S41/1

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pl. annotate where poss

THE GOVERNOR has seen. He saw the Chancellor. JB 30/4

Copy to the Deputy Governor

MEETING WITH THE CHANCELLOR
9.45 AM WEDNESDAY, 30 APRIL

I list below a number of points which you may wish to take with the Chancellor tomorrow morning.

1 The money market situation and the obviously related question of a stock issue on Friday

2 Indexation

3 Intervention policy - I am thinking in particular of the FST's interest

4 The EEC budget question

5 Select Committee

6 Iran and ?Saudi Arabia

7 NEDC meeting to be held on Wednesday, 7 May and the clearly relevant question of the financing of the corporate sector

8 Institutional involvement - I understand from DAW that you are inclined to hand the Chancellor a copy of the memorandum only. In the wallet are to be found two copies of the memorandum

9 Pay settlements - ?the public sector and ?the banks'

10 Non-Executive Directors - the joint scheme

11 British Aerospace - ?there may be nothing fresh for you to say on this

12 Any points outstanding from Hamburg.

I attach papers where relevant and the usual market information.

JB

Governor's Office
29 April 1980
J S Beverly (4121)

S41/1

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29. 4.80

MR FFORDE
THE GOVERNORS

Copies to Mr Dow
Mr Coleby
Mr Goodhart
Mr Gill

PB 29/4.

THE GOVERNOR'S CALL ON THE CHANCELLOR - 29 APRIL
DOMESTIC MONETARY POLICY OPERATIONS

There are two matters to discuss -

(a) a possible stock issue for announcement this Friday; and

(b) on a preliminary basis, the handling of the temporary assistance to the banking system which matures towards the end of banking May and on which an announcement could most conveniently be made on Thursday week, 8 May, following publication of the EL figures on 7 May.

The Stock Issue

Although the gilt-edged market was briefly disturbed by events in Iran last Friday and again mid-morning to-day, my assessment of the market remains basically as described in the note of 24 April attached.

The monetary arithmetic for banking May is evidently changing (the CGBR now looks to be overshooting the original forecast by rather more than suggested in the 24 April note and the seasonal adjustment is being revised adversely); but on the information we have it still seems that we need to sell about £1 billion gross to keep £M3 growth to 1-1½% for the month and that would need to include a first call of £20 on a new £1 billion issue. We have no further information on the prospect for banking June.

Subject to market conditions during the rest of the week therefore, I would confirm my earlier recommendation that we announce on Friday £1 billion of a 1992 maturity (a new stock) with £20 payable on application next Thursday, £30 in banking June and the balance in banking July.

I would mention that the current printing dispute could affect the operation both if it spread to our printer and by curtailing the normal advertising. We have made contingency arrangements to help ensure that we could nevertheless proceed with in-house printing.

The temporary assistance to the banking system

Last month's additional £0.5 billion gilt purchase/resale is due to mature on 12 May; £0.5 billion of Special Deposits are due for recall on 14 May; and the original £0.5 billion purchase/resale on 19 May.

On EID's current best guess at the reserve asset position for the banking system at mid-May it is clear that all of this assistance will need to be rolled forward as well as £0.6 billion of commercial bill purchase/resale over the end of the banking month (as in April) and additional help through short-term foreign exchange swaps. Even then the banks would need to withdraw a large amount of funds placed on non-reserve asset terms with the discount market. A revised forecast will become available on 7 May but there seems little doubt that this conclusion will stand - the question is more likely to be whether net additional help has to be given this month.

Failure to give help on the scale indicated (assuming this is confirmed by next week's forecast) would put renewed upwards pressure on inter-bank rates (where the overnight and seven-day rates are already consistently in the 17½-17¾ area - about as high as they can be without causing market-related borrowing to be switched into overdrafts. This in turn would call in question the present level of clearing bank base rates. With the money supply now comfortably within the target range, and with rates falling abroad, it would be difficult to contemplate engineering a rise in short-term interest rates at this juncture; nor are we persuaded - but see below - that this is required by the somewhat longer-term prospect. We presume therefore that the assistance will have to be further renewed. In this case it would be orderly, and would help to prevent uncertainty developing in the money markets, to announce the extension of the two gilt purchase/resale facilities as well as the cancellation of the May Special Deposit recall (with provision for subsequent recall if that should become appropriate) as a package. This would most conveniently be done following Court on 8 May, the day after the publication of the clearing bank and EL figures when the provisional money figure (of about +¼%) for April will also be announced. We shall in any event need to announce our decision on the first and second of the assistance measures listed above at that time.

