Distribution
Financial Secretary
Sir Douglas Wass
Sir Kenneth Couzens
Mr. Ryrie
Mr. Middleton
Mr. Britton
Mr. Lavelle

Mr. Monck
Mr. Ridley
PS/Governor of the Bank of England

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MONETARY AFFAIRS

The Governor of the Bank of England called on the Chancellor at 11, Downing Street on Tuesday, 17 February, 1981 at 8.45 a.m. Sir Douglas Wass was also present.

2. The discussion began with a survey of the present situation on exchange rates and interest rate relativities. There had been some criticism at the European Community Finance Ministers' Meeting on 16 February of erratic dollar interest rates, and fears were expressed that the US fiscal package might prove inadequate. It was noted that some German move to strengthen the DM might be made on 19 February. Meanwhile it now appeared that European Finance Ministers were becoming relatively more worried about trends in output and unemployment, and somewhat less concerned about inflation. It was noted that the detailed pattern of recent changes in exchange rates was not particularly favourable for the UK; the strengthening of the dollar tended to increase the prices of essential UK imports of raw materials, while sterling had strengthened markedly against European currencies, so adding to the difficulties UK manufacturers faced in their main export market. It was questionable now how much further it would be desirable for sterling to fall against the dollar; substantial depreciation would have serious adverse implications for inflation. All these developments added a further level of complexity to decisions on UK interest rates.

Income of the Bank of England

3. The Governor said he had concluded that changing the timing of payments from the Issue Department to the Treasury would not provide a solution to the difficulties. He was therefore thinking in terms of extending the requirement to hold cash balances with the Bank of England to cover the banking system as a whole. The present arrangement whereby the requirement was confined to the clearers was inequitable; but there was a risk in extending

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it of creating a new inducement to "disintermediation". He was looking for the best formula to reconcile these conflicting considerations; he had had one discussion in the Committee of Treasury, and was expecting to have further discussions in that Committee and in the Court later this week. He noted that it would be hard for the Bank to continue to pay substantial dividends to the Treasury in the new situation; it would be very difficult for him to ask the banking system for money, a large part of which was then paid over to the Treasury.

4. The Chancellor emphasised the importance of his being able to say something about the future of the cash ratio in the course of his Budget Statement. The Governor drew attention to the peculiar importance of the issue for the Bank, to whose operations it was vital. It was essential to avoid getting the decision wrong; there was a high risk of criticism from many people who would argue that the changes were being made in pursuit of an unreal theoretical objective - monetary base control - when there was no established relationship between the monetary base and either other monetary aggregates or the inflation rate. On the details of the new arrangements the Governor confirmed that the Bank were studying the possibility of differential minimum requirements in respect of wholesale and retail bank deposits. He drew attention to the further difficulty in negotiating a replacement of the present cash ratio, given the contentious issues raised with the Accepting Houses on the eligibility of Bills, and with the clearing banks over the levy. In further discussion of the cash ratio and related issues, it was noted that a requirement to hold minimum balances with the Bank of England resulted in effect in a part of each bank's reserves being frozen and unusable; the Bank were looking for cosmetic ways of making the funds in question look more like "reserves". The Governor said that the Bank would wish to increase its own reserves, in order to assure the future security of its income, and reduce the extent to which that income depended on the maintenance of a voluntary agreement with the banking system. Sir Douglas Wass noted that further discussion would be required

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between the Bank and the Treasury on the future of the dividend; if it were found necessary to have a clear prior agreement, this would probably need to be reported to Parliament, although if future arrangements for the dividend were determined in the light of the Bank's operating results, it might be possible to avoid this. The Chancellor asked the Governor to let him have an urgent further report on the cash ratio and the question of the Bank's income following the meeting of the Court on 19 February.

Levy on the Banks

5. The Governor restated his view that the Government would be ill-advised to impose a levy, which would be seen as most undesirably retrospective in character. 3 per cent of non-interest-bearing deposits would moreover be far too much in relation to banks' profits and free reserves. If the Government felt they had to have a levy, they should not aim to raise more than £150 million. The banks would need to husband their resources if they were to provide a sufficient measure of support for manufacturing industry during the difficulties of the next year or two; a particular example was the case of ICL, where 3 of the 4 major clearing banks and Citibank were in effect being called upon to provide a safety net of £100 million to ensure that the business could be kept going until another company could be found either to merge with or take over ICL. The Governor thought it undesirable that the only enterprises "rescued" should be those in the public sector, and with Government money. The Chancellor said the Treasury were looking further at the rate of the levy in relation to bank profits and reserves; but in the present fiscal situation he could not easily let go of any promising source of revenue.

JW

(A.J. WIGGINS)
17 February 1981