SIR DOUGLAS WASS

c Chief Secretary)
Financial Secretary)without
Minister of State (C))attachment
Minister of State (L))
Mr Burns
Mr Middleton
Mr Bridgeman
Mr Britton
Mr Shepherd
Mr Riley
Mr Cropper
Mr Cardona

Prime Minister

This summary of outside views worth reading (pages 1 and 2).

R 22/2

THE MONETARY SITUATION AND RELATED MATTERS

In the course of the last few days I have taken the opportunity to sound out the views of a number of outsiders. The attached notes constitute a hurried and compressed record of their observations which you and the other recipients of this minute may be interested to see. Copies have gone separately to Ministers.

2. By and large the conclusion to be drawn from what they have to say is not as distressing as one might at first have supposed. While there are many things about which they are anxious, some problems have every prospect of becoming less serious with the passage of time, and many of the others are amenable to appropriate action. However, I must stress that I cannot banish the suspicion that no outsider is quite au courant with the very latest developments and hence that their attitudes would be somewhat less sanguine if they had full access to all the information which we have here. In the broadest terms, their views point to little major change in the Government's policies in the short-run.

3. At the risk of gravely distorting a large number of finely nuanced opinions, I would summarise the more specific conclusions to be drawn from what they have said as follows:

a. There are still good grounds for thinking that the growth of sterling M3 and bank lending will fall back shortly. Interest rates will have an effect,

and we are facing an awkward period partly because of the time lags before they operate, partly because of the dependence of monetary trends on the reduction of involuntary stock building.

b. Under the circumstances there is no case for raising interest rates - indeed most would feel that they should come down as soon as possible. In that context it was absolutely right to release special deposits and to carry out the release and sell back gilt-edged. It would be also right to go on doing so.

c. When rolling forward the sterling M3 target, no-one is looking for any great change, though the centre of gravity of opinion is that in some way a degree of downward movement should be signalled.

d. The problem of the bill leak (i.e. evasion of the 'corset') can be solved in any of a number of technical ways. The key issue is to explain clearly what is being done in advance and not to take markets by surprise, or to suggest that there is any attempt at deceit on the part of the authorities.

e. By and large no great contraction in the PSBR seems to be needed next year, in real terms. A more clearly articulated medium-term strategy - most would want a financial plan - would greatly help in gaining acceptability for whatever is decided.

f. There are considerable anxieties about the exchange rate. Some would say it is excessively and gratuitously damaging to industry. Others see it as generating a really serious threat to monetary growth before long. This line of reasoning reinforces the feeling that interest rates can and should fall before long.

AR

ADAM RIDLEY
18 February 1980

CONFIDENTIAL

CONGDON

General

Not markedly sombre. Vital that Govt sticks to its strategy. Present institutions viable if worked properly, ie not keen for MBC. Monetary trends not disastrous.

Monetary and inflation trends

Surprised at momentum of inflation, and that monetary policy has not pulled wage settlements down more. But feels it will bite before very long.

SDs, released buy-back of gilts

Given tolerable monetary prospect, such a technical manoeuvre acceptable.

M3 target

Since monetary prospect not really too bad, some modest tightening when the target is rolled over is feasible, as well as being self-evidently desirable, if not vital, in building up perceived momentum towards the gradualist policy of monetary contraction. Essential not to be seen to be "bending" statistics, or "fudging" the target. What about, say, 6-10% for the roll forward?

Acceptances/bill leak etc

If corset comes off, the leak won't grow further, since the pressure for it will have disappeared. Nor is there any clear reason why acceptances should actually fall and re-enter M3. If acceptances are "brought back" into the record of the past, or target for the future (which is much less desirable), then recognise they are less liquid than other aggregates. [AR note: provided they remain as acceptances, ie do not revert to being very short term loans/deposits].

