

NOTE OF A MEETING

MONETARY AFFAIRS

The Governor of the Bank of England called on the Chancellor at No.11 Downing Street on Thursday, 7 May 1981 at 8.45 a.m. Sir Douglas Wass was also present.

2. The Governor began by commenting on recent exchange rate movements. During the period since the beginning of March sterling had weakened against the dollar from \$2.24 to \$2.1170, but at the same time had strengthened against the DM from 4.70 to 4.78. Much of this movement was in response to the recent hardening of US interest rates. Overall the sterling rate against the dollar had come down some 14 per cent from its high point last November (\$2.46), and by about 7 per cent in effective terms from its January 1981 high (from 105.6 to 98.8). Relative interest rates now showed a strikingly different picture from a year ago; in May 1980 UK three-month rates were over 17 per cent, while US rates were less than 10 per cent and Swiss rates as low as 6 per cent, but now UK rates were about 12½ per cent against US rates of 17½ per cent and French and German rates of 13½ per cent or more. A comparison of ten-year bond rates showed the UK at 14.3 per cent (an increase from 13½ per cent on 6 April), while the US were at 14.6 per cent, France at 13½ per cent, and Germany at 10 per cent. Given the difference in inflation rates the present German real interest rates clearly had to be regarded as exceptionally high.

3. On UK interest rates, the Governor noted that the Chancellor's Budget strategy was to make a large reduction in the PSBR in order to facilitate lower interest rates. This strategy had been well received in the financial markets, and the question now arose whether

/the authorities could

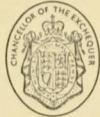


the authorities could go beyond the 2 per cent reduction in MLR which had been judged the maximum feasible in the context of the Budget itself. A further reduction would give a useful, if modest, measure of help towards reducing industrial costs, and if it led to a small fall in the exchange rate that too could be regarded as helpful despite some adverse implications for the monetary target and the rate of inflation. On the other hand, the impact on the exchange rate could well be more substantial - particularly if people thought the reduction in MLR indicated some weakening in the Government's resolve to pursue the counter-inflationary strategy.

4. The Governor thought the monetary figures for the time being were "not too bad". \pounds M3 had grown at an annual rate of 11½ per cent from November 1980 to April 1981; if an adjustment were made to allow for the effects of the Civil Service dispute, the underlying rate seemed to be about 8½ per cent. Of the counterparts to the growth of \pounds M3, the PSBR seemed "all right", but there were signs of a reacceleration in sterling lending to companies and persons, while the external adjustments were turning out negative. The overall picture seemed to be one of some worsening of the financial position of the company sector, while the greater amount of borrowing by the personal sector would be a cause for concern if it were to continue. At the same time the Governor noted that borrowing by the personal sector was tending to sustain the level of economic activity, and so contribute towards the signs now being seen of the beginnings of economic recovery.

5. The Governor said he had never felt that it would be easy to achieve the monetary target set by the Chancellor for 1981-82. A cut in MLR now could add to the difficulties. If the decision were taken nonetheless to make a reduction, it would need to be justified on general economic grounds, rather than by reference to any specifically monetary factors. The Governor, however, advised against any immediate move;

/this week's



this week's developments in the foreign exchange and gilts markets gave considerable further grounds for caution.

6. Sir Douglas Wass said that he generally shared the Governor's assessment of the situation, and he agreed that it would be undesirable to make any immediate move on MLR. He would not wish, however, to feel that the rather prolonged statistical "fog" which had arisen as a result of the Civil Service dispute should be regarded as ruling out some reduction indefinitely if other circumstances seemed propitious. If the Civil Service dispute was settled, and there were continuing favourable developments on inflation and the external position, then some reduction in MLR might be contemplated in June or July. Meanwhile there seemed to have been some reduction in pressure from the company sector for lower interest rates; the UK was, after all, now a relatively low interest rate country. The Governor said he would propose further reductions in interest rates as soon as he thought it prudent to do so; he remained extremely concerned about the health and profitability of the company sector.

