MEMORANDUM OF CONVERSATION

PARTICIPANTS

United Kingdom:	Robin Leigh-Pemberton, Governor of the Bank of England David Walker, Executive Director, Bank of England Nigel Wicks, Embassy
Treasury:	Secretary Regan Deputy Secretary McNamar Dr. David Mulford Acting Assistant Secretary Hoguet Deputy Assistant Secretary Carter Mark Bender, Office of Financial Institutions Policy Helen Walsh, Recording officer

DATE AND LOCATION: February 3, 1984; in the Secretary's Conference Room

SUBJECTS: Reform of securities markets and financial institutions, exchange rate developments and intervention, U.S. budget, IMF legislation

DISTRIBUTION: Messrs. McNamar, Sprinkel, Mulford, Healey, Hoguet, Carter, Bender, Fauver, Ammerman, Newman, Springborn, Treasury Attache (London), EXEC SEC, OASIA SEC

MR. LEIGH-PEMBERTON said that the main purpose of his trip is to discuss the U.S. securities market. He explained that the on-going change in the U.K. securities exchange is amounting to opening a Pandora's box. SECRETARY REGAN advised the Governor not to fight change in the securities market, but rather to shape change. He prefaced his remarks by discussing his first-hand experience in this area (at Merrill Lynch, and then at Treasury), since the late 1960s. Back then, he was convinced that both the U.S. and U.K. securities markets would have to be reformed. At that time, he continued, Merrill Lynch was successful in breaking up the lucrative monopoly in the odd-lot business.

He added that although the financial community was horrified when Merrill Lynch decided to go public, that decision did not force a collapse of the securities exchange, and Merrill Lynch prospered very well. Since then, every major brokerage firm has also gone to the corporate form. In 1975, he continued, Merrill Lynch broke the cartel of fixed commissions, and now the stock exchange has more shares traded than before. He indicated that the scare stories that had been heard prior to changes in stock exchange regulations proved untrue -- no one is being defrauded and the U.S. Government is being helped.

SECRETARY REGAN recognized that the tricky issue in reform of financial institutions is deciding who should own whom, and who should perform which services. He noted that there are fences

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built around different functions, either by law or by precedence (e.g., banks are banks, brokerage firms are brokers), but argued that no such fences should be erected. He analogized the situation to the emergence of supermarkets, which made shopping easier and more efficient for consumers without jeopardizing the smaller specialty stores. He emphasized that even though people may be upset by changes in securities regulation, one cannot justify halting such change under our system of free competition.

SECRETARY REGAN addressed the issue of whether there could be dangers in deregulating a system to the point where a central bank might be impeded from performing its tasks. He said that he has often told Chairman Volcker that the Federal Reserve System acts too paternalistically towards its member banks, and that instead should try to establish rules and regulations. He related that Chairman Volcker has expressed concerns that deregulation of financial services would impede control of M1, but argued that if such an effect were true, then it would be a systems problem rather than a policy problem that cannot be overcome. He urged that banks should be allowed to enter into other services, provided they can be controlled.

GOVERNOR LEIGH-PEMBERTON thanked Secretary Regan for his views, and stated that they reflect the philosophy that HMG wishes to develop. The immediate change in the U.K. securities market would be the end of fixed commissions, he explained, which would bring an end to the distinction between brokers and jobbers, which in turn would improve investor security. SECRETARY REGAN voiced some skepticism that investor security would be improved with the introduction of negotiated commissions. GOVERNOR LEIGH-PEMBERTON asked Secretary Regan to explain the effects in the United States of the abolition of fixed commissions -- specifically, whether the market experienced a period of instability. SECRETARY REGAN responded that initially there was some cost cutting and confusion with the introduction of negotiated commissions, but within 60 days the market was back to normal.

MR. WALKER was concerned that HMG's attempts to develop a U.S. style market for government securities might bring about some conflicts of interest, and asked Secretary Regan for his views. SECRETARY REGAN answered that there are little dealings in the market with the U.S. Treasury as agents -- only in minor odd-lots has this occurred (less than 1 percent). The market has simply gone to the dealer.

