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9

Summary Record of a Meeting held at 10 Downing Street at
1800 hours on 3 September 1980

Present:

Prime Minister
Chancellor of the Exchequer
Governor of the Bank of England
Financial Secretary to the Treasury
Mr. T. Burns)
Mr. P. Middleton) HM Treasury
Miss P. Brown)
Mr. C. Goodhart, Bank of England
Mr. David Wolfson
Mr. Michael Pattison

The Prime Minister said that she had talked to a number of bankers in Switzerland during her holiday. They were unimpressed with our monetary control. She had been told that British money supply was out of control, that her strategy was right, but that it was not being properly operated. She returned home to learn of the disastrous banking figures due to be announced on 9 September. It seemed to her that the Bank of England was functioning as a lender of first resort, not last resort. The clearing banks did not seem to be deeply attached to the Government strategy. Indeed, they were shovelling money out. The stability of MLR had made it too easy for the banks to lend freely. The international banking community realised that British money supply was out of control, and this would become more obvious with the announcement of the following week's figures. The Government must begin to take steps to get back in control before the announcement. Public expenditure also seemed to be out of control, and she was dissatisfied with the available estimates of the shape of the PSBR. She was not seeking explanations, but prescriptions for action. Money supply had been running at 15-16% growth since February, without taking account of re-intermediation. Bank lending had been at £0.8 - 0.9 bn per month, and the CGBR was £2 bn for banking August. She was determined to see both money supply and public expenditure back under control. She expected to be told that this would involve increased interest rates. She was

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SECRET

SECRET

- 2 -

prepared for this, but did not accept that interest rates would stay up once raised.

The Chancellor said that the broad shape of the public expenditure figures had been known in the Treasury. The last detailed Treasury estimate had produced a figure of just over £9 bn for the year, and that figure might still hold. Since April, forecasts had been more or less met. There were major revenue variations: the next big return of VAT was due in October. There did seem to be a total shortfall to date of £0.5 bn from Customs and Excise (including VAT). The economic downturn might have caused this. But this was to some extent offset by increased PAYE receipts as incomes increased. PRT should produce £2.5 bn - the first £1 bn of which had been received this week. The remainder would come through in March. BNOC advance sales produced revenue late last year and would produce a further £600 m next March. The sale of assets was planned to produce £500 - 600 m late in the year. There could be some shortfall. At present, £500 m was anticipated from our EC Budget refund. An additional distortion was caused by heavy public corporation borrowing in this part of the year which would be recovered later from higher charges.

The October PSBR forecast was under preparation. Of the prospective overshoot about £200 m was directly attributed to the recession. The picture was not a cause for major alarm, with the exception of defence - where the spending profile still showed an overspend of £400 m over the revised cash limit.

In further discussion, the Prime Minister expressed her concern that borrowing forecasts always seemed to undershoot, not overshoot. The forecasting system and spending profiles would need to be much improved. If cash limits were successful at present, it was only because the limits themselves were too generous. The real issue was whether the Chancellor was in any position to say that the money supply was under control and that targets would be met. She wanted to see a detailed month by month spending profile. The Financial Secretary explained that monetary control was not exercised on a month by month basis. The quarterly return was the best available information.

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SECRET

The Chancellor said that his main worries were the levels of borrowing and spending by local authorities, and the EFLs of the nationalised industries. The Financial Secretary had been looking at the way in which Government effectively guaranteed local authority borrowing. This was an issue which needed tackling.

The Prime Minister said that she was far from convinced that the truth of the position was yet known. She wanted to see a clear statement of where matters now stood which needed to be updated month by month. Mr. Burns explained that the latest forecasting run would be completed at the end of September. The Prime Minister said that, whilst the Chancellor had pointed to policy issues under consideration for the future, some psychological levers would be needed for the following week's banking figures announcement. The Chancellor said that he recognised the need to give some shape to figures for the rest of the year and to maintain confidence in response to the figures on Tuesday. Some refining of control mechanisms was necessary. He saw no case for any fiscal changes, but was fully aware of the need to bear down hard on expenditure. The Governor said that £2 bn in gilts was due for redemption by the end of the year, so that £10.5 bn, with any necessary over-finance, had to be found in the market in the course of the year.

