would take advantage of it if such a facility was allowed. Borrowing from the National Loan Fund was cheaper for them.

The discussion then turned to the possibility of new methods of debt marketing, and in particular the possibility of auctions. The Bank representatives explained that a change to an auction system would, in their view, seriously damage the structure of the market and, as a general proposition, they believed it would increase the cost of borrowing. But they were prepared to consider auction techniques on a limited scale in respect of short-term debt.

Summing up this part of the discussion, the Prime Minister said that on balance she was opposed to the immediate introduction of an RIG. But she did not preclude introducing one at some later date: it would be helpful if, in the meantime, the Financial Secretary would prepare a short paper setting out the pros and cons and taking account of the points raised in Mr. Nott's letter. The Chancellor could, if he wished, announce the extension of "Granny Bonds" in the New Year in his statement. Although she was disappointed that no other immediate funding changes seemed possible, she agreed that there was nothing else that the Chancellor could readily announce. She noted what the Bank representatives had said about auction techniques and she would like the Treasury and the Bank to conduct a joint study of possible new funding methods - which should also cover the possibility of new debt instruments.

#### Monetary Base Control

The Chancellor said that he would like to open up the possibility of moving to an MBC system in due course. In order to help the Bank and the Treasury develop their thinking on MBC possibilities, he had two immediate proposals. First, the 1½ per cent cash ratio should be abolished. This would enable them to study the properties of a non-mandatory system and, in particular, the banks' own requirement for reserves which was an essential feature of such a system. But some method would have

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to be found of replacing the Bank's income which was presently derived from the 1½ per cent requirement. Second, he proposed that a new series of retail deposits (M2) should be compiled. This was desirable as the possible basis for a mandatory system. He intended to announce both of these measures in his statement; he would explain that they were necessary to enable the authorities to move to an MBC system in due course if they so wished.

The Governor said that he did not dissent from these proposals, though he emphasised that, with the abolition of the 1½ per cent ratio, a new source of income would have to be devised for the Bank, and it would be highly desirable if the banks continued to provide it rather than the Government. The Prime Minister said she was content, and that both measures should be announced in the Chancellor's statement.

I am sending copies of this letter to Tim Allen (Bank of England), Sir Robert Armstrong and Robin Ibbs.

*m. m.*

*Tim Lashley*

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HM Treasury.