

CONFIDENTIAL

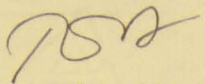
28.7.80

NOTE FOR RECORD

Copies to ✓  
The Deputy Governor  
Mr Fforde  
Mr Dow  
Mr Blunden  
Mr Page  
Mr Loehnis  
Mr Coleby  
Mr George  
Mr Goodhart

*He called*

The Governor will see the Chancellor to discuss monetary matters,  
at 5.30 pm on Wednesday, 30 July.

  
Governor's Office H0-P  
28 July 1980

T E Allen (4121)

THE GOVERNORS

Copies to Mr Fforde o/r  
Mr Dow  
Mr Page  
Mr Loehnis  
Mr Coleby  
Mr Goodhart  
Mr Sangster

THE GOVERNOR'S CALL ON THE CHANCELLOR: 30 JULY

The Governor has already seen the detail of the "first guess" at monetary growth in July based upon the weekly-reporting bank figures. This showed EM3 growth of 4 $\frac{3}{4}$ % (£2.8 billion) made up of:

- a low CGBR (£420 million seasonally adjusted);
- disappointing debt sales to non-banks (£380 million) in large part because of massive gilt purchases by the banking system (some £700 million ignoring our purchase/resale operations and excluding the LDMA);
- large bank lending to the "other public sector" (£500 million);
- quite massive bank lending to the private sector (£2.6 billion or £1.9 billion if the fall in the bill leak is taken into account);
- leaving DCE at £3.4 billion partially offset by a largish negative residual of £0.7 billion.

M1 rose by £1 billion (3.6%) bringing it closer to what might have been expected from the equation.

The still very early suggestion from the monthly figures is that the picture may not be quite as bad as this with EM3 growth of just below 4% (£2.3 billion) and bank lending of £2.3 billion (or, say, £1.6 billion after a larger - £760 million - adjustment for the decline in the bill leak.

Any assessment at this stage is highly uncertain with the figures themselves still shifting around and a dearth of information - which we might hope to fill to some small extent by the proposed bilateral discussions with the clearers and by information to come later this week, eg, on the sectoral breakdown of the clearers' lending - on what lies behind the figures. But a tentative broad view might be that -



2.8

- (i) of EM3 growth of around £2½ billion, £1½-2 billion can be explained by post corset activity, ie, £¾ billion of smaller bill leak - which adds to EM3 but not PSL 1; and perhaps £1 billion plus of bank take-up of public sector debt (£0.7 billion of gilts - excluding the LDMA and some part of the unusually large growth in lending to the "other public sector") - which as far as gilts are concerned adds to both EM3 and PSL 1;
- (ii) this would leave "normal" EM3 growth in the month of £½-1 billion, say, 1-2%, possibly nearer 1%, if the monthly-based EM3 figure is confirmed and the other public sector component proves to relate largely to lending to local authorities;
- (iii) this makes no allowance for reintermediation from the euro-£ market or from foreign currency transactions that may have been switched back into sterling;
- (iv) on this basis we can genuinely hope that the underlying July figure was not too bad BUT we will be pressed to persuade the markets of this AND - by looking at the fall in the bill leak alone, which is well short of the amount we might expect to come back (£2.7 billion outstanding in mid-June) - we must expect that there is further reintermediation to come. (There could also be further bank take-up of gilts, including calls on the partly-paid issues.)

We will need to look closely at presentation in the light of the proposed discussions with the clearers. But however successful we are in presenting the figures - and there is the difficulty that we will not be able to go into great detail on the counterparts when we present the preliminary EM3 figure next Tuesday - there is no doubt that they will come as a severe shock to the markets, abruptly extinguishing current hopes for a further cut in MLR in the next 2-3 months.

In the money market this may not be unhelpful to our operations, since it may enable our dealing rates to re-engage after next Tuesday and to buy paper outright. In the gilt-edged market I would - given an already jittery background - expect a very sharp adjustment, with the probability that the overseas traders and perhaps the banks and discount market will seek to unload loose holdings. We may need to provide some support. In terms of monetary control, however, the short-run implications are not unfavourable, given the technical position already established with future calls, although it will set back the prospect of a reopening of the company debenture market. The most difficult decisions may arise in the exchange market where we could need to intervene to keep control of a decline in the rate.