The Governor may wish to alert the Chancellor to the possibility that we may have to continue providing this kind of assistance to the banking system for a good deal longer than was originally envisaged - perhaps for the rest of the year. This is because, with inflation running higher than expected, the company sector deficit will continue to be very large so that companies' demand for bank credit will tend to continue to outstrip the money target. Achievement of the money target will therefore involve over-funding of the government's borrowing and consequent pressure on the banking system's liquidity. We will be examining this prospect with the Treasury and the possible means of alleviating it urgently in the next two to three weeks. Meanwhile, it is possible that the pattern of monetary development in April, when it becomes known next week and when the full money figures are published on 15 May, will provoke outside commentators themselves to think in these terms: the very large bank lending figure and massive over-funding to contain the money supply will invite this analysis, although there may be a tendency to dismiss this pattern as erratic. In any event we shall need to consider carefully how the continued assistance to the banking system should be presented, and we will need further contact with the Treasury on this on Tuesday/Wednesday of next week. Our present inclination is to de-emphasise the temporary nature of the assistance to prepare the ground for a possible move to the more protracted assistance that we now believe is likely to be necessary. This will however need to be carefully managed since the implications for the future of interest rates and of the extent of our gilt-edged funding operations are very different once it is understood that the assistance is not quickly to be unwound.

At this stage therefore we would like the Chancellor's agreement in principle to extending the support in one package on 8 May for a further month - this to be confirmed and the presentation to be considered after the Bank Holiday.

29 April 1980
Dictated by Mr George and circulated unseen

copies filed in MP Does
Iran Does

SECRET

30 4 80

The Governor has seen
JB 19/5

Copies to the Deputy Govr
Mr George/
Mr Flemde ?
Mr Dow

NOTE OF A MEETING HELD IN THE CHANCELLOR OF THE EXCHEQUER'S ROOM, H.M. TREASURY AT 9.45 A.M. ON WEDNESDAY, 30TH APRIL

Mr Loehnis
Mr Holland
Mr Goodhart
Mr Walker
JB 1/5

Present:

Chancellor of the Exchequer
Governor of the Bank of England
Financial Secretary
Mr. A.J. Wiggins

MONETARY AFFAIRS

The Chancellor discussed a variety of issues with the Governor of the Bank of England this morning. The Financial Secretary and I were also present.

Iran

2. The Governor reported on various conversations in the margins of the IMF meetings in Hamburg last week. His Middle East contacts all emphasised that patience and peaceful persuasion were the only way of settling the US hostages issue; the Shi'ite section of Islam positively wanted martyrdom, and would therefore welcome hostile action of all kinds against it.

3. Nowbari, the Governor of the Iranian Central Bank, had said the Iranians had been assured by the Germans that, although there would be trade sanctions against Iran, there would be no question of a freeze on Iranian assets. The Austrians had apparently also given strong assurances, and there were signs that Iranian deposits were being moved there in consequence. Nowbari had asked the Government whether the UK would freeze Iranian deposits, and had been assured that we should not do this provided the Iranians continued to obey the rules of good behaviour. Nowbari had assured the Governor that any irregularity would be inadvertent, and had asked that any complaints the UK had should be put to him so that mistakes could be put right.

4. The Governor reported that, following his conversations in Hamburg with Messrs. Volcker and Solomon, the Chemical Bank had undertaken not to intercept the next interest payment due at the end of June on the Iranian loan to the National Water Council; however, the possible problem represented by the Chemical Bank legal action remained, although the immediate difficulties had been averted.

5. The Governor had been assured by the head of the Saudi Arabian Monetary Authority that there were no problems for financial relations between the UK and Saudi Arabia, but the Saudi royal family felt threatened, and were very preoccupied by the risks implicit in the present hostilities between Iran and Iraq.

6. The United Arab Emirates were in progress of organising a central bank, which the Governor expected to take part in various BIS discussions in the coming months.

7. The Governor undertook to prepare a note of his recent discussions about financial relations with Iran. He suggested that the Chancellor might emphasise to the Prime Minister the fragility of financial relations with the Middle East countries; keeping them on an even keel was very dependent on the personal relationships and trust among the leaders of the banking communities principally involved.

The UK monetary situation

8. The Governor reported that there were signs that bank lending in banking April was exeptionally high - more than £1½ billion, and that as a result there was likely to be a small increase in £M3 rather than the previously expected fall of 1 per cent. Meanwhile the figures for banking May could well prove less favourable; the CGBR was likely to be higher than earlier expected, and the authorities would

probably need to sell about £1 billion of stock to keep the increase in sterling M3 to about 1-1½ per cent. In order to achieve sales of this magnitude, at least the first payment would be needed on a new stock, and the Bank were thinking in terms of a 1992 stock with one payment in each of the banking months May, June and July. Although the market had weakened on Friday 25th April, it seemed likely that the conditions for a stock issue this week would be favourable; the underlying tone in the gilts market was strong, with confidence that US interest rates were moving down from their peak. But the Governor thought it unwise to let interest rates move down very far until there were clearer evidence of a deceleration in inflation - if rates moved down, but inflation remained high it could subsequently prove difficult to resume funding.