In later discussion, the Governor presented his prepared analysis of the economic situation. There was a marked inconsistency between what was happening in the real economy and the performance of the financial variables - PSBR and M3. M3 was developing as should be expected with a monetary squeeze, but real incomes remaining obstinately high. The Prime Minister said that this was not true of the public sector. The Governor stressed that he was particularly concerned with the private sector. The strength of the pound was the greatest diversion from the Chancellor's budgetary forecasts. The oil price rise played a considerable part in this, but the rises had now worked through and the rate was still strengthening. So the strong pound must be a reaction to monetary policy. The first sign of lax monetary policy was a weakening in a currency. But if money supply figures were bad, this offered prospects of high interest rates, and therefore sustained the strength of a currency. The

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- 4 -
SECRET

enormous strengthening of the pound was much more than anyone had expected. It was exercising a far more deflationary effect on the private sector than had been anticipated in setting the targets. The recession in output and employment was well under way, although it had taken longer than expected to take effect. From this point, there was a danger of a much greater acceleration than forecast. Even if PSBR and M3 were out of control, there were no indications in the real private sector economy to suggest a failure of policy, but the exchange rate was a major consequence of the Government's major monetary policy stance. Inflation prospects were now encouraging. RPI had peaked well below 23%. Over the last 3 months it was running at 11.3%. There was a similar sharp fall in wholesale price whilst the latest CBI survey forecast the smallest range of price increases for 12 years. Nor were there signs of lax money supply in asset prices - neither house nor land prices were running riot. The issue was what had gone wrong on the public sector side. The skew in the funding figures was much worse than expected. Gilts were about right, but other Government debt had yielded only £250 m, not the projected £1150 m. The £2 bn excess on PSBR gave a total of nearly £3 bn. With most of the planned £8.5 bn already used up, the Treasury had to persuade people that this would swing back to the £8½ - 9 bn range.

The Prime Minister intervened to argue that the real problem was the volume of money being pumped out by the banks. Some of it was being pressed on companies who were not even seeking extended facilities. The Governor responded that he was trying to show how the components of M3 differ from the forecast. He felt that the Prime Minister did not properly understand where the figures had gone over the top. The bank lending was only £800 m up for the period. The real dilemma was how bank lending could come down in the future. The corporate rate sector deficit was up perhaps £11 bn this year. In previous years the figure had been £6.7 bn and £5.6 bn. Companies were finding their liquid assets down, and were unwilling to raise capital (only £900 m so far this year). With this huge corporate sector deficit, the personal sector had bloomed. The funds had put their money in gilts, while others had put money in banks and building societies. The greatest proportion of bank lending was going to the corporate sector and to unincorporated businesses. He characterised it as a domestic OPEC situation. Money had to be recycled from the personal to the corporate sector.

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SECRET

The Prime Minister interjected that the banks were being allowed to print money for the corporate sector instead of collecting from the personal sector. The banks were not nearly selective enough. There was effectively no venture credit for small but sound businesses. She doubted whether the banks really understood what was happening. The Governor said that the major task was to get the balance right by a major attack on the personal savings sector. The Prime Minister said she felt that the centre-piece of Government strategy was being undermined by her own supporters. Mr. Goodhart said that the capital market was not functioning, and this had created a corporate squeeze. The choice was simple. Either the banks lent to industry or many more businesses would go bust. The Prime Minister said this confirmed comments from her Swiss friends that the Bank was simply unwilling to implement Government strategy.

The Chancellor said that the Bank was not simply brushing aside the targets. All institutions of Government are trying to fulfil the M3 target. Working back from the effects of reintermediation it seemed that M3 had been growing at 15 to 16 per cent all along. When he had assured the Select Committee that money supply was coming under control, he had had no idea of the scale of reintermediation, nor of the underlying picture. In retrospect the authorities might have been too eager to help the system on liquidity, because interest rates were thought to be too high. But if lending was restrained, it would reinforce the imbalance against the private sector. The Governor commented that if the Prime Minister were able to stop lending to the private sector, companies would seek to raise money overseas despite the exchange rate risk.

In the light of this discussion, the Prime Minister said that she would wish to see urgently a plan covering four points: how to get back to the 7 to 11 per cent monetary growth target, or how to revise the target; whether to return to a base interest rate set by the market; whether to use the ^{serv}reverse asset ratio to control lending in addition to its role as a measure of prudence; and how to carry to a conclusion the discussion on monetary base. The Chancellor explained that he was working on these topics, and would be ready to put proposals to her in the middle of October.

The Prime Minister felt strongly that she should herself see the clearing banks. The Chancellor counselled equally strongly against

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SECRET

- 6 -

doing so. The Prime Minister deferred the matter until she returned from her Scottish trip.

The Chancellor emphasised that these complex issues would have to be taken step by step but there were three pressing questions in relation to the 9 September figures. First, was a substantial rise in interest rates right? In view of the state of the real economy he had doubts about this. Either interest rates were having less effect on borrowing than expected, or larger variations in the rate were necessary to achieve the desired effect. Secondly, the question whether anything could be achieved through funding policy to get interest rates down. One useful but small element would be an extension of the "Granny Bonds" principle through the population. He now had ready a plan to do this in two stages. It would require a dispensation on staff numbers by the Department of National Savings but the scheme could be implemented from mid-November. He might hope to raise about £1 bn. An announcement on 9 September might be appropriate. The Prime Minister was content in principle. The third issue was the one of pure presentation on 9 September. The Chancellor was working on this, and would have proposals ready for the Prime Minister on her return from Scotland. He confirmed that he would be available for television and the media in general on 9 September.

3 September 1980

SECRET