7. The Governor noted that interest rate/exchange rate issues would dominate next week's meeting up in Basle of central bank governors. There was an increasing feeling among central bankers that a situation in which the US authorities pursued a monetary policy set exclusively by reference to domestic objectives, and did nothing to damp down movements in exchange rates, was difficult for the rest of the world to accept, given the key role paid by the dollar in international monetary relations. He would report further to the Chancellor on these issues following the Basle meeting.

8. The Governor left with the Chancellor a paper assessing the possibility of an early cut in MLR, a copy of which is attached to this note.

Distribution:

CST	Mr Middleton
FST	Mr Lavelle
SIR D Wass	Mr Monck
Mr Burns	Mr Turnbull
Sir K Couzens	Mr Ridley
Mr Ryrie	PS/Governor

JW

A J WIGGINS

8 May 1981

did they take place?

THE GOVERNOR

YOUR MEETING WITH THE CHANCELLOR: 8.45 AM, 7 MAY

You may wish to mention the following topics:

- 1 The latest money figures (notes by GEAK of 5 May).
- 2 Interest rates (JCRD's note of 6 May, which you may wish to leave with the Chancellor). The recent course of US interest rates is of course relevant.
- 3 Progress with Monetary Control: Next Steps (JSFF's note of 1 May). *MC Doss*
- 4 Suggested abandonment of MLR (JSFF's note of 27 April). [It is almost certainly premature to discuss this with the Chancellor yet, but you may wish to have it at the back of your mind.]
- 5 You may wish to refer to the Chancellor's Mais Lecture, to be delivered on 12 May. - *Gov did not attend - copy spec-OSA*
- 6 PQ on Mullens' Commission (EAJG's note of 6 May). - *G.E.*
- 7 Legal powers over taxation of UK banks. (Wass's letter of 28 April referred to this. You may like to be aware of WPC's note of 6 May, which has not, however, been discussed within the Bank yet.)
- 8 Saint Piran and self-regulation (JQH's notes of 1 May, 29 April and 27 April). - *pps on T/S*
- 9 The future of the No 3 Escrow Account (RPW's note of 6 May). - *pps on T/S*
- 10 Relations with the Treasury - your proposed dinner with Wass et al. *April 29 & 81*
- 11 The Chancellor asked for a presentation case in which to keep his £50 note - one is enclosed.

7 May 1981

A J Wiggins Esq
Principal Private Secretary
to the Chancellor of the Exchequer
HM Treasury
Parliament Street
SW1P 3AG

(Dear John,)

I enclose a copy of the paper which was mentioned by the Governor at his meeting with the Chancellor this morning.

(Yours sincerely,)

(Sgd) Stephen Collins

S P Collins
Assistant Private Secretary
to the Governor

THE POSSIBILITY OF AN EARLY CUT IN MLR

1 This note considers the possibility of a cut in Minimum Lending Rate. It deals first with the reasons for which such a move might be thought desirable; and then looks at the case from the point of view of monetary policy and probable market reaction. It considers only the possibility of a 1% cut in MLR, and not a larger move.

Why reconsider the case for a cut in MLR?

2 The general strategy of the Budget was to make large increases in taxation in order to contain the PSBR and open the way to lower interest rates within the constraints of the MTFS. In view of the uncertainties as to how the Budget would be received in financial markets, it was wise to limit the reduction in interest rates to a 2% cut in MLR. In the event the Budget was well received, large debt sales were made, and a lower level of MLR might thus appear a possibility worth considering.

3 The background for wanting lower interest rates within the framework of the monetary target remains that seen at the time of the Budget - that the recession has hit industry particularly hard, while the consumer, largely as a result of the high exchange rate, has so far benefitted. Even though there are many reports of a better mood in industry, and some flattening out of the recession, there could be a case for a further reduction of interest rates in order to shift more of the burden from industry.

4 The direct relief to industry from a reduction in interest payments paid would necessarily be fairly small but not insignificant - perhaps immediately £350 mn. equivalent to somewhat under 1/4% of capital employed. The psychological impact would also be important.