9. The Governor noted that a decision would shortly be needed on the roll-over of the temporary assistance the Bank had given to the money markets. £½ billion was due to be repaid to the banks on each of 12th, 14th and 19th May, and in addition the Bank had extended further assistance to the money markets by the purchase of £600 million of bills, which would also need to be rolled-over. If the authorities failed to take these steps, there would be upward pressure on money market rates, and also some risk of round tripping. The Bank had in mind an announcement on Thursday 8th May (following the publication of the April eligible liability figures the previous day) extending the two gilt sales and repurchase facilities and cancelling the 1 per cent recall of special deposits.

10. The Bank were concerned that the temporary assistance provided to maintain liquidity in the money markets was becoming more and more permanent, essentially because bank lending to the company sector was continuing to move ahead rapidly, while the Government were obliged to "over-fund" the PSBR in order to maintain monetary control.

The consequence was that private sector liabilities were displacing those of the public sector in banks' balance sheets, with the result that bank liquidity was being steadily reduced. As long as this situation continued, the prospects for any substantial reduction in short-term interest rates remained rather doubtful; the authorities' room for manoeuvre was restricted by the continuing rate growth of bank lending, and the need to prolong the temporary assistance to the money markets.

11. The Chancellor noted that he would have to say something about the monetary position and the prospects for interest rates in the debate on the Public Expenditure White Paper on 7th May. His remarks could conveniently take into account the April eligible liability figures which were due to be published at 2.30 p.m. that afternoon. He and the Governor would need to follow the same line as that taken on interest rates at the Treasury and Civil Service Committee when they spoke at NEDC on 7th May. They would need to emphasise again the fundamental importance of securing a deceleration in the rate of increase in earnings, and might perhaps make use of the thought - which had derived from the Governor's evidence to the TCSC - that pay prospects would be better if pay settlements fell into the same range as the monetary target.

Relations between financial institutions and industry

12. The Governor asked how the Chancellor intended to respond to Sir Keith Joseph's letter proposing to invite the banks to develop their facilities for unsecured lending to small companies. The Chancellor confirmed that he thought such an approach inconsistent with the Government's objective of securing a deceleration in bank lending, as well as having a number of other undesirable features. He would be writing shortly in this sense to Sir Keith Joseph, and would copy his letter to the Governor.

13. More generally, the Governor drew attention to the substantial steps the financial institutions had already taken to develop their relationships with industry. This was likely to be become a focus of a good deal of attention when the recommendation by Sir Harold Wilson and a number of the members of his Committee for the establishment of a National Investment Fund was published. The Governor had arranged for the preparation in the Bank of a note describing the steps already taken by the institutions, which he would let the Chancellor have very shortly.

14. The Chancellor noted that a number of his colleagues were anxious for some new initiative by the institutions to promote improvements in the performance of the industrial companies in which they were investing. He would send the Governor a note about these ideas, and would then like a further discussion with him before going back to his colleagues. It was important that any initiative - if and when it emerged - should be seen to come from the institutions rather than the Government.

JW

(A.J. WIGGINS)
30th April, 1980

Distribution

Financial Secretary
Sir Douglas Wass o/r
Sir Kenneth Couzens
Mr. Ryrie
Mr. Barratt
Mr. Middleton
Mr. Bridgeman
Mr. Lavelle
PS/Governor

SECRET

Copy filed in Iran doss /

29th April, 1980

C.W. McMahon, Esq.,
Bank of England,
Threadneedle Street,
LONDON,
EC2R 8AH.

Dear Kit

ASSURANCES TO THE IRANIAN CENTRAL BANK

Thank you for your letter of 24th April; I have corrected the record of the meeting between the Chancellor and the Governor on 17th April in the terms you suggest.

As you will know, the Governor had some further conversation with Mr. Nowbari in Hamburg last Friday, and - if I understood his account correctly - told him that there would be no question of freezing Iranian assets provided the Iranians behaved properly. In view of continuing Ministerial discussions of the economic sanctions we have committed ourselves to introduce, I should be very grateful if you arrange to let us have an authoritative note of the wording of the Governor's assurances to Nowbari which could, if necessary, be shown to those most closely involved in the other Departments concerned with the imposition of the sanctions.

Yours ever

John Wiggins

A.J. WIGGINS

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