PSBR

Particularly if M3 target is lowered, but even if not, err on the side of caution (ie low figure). Best means to achieve this is

further pressure on the indirects. The structure of Govt revenue must be shifted more in that direction. De facto indexing (if de jure is ruled out) would obviously help greatly. That said, income tax allowances much more important than standard rate. Concerned less we should, following Brittan's recent article, move too far away from tax indexation. Recalls that failure to do so '73-78 responsible for much of our present trouble. Weakening the (till now) growing presumption it will be respected each year will have costs in the future. Imagine the next Labour Chancellor's temptations.

Monetary Control

Key issue here to make bank liabilities (ie deposits) and assets (ie loans) less liquid, as Germany does. Longer term market for CDs an obvious answer, or more MT and LT term loans. To get this you may well have to look at definition of banks' reserve assets. Longer term loans/borrowing by definition less liquid, and out of M3. However this won't happen while corset is on. [AR: Of course this process is an alternative to the redevelopment of a market in private sector fixed interest paper - the difference lies in the Banks' role as intermediaries in the SD case.]

MTFP

Still thinks it important, indeed perhaps central. But notes growing vulnerability to financial disturbances arising from growing risk of volatile oil prices - a subject he will probably write about shortly.

ROBERT THOMAS - GREENWELL's

Only a brief discussion. Stressed:

(1) SD and Govt release an acceptable technical change;

(2) Sterling far too high; equally dangerous is sucking in £s from overseas and creating gratuitous and excessive pressure on company sector. This in itself an argument for lower interest rates.

(3) Present prospect puzzling. CGBR low, yet M/ growth considerable. Worries that public sector other than CG is borrowing heavily - eg LAs. [AR: they are .....]

GRIFFITHS

General

Sombre above all because of his own and others fear the Govt has no MT strategy or courage. Much reassured even by modest indication of spending trend next PEWP would describe. Fear, all the same, that if policy is not pulled together very soon, it will swiftly disintegrate, and U-turns will shortly follow. Said, en parenthèse, that some degree of intervention in BSC dispute was not a U-turn, and would not generally be interpreted as such.

Present trends

Monetary policy not really restrictionary when bill leak is allowed for. True monetary growth at circa 15% pa won't get inflation down to a lower figure. Reasons for high growth clear: fiscal policy too expansive, and £ being supported by too much intervention. [AR: ie BG not worried, one infers, by relatively high interest rates sucking in foreign money which is, I am sure, more important.] Not surprised that higher MLR has not yet worked wonders. The lags are long after all. To allow higher MLR or Bank base rates would be not merely unnecessary, but foolish and panicky.

SDs and release of gilts

It follows that "technical easing" to prevent higher MLR is acceptable, providing easing does not go as far as fully accommodating and indicating that the heat is off.

£M3 target

Precise figures or presentation an arbitrary or at least secondary matter. Only essential is to indicate a tightening, and a MT gradualist strategy which is viable. Tightening could be achieved in many ways. You can lower by a little, any or all of the "centre" of the £M3 range, the upper limit, or the lower.

Bill leak presentation

No real problem about this provided markets can understand what is being done and suspect no monkey business.

PSBR

Next year's precise figure of less importance than the long term goals which Govt is believed to be aiming for. The more it is credible in the MT or LT, the easier the ST. A slight reduction in the GDP share of the PSBR should suffice for 1980/81 given the recession.

ROSE

General

Not too worried, but less "hawkish" than last year.

Monetary Trends

Barclays have always seen loan demand strong till the end of this (1980 I) quarter. And so it is proving to be, with personal borrowing slack, but corporate still firm. Surprised B of E have come up with such a big estimate of the seasonally adjusted M3 increase for Jan. Debiting of interest should not affect M3 for technical reasons [AR: I suspect because in crude terms interest is credited to Bank's reserves]; there has been heavy payment of taxes; and CGBR is small. Anxious lest the high Bank estimate be attributable to bad seasonal adjustment. That could be very disruptive. In the real world, expects considerable improvement shortly for varied reasons such as de-stocking, interest rates biting, continued low level of Govt borrowing. Growing corporate deficit will require much less bank finance than stocks - experience shows £1 of stocks takes 70p of bank advances, while £1 of underlying deficit in co. sector only takes 30p.