On the picture as envisaged above, it would seem to me premature to think in terms of more strategic policy reaction. There may well be a need for fiscal correction at some point but it seems unlikely, given HMT's somewhat relaxed stance at present, that a compelling need can be demonstrated before the autumn. The evidence on bank lending - bearing in mind that July may anyway have been a high month on the recent 3-monthly pattern - is insufficient to overturn the view we took at the time that MLR was brought down that the industrial position was likely in due course to bring a slow-down in bank lending. Nor is there yet evidence of a surge in lending to persons which might make a case for direct controls in that area which, if not palpably justified by the numbers, would suggest desperation and an unwillingness to face up to more serious corrective action. Certainly there is a case for tapping a wider debt market through sales directly to the personal sector; this exercise is already in hand though HMT may need to be persuaded of its urgency. This - and if the clearers' figures seem to justify it later in the week possible action on consumer lending - apart, I believe, on the present information, we need to sit tight.

29 July 1980

Typed from EAJG's manuscript  
and circulated unseen



THE GOVERNOR

*6/2-30/7*

Copy to the Deputy Governor

*- you will also recall that the Deputy Govt wrote to the Chancellor on the proper role of the intervention (copy at end of*

MEETING WITH THE CHANCELLOR: 5.30 PM  
30 JULY AT NO 11 DOWNING STREET

*(above)*

*JFB*

Clearly your session with the Chancellor this afternoon will be dominated by the figures for banking July and all their implications. You will perhaps wish to consider discussing with the Chancellor the suggestion from No 10 of a meeting soon (Lankester telephoned first last Wednesday). You may, however, wish to have at the back of your mind the following subjects:-

*attached*

- 1 Bank of England Annual Report and the Banking Act Report

You will recall that the Chancellor wrote to you about this yesterday. I do not know whether there is anything you would wish to say on the question of senior salaries.

*S.P.C.'s note*

- 2 Select Committee

*attached*

You may wish perhaps to take stock of the Committee's work so far following the recent appearances of yourself and the Chancellor. You will recall that we have been asked to put in a number of written answers.

- 3 NEDC Meeting on 6 August

You might perhaps wish to raise briefly next week's macroeconomic discussion.

- 4 Yugoslavia

Depending on this afternoon's meeting with the CLCB you may wish perhaps to say something to bring the Chancellor up to date.

5 Iran

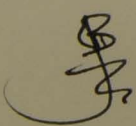
I do not know whether you would wish to say anything about the situation in Iran, given the likely deterioration politically.

It is possible that other matters (eg Turkey) may be worth a mention depending on this afternoon's meeting.

The folder contains the usual market briefing together with papers on the monetary situation.

Governor's Office H0-P  
30 July 1980

J S Beverly (4121)





SECRET

COPY FILED IN MP DOSSIER.

Copies to Re Deputy Governor

Mr Hoebner  
Mr Gease <sup>has already</sup>

rec'd 11 AUG 1980 5:00pm

Mr Cahaly  
Mr Sanson



NOTE OF A MEETING HELD AT NO.11 DOWNING STREET AT 5.30 P.M.  
ON WEDNESDAY 30 JULY 1980

Present: Chancellor of the Exchequer (In the Chair)  
Governor of the Bank of England  
Sir Douglas Wass  
Mr C W MacMahon

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MONETARY AFFAIRS

The Governor reported that the Bank were still looking for more information about monetary growth in banking July; further details should be available by the end of 1 August, but probably still not enough for the authorities to make as reliable judgements as they would wish. His meeting today with the Clearing Bank Chairmen had not produced any new information, although technical meetings had been arranged in the immediate future between Bank officials and the banks' Chief Executive Officers. Meanwhile the monetary figures were still changing. Essentially the picture was one of a low CGBR, not quite covered by gilt sales outside the banking system. It did not appear that the clearing banks were responsible for more than a relatively small part in the large increase in banks' holdings of gilts. It seems likely that there had been a substantial volume of bank lending to local authorities, which in effect represented a form of reintermediation, with the banks taking up local authority short-term paper previously sold by non-banks. The Governor found it hard to believe in a very large real underlying increase in bank lending; it would be an extraordinary coincidence for this to happen suddenly precisely at the end of the SSD scheme. It was also possible that the figures

/were inflated by



were inflated by the quarterly crediting of interest, where the seasonal adjustment with present very high interest rates might not be quite large enough. The very large change in banks' balance sheets in banking July provided some measure of the distorting effect of the corset continuing in force for a long period. There was a further puzzle about M1, where much of the 3½% increase had been non interest-bearing; on the other hand, although the July M1 figure was out of line with the experience of recent months (where the corset may well have had some impact), it was consistent with the bank's forecasting equation.

