54/1

Copy filed in M.P. doss &
Copy filed in ER doss

SECRET

11.1.80

NOTE FOR RECORD

aware

Copies to: The Governor
The Deputy Governor
Mr.Fforde
Mr.McMahon
Mr.Dow
Mr.Blunden
The Chief Cashier

11/1

they met

The Governor will meet the Chancellor on Wednesday, 16th January at 10.15 a.m. in the Treasury. The Chancellor's Office indicated that the discussion would cover monetary policy, monetary base control and exchange rate policy. It was intended that the meeting should be between the Chancellor and the Governor alone. I also gathered that the Chancellor would be having his own meeting with officials some time beforehand.

MP DOSS

P.W.F.Ironmonger (4122),
Governors' Office.

11th January 1980.

SECRET 15. 1.80

See 17 / 1 80

THE GOVERNOR has seen.

JB Meeringhead 16/1

MEETING WITH THE CHANCELLOR: 11.30 A.M. 16TH JANUARY

The Chancellor's Office informed us that this meeting was to cover monetary policy, monetary (base) control and exchange rate policy.

You might find it helpful, however, to bear in mind the following additional points:-

1. Markets - the usual briefing is attached.
2. Membership of the Court - draft letter to Lord Armstrong attached.
3. Burmah - a copy of the Deputy Governor's note is attached.
4. City salaries - papers attached.
5. Iran
6. G5 meeting
7. Roosa meeting - note attached.
8. Membership of the NEDC and the reconstitution of the Roll Committee.
9. Select Committee on the Treasury.

J.S.Beverly (4121),
Governors' Office.

15th January 1980.

~~Lots~~. Lots of issues rolling at the Bank and

Open document   Bank — can't win them all.

Select Committee on Tsy.

Gilt-marketing efforts

— legitimately open question.

Tsy ~~supply~~ position = Burns — not persuaded
and not persuaded to
lower supply constraint

Not automatic vehicle

Joint paper by Bank / Tsy.

Basis of consultation. — open pattern

Auction system — acknowledge issue.

Move

~~St~~ Sporadic examination of rediscount

1. Consumer Credit Control — part of monetary policy
— ~~de~~ — ? tapping consumer credit.

1. Control
2. Tax

Scottish Banks — London Clearing Banks resulting into redundant monetary restraint

2. Bank profits   2 ½ 20 times what they were in 68

3 Banks ~~8/~~ Contrived to offset wage costs at same time.

One of mandate as Bank gauges

Nothing on 1979 — retrospective

Banks' something ~~with~~ competition — cutting charges

Secret   Mr Flemming BF

The Governor has seen JB 16/1

Copy to G.P.S.

You asked me to note the gist of the points made to me by Littler, ahead of your meeting with the C/E today :-

1. On the draft Consultative Document, the C/E was reported to be much more receptive to the view that 'monetary base control' was not in practice going to yield very much — though it might still yield something worthwhile. The heart of the matter would still lie with the PSBR, short-term rates, gilt-market management, and patience.

2. Some interest was shown in Indexation. H.F officials & Lawson are reportedly becoming 'pragmatic' on this question. The views of the Bank may be sought. ?? a possible runner for Budget time. [Pl see my note of yesterday]

3. The question of EMS, and short-run conflicts with an 'automatic' domestic interest-rate mechanism, was well 'taken on board' in the Consultative Context. HMT wants to push EMS well into the future. FCO does not. What is the view of the Bank?

4. The C/E may want to discuss the external outlook, & prospects for sterling, over the next few months (ie. up to the Budget)

5. The C/E will wish to run over the current domestic monetary situation & prospects; and our ideas for new stock issues.

JSF 17/1[9]   BF 16/1

SECRET

Copies to Mr McMahon
Mr Fforde
Mr Dow
The Chief Cashier
Mr George
Mr Goodhart
The Governor.

Received 6/2.
given I had requested
it from John Wiggins
JB 7/2

JB 11/2

NOTE OF A MEETING ON 16TH JANUARY 1980 AT 11.30 A.M. IN HM TREASURY

Present:-

The Chancellor of the Exchequer
Governor of the Bank of England
Sir Douglas Wass

MONETARY ISSUES

Current Position in the Money Market

The Governor commented on the continuing severe pressure in the money markets. There had been a very large shortage in the money market (of the order of £1,000m.) on 14th January, and there was another moderate shortage to-day. Over night rates were at 22 per cent and one week rates around 18 per cent, although further out rates were in the 16 - 17 per cent range and had fallen by up to 3/8th per cent in recent days. Very strong pressure in short term markets could put upward pressure on the exchange rate, which had risen by 1 per cent in recent days against the dollar and by 1½ per cent in effective rate terms. Sterling was now within about 2½ per cent both against the dollar and in terms of the effective rate of the peak reached in July 1979. Meanwhile the giltsmarket remained firm, with substantial take up of the 3 per cent 1984 stock, while equities continued to rise.