SDs; gilts release/buy-back

Since prospect is not that alarming, technical easing is justifiable. No case for higher MLR or base rates. All this assuming PSBR for '79/80 is not out of hand!

Roll-forward

Hasn't considered precise arithmetic of targetry. But estimates 9% increase in M3 feasible during calendar '80, consistent with falling interest rates. This suggests a modest lowering of the range is feasible, provided one is reasonably confident one would not excee the upper end. [AR: Doubtful we can have such confidence ....] However there is more to consider in this connection.

Budget and other policy

Degree to which a figure is accommodating is determined also by extent of future action on prices by Govt, and extent of TU reforms. To have continued union strength and to give a further hefty jolt up to, eg, indirects like last year would be excessive. At most one of these contingencies is tolerable. Co-existence of both part of last year's problem.

Bill leak

The vital point that it has happened. Key question now, therefore, that one "confesses", and does not allow market to be unsettled by what, if it happens, would be a bad statistical performance as past errors are revealed to the naive through reintermediation. The key thing is not how the statistics are juggled. There are many ways of doing that. Rather it is that markets should be fully aware of the problem in advance, ie be softened up by the right sustained guidance; that the device ultimately adopted be honest, transparent and not catch them by surprise. [Barclays aim to do their bit as soon as possible, starting in their next monthly bulletin.]

Exchange rate

Definitely too high. Lower interest rates and a reduction in the £'s speculative attractions should help promote a lower rate 'ere very long, when speculation in commodities may become more attractive than holding pounds.

PEPPER

General

Not sombre about recent developments, but concerned about several important issues. The latest MS figures (for Jan) and their causes could be interpreted relatively favourably in their implications for underlying trends, justified the release and re-purchase of gilts; but pointed up yet again weakness of monetary instruments and threats to policy. Immediate message: steady as she goes.

January Money Supply

By record gilt sales and a very-low-CGBR, authorities drained money out of the system by a record amount, just as the same 2 factors had injected a record amount in October 1979. The vacuum thus created inevitably led to partly compensating increases in bank advances and inflows from abroad.

In total the authorities drained over £1.2 bn from the system. In the UK Treasury bills are the residual form of Government finance - ie when Government is in deficit in the short run, it sells bills, when in surplus it buys them back from private holders. Bills are one of the most important reserve assets of the Banks, hence support advances of a large multiple of the Banks' holdings. Massive run-down of, ex ante, over £1 bn put them in a very difficult position. Even with £900m of Government help (SD and gilt release) they were several £100m short, even of what was needed to support their existing lending

In the event they had to have recourse to every expedient and, since the Bank was not very quick to help them they were fairly desperate in their search. Without going into technicalities, the unsurprising outcome was massive pressure on interest rates as clearers bid for deposits; "manufacture" of IBELS, helped by the discount houses; inflow of overseas money; and, most important, arbitraging and round-tripping (encouraged by corset) which inflated the money supply figures The latter is one of the reasons Pepper is less worried than most by the superficial trends suggested by January's figures.

Lessons for future of monetary instruments

Government's residual financing means - Treasury bills - should not be a reserve asset of the banking system.

Underlying loan demand

Evidence available suggests it is evolving as one suspects: personal demand drying up, voluntary corporate demand withering, involuntary demand to finance stocks (till they run down) still strong, but likely to come off shortly. If February's figures improve, there would be a case for a MLR cut in the Budget.

Inflows

Could, however, swiftly ruin things.

