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NOTE OF A MEETING HELD IN NO.11, DOWNING STREET AT 5.15 P.M. ON FRIDAY, 13 FEBRUARY 1981

Present:

Chancellor of the Exchequer (in the chair)
Chief Secretary
Sir Douglas Wass
Mr. Burns
Sir Kenneth Couzens
Mr. Ryrie
Mr. Middleton
Mr. Monck
Mr. Lavelle
Mr. Turnbull
Mr. Ridley

MONETARY AFFAIRS

Cash ratio

The Chancellor emphasised the urgency of his making progress with the Governor on the cash ratio issue on 17 February. Mr. Middleton suggested that the only arrangement likely to be feasible within the time available would be a minimum cash ratio applicable to the banking system as a whole; this could be presented as consistent with non-mandatory monetary base control (with a wide definition of the monetary base). Sir Douglas Wass noted that the non-clearers would then have a substantial incentive to take offshore deposits and to disintermediate in other ways. It would be argued that, unlike the clearers, they received no benefit through the provision of the clearing from their cash holdings with the Bank of England.

Policy for short-term interest rates

2. The discussion was based on Mr. Monck's submission of 12 February.

3. The Chancellor noted that as well as the basic question how short-term interest rates were to be set, there remained also some technical questions about the width of the interest rate band within

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which short-term rates would be allowed to fluctuate under the new system. Mr. Middleton suggested that a relatively narrow range could be set initially, and then be widened later.

4. On the main issue, Mr. Middleton thought (a) of the four courses distinguished in Mr. Monck's paragraph 6 would not be compatible with the maintenance of a £M3 target. But it was questionable whether it would be possible to stick firmly to an unqualified target for one or other of the narrower aggregates. Although M_0 and M_1 had behaved reasonably well over the last year, and had met the target set for £M3, there was now a prospect of M1 growth of 13 per cent in 1981-82. Thus course (a) in an unqualified form would mean higher interest rates.

5. The Chancellor thought the alternative courses were perhaps too exclusively defined. Courses (c) and (d) sounded like alternative presentations of the Bank's view. It was suggested in discussion that course (d) was not after all very tightly defined; it suggested only a presumption, and not a rigid rule, for setting interest rates, and the circumstances which might justify exceptions would not be published. It was noted, however, that this course still left the question whether or not there were already circumstances which would justify interest rates being set other than in the light of movements in the monetary aggregates, or - to put the matter a different way - what the trigger level for the exchange rate would be.

6. Sir Douglas Wass and Sir Kenneth Couzens suggested it might be better to stick pretty close to course (a), although explanations would need to be provided for the experience during the last year, and some qualifications might be needed. If this course were not followed, and some clear significance were attributed to the exchange rate, then it was likely that a monetary target would have to be abandoned. This then raised the question about the extent to which movements in the exchange and inflation rates would be seen as justifying changes in interest rates. Decisions on

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trade-offs in this area would need to take into account the balance between fiscal and monetary policy.

7. Mr. Middleton doubted whether the monetary target for 1981-82 set in the MTFS could now be maintained; on the other hand, only reference to the movement in the exchange rate provided a reason not to increase interest rates. It was noted in further discussion that there were two alternative formulations of the role of the exchange rate in determining short-term interest rates:-

(i) Interest rates would be set with a given exchange rate objective. If this were the case, however, further interest rate reductions would be required if the exchange rate objective were not achieved, and this would present insuperable problems for monetary control.

(ii) Interest rates could be set in the light of the level of the exchange rate, without any pre-determined objective for the exchange rate. This would imply that the authorities were confident that sufficient downward pressure was being exerted on the inflation rate to permit some relaxation of monetary objectives, and it would give industry the benefit of lower interest rates even though there might be no impact on the exchange rate.

It was noted that in practice it might prove more difficult to distinguish between the two approaches; and it would still be necessary to decide at what point a switch would be made back from allowing more prominence to the exchange rate to operating by reference to a monetary target. Mr. Burns suggested that the normal relationship between £M3 and inflation should reassert itself in the medium term, as the real exchange rate adjusted either through the domestic price level or through the nominal exchange rate.

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8. The Chancellor, concluding the discussion, said that £M3 seemed likely to remain the best guide to policy in the medium term, and that it should retain primacy in the presentation of monetary policy. Nevertheless it was clear that other factors would also need to be taken into account, although exactly how this should be done could not be specified precisely in advance. He invited Mr. Middleton to prepare a further paper on interest rate policy for discussion with the Prime Minister on 18 February.

JW

A.J. WIGGINS
18 February 1981

Distribution:-

Those present
Financial Secretary
Mr. Britton