2. The Governor thought the latest figures suggested that although interest rates had been high, they had not been high enough in relation to the rate of increase in earnings which had actually been experienced. With hind-sight it was possible to say that MLR could with advantage have been pushed even higher in order to slow the rate of monetary growth, although if the short-term assistance to the financial markets were to have been avoided, MLR could well have needed to be over 20%. Notwithstanding the fact that the money figures had not been within the target range, policy had still borne very harshly on the corporate sector; and there would be the most serious difficulties for UK industry if interest rates had now to be increased in response to recent monetary developments. In further discussion the obstinate growth of private sector liquidity (on the alternative measures) was noted; this seemed likely to be a feature of a period in which there was a large and increasing personal sector financial surplus matching substantial financial deficits in the public and company sectors. It seemed likely that there had been a considerable increase in the savings ratio during the second quarter of 1980. Sir Douglas Wass suggested

/that in these





that in these circumstances, if corrective action were to be required, this should preferably take the form of a reduction in public sector purchases of services; it would be very difficult to increase taxes, while reductions in public sector purchases of goods would only add to the difficulties of industry.

3. The Financial Secretary asked whether there was any sign of a large increase in bank lending to the personal sector. If there were any such development, it would provide evidence that the corset had had some impact in reducing the real underlying volume of credit, and there would be a strong case for the authorities responding by imposing some form of control on consumer credit. It was noted, however, that there could be some difficulty in presenting the imposition of a fresh distortion as a response to the unwinding of the distortions which had led to the abandonment of the corset itself.

4. The Chancellor and the Governor felt that the best course would be for the authorities to explain the July figures as best they could in terms of the unwinding of distortions and as not signifying any appreciable change in underlying conditions. The extent to which such explanations would carry conviction would depend on the further work to be done during the next few days. Any steps which demonstrated the Government's firm intention to keep public expenditure under control (particularly in the defence field) would be helpful; and in the slightly longer run it would be sensible to explore the scope for securing further funds through National Savings during the late summer and early autumn when the gilts market was likely to be relatively inactive. Although this could mean stronger competition by the Government with the Building Societies,

/there were now signs



there were now signs that the societies had more than enough funds to lend, given the extent of demand for funds in present economic circumstances and at present levels of interest rates. It was further suggested that the beneficial effect on the monetary aggregates of a larger flow into national savings could in due course be reflected in lower interest rates, so setting in motion a virtuous circle.

5. The Governor thought the market response to the first announcement of the July figures on 5 August could well involve a sharp set-back in the gilts market and a significant fall in the exchange rate. It was noted, however, that if the response to the figures suggested that short-term interest rates would have to rise, there could be some countervailing upward pressure on the exchange rate, so that the net immediate impact of monetary developments could not now be predicted with any certainty. It was agreed that, since there had been relatively little intervention by the authorities while the exchange rate had been rising, there should equally be only modest intervention as the rate fell back.

#### CONCLUSIONS

6. The Chancellor confirmed that he would wish to avoid any immediate response to the July figures, either by way of fiscal action or through an increase in MLR. The exchange rate should continue to be determined by market forces. The authorities would provide the best explanation they could of the July figures, drawing attention to all the exceptional features, and at the same time emphasising the firmness of their control over public expenditure and their determination to stick to the monetary strategy. If the position could be held during the week beginning 4 August, without market reactions

/developing which





developing which required some response from the authorities, it would then be necessary to review the situation very fully in early September, in the light of the August money figures. Meanwhile it would be useful to see as soon as possible drafts of the guidance to be given by the Bank in interpreting the July eligible liabilities figures, and the briefing to be provided for Prime Minister's questions on 5 August. If at all possible, first drafts of this material should be available by Friday evening, 1 August.

JW

A J WIGGINS  
31 July 1980

Distribution:

- Private Secretary/Financial Secretary
- Sir Douglas Wass
- Mr Ryrie
- Mr Middleton o/r
- Mr Bridgeman
- Mr Ridley
- Private Secretary/Governor

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