1. UK monetary policy much tighter than overseas, the only country's to involve contraction in real money supply. Elsewhere the recession has been postponed. Overseas monetary conditions could remain loose generally for another 6 months or more. Until they tighten too, and recession begins, we will be unusually vulnerable to massive inflows. To "aim off" too much in the degree of tightness of our policy relative to others a great danger - cf Switzerland and Germany in 1977 and 78.

2. It could already be too late to avoid the danger - in which case temporary inflow controls quite vital, however unappetising. The methods in the ST not a complicated matter. EG orders to gilts brokers not to sell gilts to foreigners would be respected and effective. Controls could just about buy one the 6 months needed to carry us through till monetary conditions tightened overseas - which would take the heat off us automatically.

3. The current alarming problem of inflows must, as far as an outsider can judge, have been aggravated by intervention by the Bank of England when sterling was under pressure. The criticism is not of gentle massaging or smoothing, or of intervention to acquire finance needed for subsequent payments overseas by the authorities.

Rather it is that the correct response to gusts of speculation in favour of the £ cannot always be to "cream" off (even at a subsequent profit), and have clearly perceptible and foreseeable restraint on upward movement in the exchange rate.

4. Such intervention is predictable, offers speculators a one-way option in the short-term, and attracts more people and money before long. As a result what could have been a short gust which quickly blows itself out becomes a bigger and lengthier affair. Before very long leakages into the domestic money supply are probably. That could well provoke a further tightening of interest rates, and then a doubly vicious circle is set up. The intervention should rather be unpredictable, or even apparently perverse on some occasions. Let the rate ride up without intervention,and then bounce down, help it on the way down and burn speculators fingers.

[AR Note: I am summarising a lengthy discussion. The basic argument is the same as that applicable to gilt-selling tactics. I attach, for those who wish to pursue it, an extract from Pepper's unpublished talk on that theme.]

Greater instability in the rate in the short-run will follow from such tactics - but it would purchase greater stability in the long run, since it would make "speculators" discount more heavily the potential gains from short-term switches into and out of sterling. The Swiss and Germans already pursue such tactics from time to time, so they are not untried.

5. To sum up, proper handling of intervention could well be one of the most important considerations in the near future.

£M3 roll-forward

The target is quite tight enough now, and will continue to be as long as "12-month inflation" is rising. The time to lower it is when one is confident inflation is clearly falling. On balance the 7-11%

target should be rolled forward as it was in the autumn. But very clear and firm announcement should be made to the effect that: inflation about to fall; and target will be brought down when it is.

PSBR targets

The PSBR a bad measure to steer by. "People getting less and less impressed when PSBR is lowered by cosmetic tricks like BP borrowing £250m off a bank in order to buy oil forward from BNOC at year end".

The PSD infinitely superior, and not to shift to thinking and (in part) talking in terms of it will increasingly cost credibility. No precise view yet as to suitable figure except on a full employment basis. Convinced some allowance for recession appropriate, suspects on very much the basis Mr Burns favours. The reason for this that growth in private sector demand for credit falls back in recession - cf 1975 when it actually fell for a whole year in current price terms, a fact people ignore. This cycle will enter a comparable phase before long, in which "undershooting" will rear its head, and problem of interest rates will greatly diminish.

Gilt sales

Favours one more grand excursion of the Duke of York before hoped for switch to monetary base later in the year.

Bank profits

Very frightened by effect of wage settlement. Since date has for this year been advanced from July to May, and a 20% settlement seems likely, bank employees could well end up with circa 40% increases in 9 months. Wider consequences considerable in both numbers of other sectors affected, and scale of influence on settlements. Clearers affect City firms which affect London Labour Market generally, which affects Government and LA employees .... Authorities should either lean most violently on Clearers, tax "endowment element" in profits due to high interest rates, or do both. The alternative course - that Clearers pay interest on current accounts - has its attractions, but would raise problems for monetary control, particularly under MBC. The need for inflation accounting to reduce declared bank profits also self-evident.