5 A cut in MLR would probably also have some effect on the exchange rate - as anticipation of the March cut appeared to do before the Budget. The effective rate then dropped by over 5% below its end-January peak and has since remained roughly at that lower level, and at about the level ruling in December last year. That was judged at the time, and can still be regarded as, a very high exchange rate from the point of view of firms engaged in export. A small further fall in the exchange rate could therefore be considered a worthwhile additional relief to that part of industry, even though it would also entail some adverse effect on retail prices and perhaps on monetary control.

6 It is not possible to say how much the exchange rate would respond to a cut in MLR. But the sensitivity of the market may be increasing so that even a 1% cut in MLR might now have an effect comparable to last March's cut of 2%. Changes in UK interest rates last year did not have noticeable effect on the exchange rate. But US interest rates are now higher; and this impact might be somewhat larger. In addition, there might be some possibility of a substantial effect if a reduction in MLR in present circumstances were taken as indicating some weakening in the Government's firmness of monetary control, or its stand against inflation.

Considerations of Monetary Policy

7 Underlying monetary trends are not too unfavourable. They are likely to be greatly distorted by the effects of the dispute with the Civil Service unions. This is likely to produce very high numbers for the PSBR and thus for the growth of £M3. Even though commentators will allow for these abnormal effects, the market is unlikely to discount them completely.

8 The growth of £M3 slowed down in the three months to mid-March to 10% at an annual rate - a relative undistorted figure. (This figure is based on old seasonal adjustments; new ones, to be published with the April figure, will probably suggest slightly slower growth in this period - but will enlarge the April number). Preliminary estimates suggest that underlying growth in April - i.e. excluding the effects of the Civil Service dispute - was perhaps much the same; and in the next few months underlying growth could well continue at about this rate. In the three months to March, some other aggregates

grew faster than EM3 - including total M3 - reflecting holdings of foreign currency deposits - other aggregates grew more slowly - but the April figures could change these relative rankings. It should be noted also that there are signs that bank lending may have passed its low point and be rising again; and, if some economic recovery is indeed now in prospect, firms may at some stage well find their borrowing needs increasing further.

9 The general conclusion suggested is therefore that monetary trends do not provide good justification for a further cut in MLR at present; and that if the chief criterion were achievement of the declared monetary target a cut in MLR should not be made.

Questions of timing

10 As a result of the Civil Service pay dispute, statistics of the government finances and the banking system will be heavily distorted by the interruption of flows of tax revenue to the Exchequer. It can be argued that whereas a cut in MLR would be possible now, before we have gone far into this statistical fog, it will be more difficult later till the end of the period of statistical ignorance. There is undoubtedly something in the argument. But we are already within full view of these conditions, so that if the distortion of the money numbers is going to be taken as alarming, it will already appear imprudent to act in disregard of them.

11 There are more general points relating to market confidence. There is at present no wide expectation of such a move, nor therefore acceptance of its justification. A cut in MLR now might then appear in some degree a weakening of resolve. If so, it could accelerate the effect on the exchange market and damage sentiment in the gilt-edged market. The appearance of weakness might also be increased by its timing in relation to the Civil Service dispute. How wise it was might moreover be judged in retrospect very much in relation to the outcome of the dispute. An outcome to it which was successful from the point of view of the Government might thus be the more favourable moment to make a cut in MLR; whereas an

unsuccessful outcome might make it difficult to do then. The possibility of the latter might make a move appear unwise till the outcome was clear.

Conclusions

This note does not attempt definitive conclusions from these arguments, which are difficult to weigh up. But two points emerge: first as to the nature of the arguments for a cut in MLR; and second, as to its timing.

- The first point is that at the moment monetary trends do not provide grounds for a downward move; and if a move was made now it would be necessary to accept a likelihood that the monetary target would be exceeded. A cut in MLR could of course still be held to be required on more general grounds, as was perhaps the case with the previous recent reductions in MLR.

- The second conclusion is that, even if the non-monetary case were accepted, general considerations relating to market and political reactions to a cut in MLR create a certain preference in favour of delaying any decision on MLR till after the outcome of the Civil Service dispute is known and the statistical confusions caused by it had begun to clear.