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NOTE OF A MEETING HELD IN THE CHANCELLOR OF THE EXCHEQUER'S ROOM, HOUSE OF COMMONS, AT 4.45 P.M. ON THURSDAY, 19TH FEBRUARY, 1981

Present:

Chancellor of the Exchequer (in the chair)
Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr. Ryrie
Mr. Burns
Mr. Middleton
Mr. Bridgeman
Mr. Monck
Mr. Unwin
Mr. Cropper

MONETARY TARGETS AND MONETARY CONTROL

The monetary targets and interest rates

The Chancellor recalled that the Governor was anxious the authorities should not be committed to unrealistic targets; but there was a risk this might result in a position in which there were no targets at all. He asked whether the Treasury were reasonably confident that £M3 would be on a declining trend. Mr. Middleton said that a PSBR of £11¼ billion, combined with a reduction in MLR, was bound to be seen as putting at considerable risk the prospect of £M3 growth of about 8-10 per cent. It seemed unlikely that the growth of £M3 would be within the 6-10 per cent range during the first few months of 1981-82, and it would therefore be necessary to qualify the target in some way, or perhaps to extend the range.

2. Mr. Ryrie urged the importance of doing something to help industry. His preference would have been a reduction in the NIS, leaving interest rates where they were and accepting an extra £0.4 billion on the PSBR. Given, however, that this was excluded,

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he would favour a reduction of 2 per cent in MLR, and would be inclined to accommodate this by setting a wider range for the monetary target. The Chancellor recognised that there were risks with any of the possible courses of action; he felt on balance that relief for industry through interest rates was more psychologically and practically effective, and this pointed to keeping the PSBR as low as reasonably possible in pursuit of the MTFS monetary targets. The Financial Secretary suggested that the markets were probably already expecting the monetary target to be overshot in the early months of 1981-82; he thought furthermore that the sensitivity of £M3 to interest rates could easily be exaggerated. He agreed that a reduction in the NIS should not be further pursued, but wanted to see some reduction in interest rates as part of the Budget.

3. In further discussion the following main points were made:

(i) The risks involved in reducing interest rates while maintaining the 6-10 per cent target for £M3 arose over the whole target period rather than in the opening months of 1981-82; in the short run a reduction in interest rates could even be helpful in slowing down the growth of sterling M3, in that it might both help gilt sales and reduce companies' need to borrow from the banks.

(ii) It would be important to give the markets sufficient assurance that the authorities were making real effort to control monetary growth. In practice the substantial deflationary impact of the Budget at a time of deep recession should provide an adequate measure of reassurance for the markets.

(iii) There could be a case for widening the target range, and letting monetary growth rise towards the top of the range if the exchange rate were under upward pressure; it would be implicit in this that if the exchange rate

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were falling the authorities should aim at the bottom end of the target range, and that action would not be taken to offset a shortfall below the range. It was pointed out, however, that the margins of error in forecasting monetary growth rates were such that even widening the range to 6-12 per cent would not guarantee the feasibility of achieving the target.

(iv) It would be as well to make clear that the authorities would not be relying mainly on interest rates for the achievement of a £M3 target; indeed it would be desirable to "de-couple" short-term interest rates from £M3. The fact that action was being taken on funding as well as in the fiscal area should provide a further measure of assurance on the feasibility of achieving a £M3 target.

(v) One possibility might be to avoid any explicit commitment to a target for £M3 in 1981-82, by presenting the MTFS as a whole as the target. It was generally thought however, that this formulation would represent too much of a watering down of the Government's commitment, although it was agreed that there should be no commitment to rolling the target forward halfway through the year (but equally no commitment to not doing this).

4. The Chancellor, summing up this part of the discussion, said that the 6-10 per cent range should be retained for the £M3 target in 1981-82. However, it would be necessary to make clear that, in pursuit of the target, and in the determination of nominal interest rates, the authorities would also have regard to movements in the narrower monetary aggregates, in real interest rates and in the exchange rate. Clear notice should be given that circumstances might arise in which it would not be appropriate to seek to achieve the 6-10 per cent target. He asked Mr. Middleton to prepare a draft of the relevant paragraphs of his Budget speech,

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explaining the Government's monetary stance on these lines.

Cash ratio

5. The Financial Secretary said he would favour financing the Bank of England directly from the Treasury. This was a course of action which could be firmly and clearly decided before the Budget, and would also get over the problem that extending the cash ratio to the rest of the banking system would give a new inducement to "disintermediation". If this approach were not followed, the Financial Secretary suggested the best option would probably be to leave things as they were; it would hardly be possible to agree a satisfactory alternative system in the time available.

6. Sir Douglas Wass noted that Treasury finance for the Bank of England, whether through a Parliamentary Vote or through a revised Treasury minute on the terms under which the Bank paid over the profits of the Issue Department would both imply some increase in accountability to Parliament. The Governor had indicated he had decided against a solution on these lines; it appeared that the threat of greater accountability might oblige him to intensify his efforts to find some other solution.

7. In further discussion it was suggested that the problem of possible disintermediation should not be exaggerated; if the cash ratio were to be extended across the whole banking system, and converted into a daily minimum, that minimum would not exceed ¾ per cent of eligible liabilities. There was no evidence from BIS statistics of any rapid growth in disintermediation through the Euro-markets, following the abolition of exchange control.

8. The Chancellor emphasised the need for him to be able to say something in his Budget speech about progress towards the changes in monetary control foreshadowed in his 24 November statement. The reserve asset ratio, the future arrangements for Prudential supervision, the way the discount market would operate and the cash ratio all formed part of the same picture;

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consultation on the first three was going on at Executive Director/General Manager level between the Bank of England and the banks; but the cash ratio was reserved for separate discussion between the Governor and the Chairmen of the banks. The Governor had indicated that he would be tackling the question of the Bank's income at Court on 19 February; Sir Douglas Wass undertook to find out from the Governor what progress had been made, in preparation for a further discussion between the Governor and the Chancellor early next week.

JW

A.J. WIGGINS
20 February 1981

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