The decisions of when and by how much to lower a tap price are complex. It is important to avoid the precedent of the market usually having a further fall after a tap price has been reduced, because this would lead to a delay before any stock is sold. The market tends to fall because the reduction of a tap price increases the potential supply of stock from the GB close to a current market price. Very often, though, the authorities reduce a tap price only when they consider either that the market has fallen to a level which is sustainable or that favourable news implies that prices should rise. Thus, the bearish implications of the additional supply of stock are offset by official expectations being signalled to be bullish. In this way the authorities avoid the precedent of the market falling whenever a tap price is reduced.

(The reason why the offer for sale price of a new issue is pitched in line with the market or slightly dear is similar. If a new issue were priced cheaply relative to other stocks, the whole market would fall on the announcement of the issue.)

If a market that has been falling rallies before a tap price is dropped, the authorities can sell stock without adjusting tap prices by supplying "unofficial taps", i.e. they can sell some of the Issue Department's holdings of stock acquired when the authorities have assisted switches going longer.

Overall, it should be realised that the tap method of issuing stock is extremely flexible. The U.K. authorities can act much faster to take advantage of favourable news items and unexpected events than can the U.S. authorities who use the tender (or auction) method of issuing bonds.

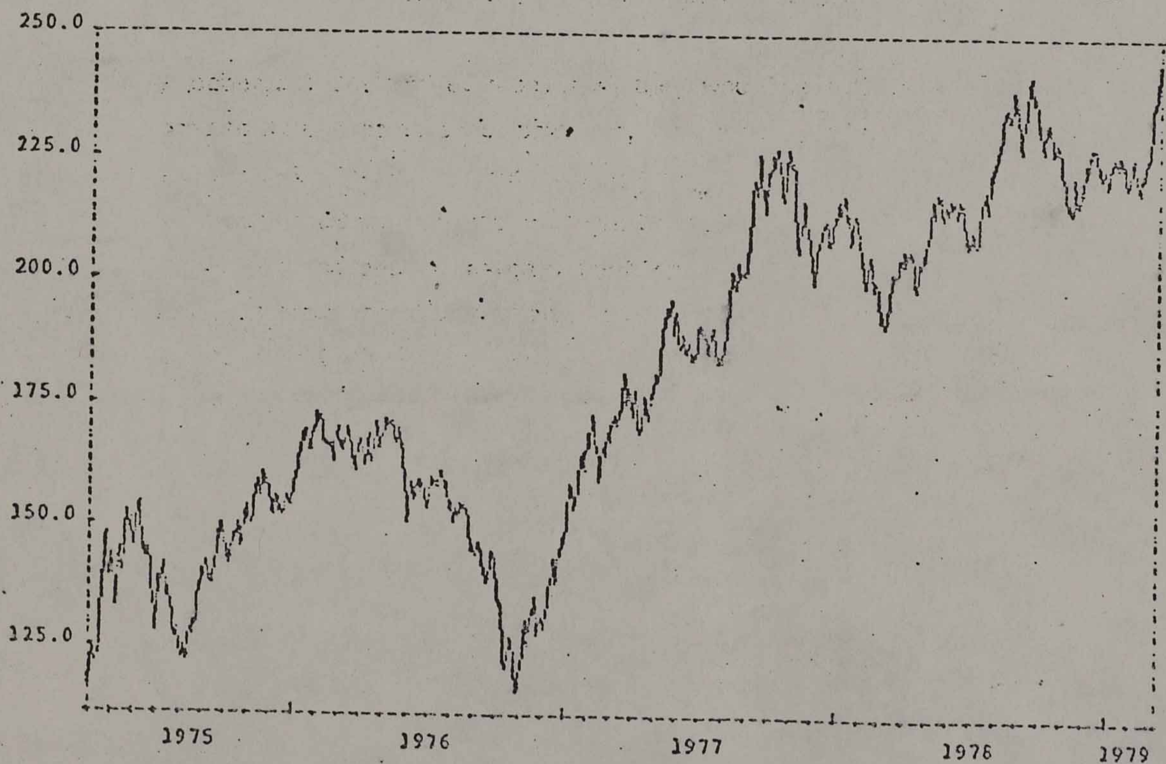
PART II - A PROBLEM PRIOR TO CCC

After the 1939/45 War the Bank was worried about the problems which might arise at the redemption of the large war-time issues. Later the Bank was worried about the redemption of the post war nationalisation issues. The Bank was afraid that it might not be possible to roll over this debt. Accordingly, until the introduction of CCC in 1971 the Bank's first aim in debt management was "to maximise investors' desire to hold gilt-edged stock in the long run". The Bank tried to do this by maintaining an "orderly" market. The theory was that over the years gilt-edged investors would buy more stock if they thought that they would always be able to sell at a reasonable price. A reasonable price was thought to be close to the middle market price, which should not be too far below the

Extract from "Official Transactions in the Gilt-Edged Market".
Gordon Pepper - Privately Circulated

previous day's price, which in turn should not be too far below the one the day before, and so on. The authorities, therefore, supported the market when it was falling - the GB used to be willing to buy stock offered by jobbers - in attempts to smooth falls. They also smoothed rises because a sharp rise was thought to indicate the presence of speculators who might subsequently sell suddenly and cause a disorderly fall in prices.