MR. LEIGH-PEMBERTON explained the limits on membership in the U.K. stock exchange. He related that no firms are allowed to incorporate and sell shares, and there is a 29.9 percent limit on outside ownership of members. He indicated that the limit on outside ownership might soon be eliminated, as the change is not resistable. He also added that the Bank of England has been asked to become a member of the stock exchange. In response to SECRETARY REGAN's question regarding entry of U.S. banks in the U.K. stock exchange, GOVERNOR LEIGH-PEMBERTON replied that U.S. banks would be allowed entry, adding that they should help the market by introducing the extra capital needed. SECRETARY REGAN noted that the USG would

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appreciate it if HMG made entry possible only through a subsidiary company, rather than directly. GOVERNOR LEIGH-PEMBERTON said that HMG would like to keep the banking operations separate from the brokerage operation. MR. WALKER pointed out that banks may be required to have a separate entity to be formed with separate capitalization in order to be eligible. SECRETARY REGAN briefly discussed U.S. financial deregulation, and stressed that financial deregulation has not hurt financial services.

Turning to exchange rate developments, SECRETARY REGAN noted that the dollar had recently weakened, and asked whether the British viewed a declining dollar favorably. MR. LEIGH-PEMBERTON hesitated, answering that the British do want a lower dollar, but indicated that if pushed against the wall on the dollar question, he would be hard pressed to identify the harm of a high dollar to the U.K. economy. It has helped on exports, and oil prices denominated in sterling have increased.

In response to SECRETARY REGAN's question about how much capital the United Kingdom has lost, GOVERNOR LEIGH-PEMBERTON indicated that the British have lost some, but not a substantial amount of capital. MR. WICKS interjected that the capital has not been lost but, rather, profitably invested in the United States. The GOVERNOR said that it might be possible to reduce interest rates if the dollar declined. Equally, if the dollar starts to fall, there might be anxiety about how fast and how far it might fall. SECRETARY REGAN indicated the a weak dollar is not a panacea. Further, getting U.S. interest rates down might not cure all problems. It depends on how fast it takes.

Given the flow of capital and the likely current account deficit for the United States this year, MR. WALKER observed that depreciation of the dollar would require a slowdown in the rate of capital inflow. A rising inflow would be required to hold the dollar at its present level. SECRETARY REGAN saw no need to intervene to support the dollar should it decline from current levels, unless the markets are absolutely disorderly. For sterling to go to $1.50 or the DM to 2.2 DM/$, Treasury would not intervene. Thereafter, if the decline in the dollar persisted, or if it got out of control, Treasury would consider intervention. He added that in the event of intervention, Treasury would certainly be in touch with other governments.

GOVERNOR LEIGH-PEMBERTON stated a large part of the relative strengthening of U.K. competitiveness has been due to domestic developments, notably lower wages. SECRETARY REGAN commented on the U.S. Administration's strategy to reduce the budget deficit. He indicated that negotiations will be difficult, but if they result in a "downpayment," the deficit will be 4 percent of GNP next year; 3 percent by 1986; and below that for 1987. MR. LEIGH-PEMBERTON noted that U.K. budget deficits are also coming down.

MR. LEIGH-PEMBERTON asked if, given the election year, the Administration would be able to get a budget through Congress, or whether a continuing resolution would be required. SECRETARY REGAN said that if negotiations are good, then there will be a budget. MR. MCNAMAR added that one constraint is that there are only 57

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legislative days left in the fiscal year. SECRETARY REGAN mentioned that the Administration would try to get Senators Garn and Proxmire to push through their legislation on financial institutions, noting that in an election year, this type of legislation has better chances of passing, since it is not considered to be controversial.

In closing, SECRETARY REGAN introduced the Governor to Dr. David Mulford. He reiterated his belief that U.K. officials should allow change in financial regulations to occur, particularly those affecting the stock exchange. Change will help broaden the the market, make capital easier to raise, and debt easier to handle. MR. LEIGH-PEMBERTON asked whether the small investor has suffered as a result of changes in the U.S. stock market. SECRETARY REGAN indicated that 70-80 percent of the trading in stocks is by institutions; the rest is by individuals. 20-30 million shares are now traded in an average day. Before negotiated commissions, there were only 15-20 million shares traded each day.

DR. MULFORD noted that there is a wider range of investment opportunities available now for the smaller investor, with relatively small amounts of money required. He said there should be a flowering of opportunities for the small investor in the United Kingdom following stock exchange reform. The GOVERNOR agreed with MR. MCNAMAR that currently only limited financial services are provided by U.K. banks to small investors. In response to a question by DR. MULFORD, the GOVERNOR answered that the large U.K. banks are expected to become members of the U.K. stock exchange.

On a final note, GOVERNOR LEIGH-PEMBERTON congratulated the Secretary on passage of the IMF bill. SECRETARY REGAN indicated that ratifying the IMF quota increase was not a popular decision, nor was the U.S. decision on IDA, but it was all that the United States could afford.

Helen C. Walsh

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Approve

Approve as Amended

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