Ironically, this method of operation eventually led to more disorderly markets. In the face of rapidly changing events an official resistance to changing prices encouraged speculation. Further, the extent of official smoothing damaged the gilt-edged market's own self stabilising mechanism, which in the long run is necessary for its efficient functioning. Such mechanisms are reflected in secondary fluctuations. All uncontrolled markets have these. Those in the equity market during the last four years are illustrated, as an example, in Chart III (this graph shows the equity market rather than the gilt-edged market because the pattern of ordinary share prices is not distorted by official intervention). The broad picture is one of rising prices until early 1976, a sharp fall in the middle of 1976 and a rise since then which has gradually been slowing down. Superimposed on this broad cycle are numerous secondary fluctuations. They occur for two main reasons.



Firstly, there is an uneveness in the stream of news reflecting economic and political developments. Prices fall in spates of bad news and rise when there is a run of good news. Secondly, there are technical reactions. A rising market always attracts loose holders. Speculators are attracted by other people making money. A rising market also creates confidence, which attracts even more investors. If markets have been rising, the announcement of some unexpected bad news will always put downward pressure on prices; the question is the amount of the pressure. Speculators threatened with losses usually react very quickly - they sell. Speculators who still have profits may also sell; they are only short term investors. Falling prices upset confidence and some other investors are frightened into selling.

A set back to a rising market that is sufficiently sharp to frighten investors fulfils a most useful function; it shakes out the froth of loose holders. These set backs are called technical reactions; following one a market is much more resistant to further bad news and the chance of a more substantial fall in prices is thereby reduced.

Technical reactions also occur in falling markets. A falling market undermines confidence. This discourages some financial institutions from committing funds to the gilt-edged market as they flow into the institution. Sharp upward technical reactions tempt these institutions to invest their surplus liquidity.

Prior to CCC, official smoothing of gilt-edged prices discouraged technical reactions. For example, when prices were falling, the authorities used to take stock offered by jobbers; if the market recovered, they would re-sell the stock when the price had recovered to its earlier purchase price (or, perhaps, a $\frac{1}{4}$ point higher). The authorities undercut anyone in the private sector who had initiated a technical reaction and who had to pay brokers' commission and jobbers' turn. Because technical reactions were impeded, investors were not induced to bargain hunt on a falling market. The private sector progressively withdrew and the authorities had to provide more and more support in a falling market. Eventually the burden became too onerous and the authorities stopped supporting the market following the publication of CCC in May 1971.