December Money Figures.

2. The Governor noted that M1 was unchanged in banking in December , which implied an increase of 8½ per cent at an annual rate since June 1979. Sterling M3 had increased by 0.4 per cent in banking December, or 11½ per cent at an annual rate since June. A large CGBR had been almost completely offset by

non-bank take-up of Government debt, while bank lending had been relatively low. However, the trend of bank lending was obscured by a number of special factors. The Governor further mentioned that the abolition of exchange control facilitated a greater degree of switching in and out over the make-up day, and this also had to be borne in mind in interpreting the figures. Over the last three months there had been a 5¼ per cent increase in advances to manufacturing, and a 5½ per cent increase in advances to persons. Of the total increase of £280 million in lending to persons, credit card lending was thought to account for not more than £75 million.

The Immediate Monetary Outlook

3. The Governor commented in general terms about the outlook for the three banking months January to March. There seemed at present a fair prospect of an actual contraction in the Sterling M3 in banking ~~in~~ January, followed by a 1 - 2 per cent increase in February and a small increase in March. If these expectations, which depended on very uncertain assumptions about bank lending and about future non-bank take-up of Government debt, as well as on external factors continuing to exert a contractionary influence, were realised, then the increase in Sterling M3 at an annual rate since June 1979 would remain within the 8 - 9½ per cent range during this period. The banking system would continue to be under tight reserve asset pressure, and in practice it was unlikely that the special deposits recently released could be recalled on the present schedule. In order to achieve this relatively favourable outlook, the Governor thought it important to keep up the momentum of gilt sales, and suggested that it would be as well to achieve a smaller increase in Sterling M3 in banking ~~in~~ February than had so far been achieved, since this figure would be the latest available at the time of the budget. The fact that, once the corset was removed, re-intermediation was likely to add about 3 per cent to Sterling M3 was a further reason for maintaining the momentum of funding into 1980-81. The trend in bank lending remained

rather

uncertain: there had been some signs of acceleration in the course of banking in January, although more recent fragmentary evidence suggested that the peak might now have been passed. For the immediate future the Bank were thinking of new short and long stocks, with at least substantial part payments in banking February which might be of the order of £1.1 billion. Detailed proposals would be put to the Financial Secretary later this week.

External Aspects of Monetary Policy

4. The Governor commented on the difficulty of forecasting the exchange rate. The Steel strike and deteriorating UK industrial competitiveness were both bear factors, while the oil situation and international uncertainties were at present tending to strengthen sterling. For the time being the UK was not losing much by remaining outside the EMS; 20 per cent of UK reserves were being assigned to the EMCF, with which we were fully associated. However, the Governor thought we should need to clear our minds soon on the direction and objectives of the European Fund; were we ready to move from co-operation on monetary matters to the surrender of some element of financial sovereignty? Would the Fund develop into the beginning of a European Central Bank, or into an institution more like the IMF? It appeared that the Germans were not yet ready to consider jumping the hurdle, although the French had been making more favourable noises about such a step.

5. The Chancellor saw the broad political arguments in favour of the UK joining the EMS; we wanted to avoid looking grudging and reluctant to the Eight. The Governor thought it undesirable for the UK to be separated from Europe on monetary issues and pushed towards the United States, who in the last resort would take no notice of UK views and interests. Nevertheless, despite the longer run advantages of closer monetary alignment with Europe, it was agreed that present currency instabilities associated with the oil situation meant that it would be better

ACTION:
Mr.Bridgeman
Mr.Hanock
Mr.Middleton

for sterling to remain outside the EMS for the time being. Sir Douglas Wass noted that there might be advantage in a UK move to join EMS once the issue of the UK contribution to the EEC budget had been settled; it would, therefore, be sensible to look again now at the implications of such a step.

The Consultative Document

6. The Governor referred to the particular difficulty in the consultative document relating to the treatment of the EMS and exchange rate policy. If single minded pursuit of monetary targets required a completely freely floating exchange rate, this, in effect, implied a decision not to join EMS. The Chancellor emphasised the the importance of producing as soon as possible a consultative document which left all issues genuinely "open"; he wanted to avoid any suggestion that any issues, whether of monetary base control or the management of the gilt edged market had already been settled. Similarly, the consultative document should not raise expectations of substantial benefits from major changes. A discussion of monetary base control should be the centre-piece of the document; but it should start with an introductory description of the overall monetary picture which could be offered to the Select Committee of the Treasury.

7. The Governor cautioned against attaching too much importance to monetary base control. He thought the mention of a precise quantative control had been shown to be unworkable; in practise, cash always had to be supplied to the system, and the only question was on what terms. Monetary base control would not solve the problem of how you get the price of money to a level which restrains demand. Sir Douglas Wass said that, although he was not wholly persuaded, his views had been moving in the direction of those expressed by the Governor. The Chancellor commented that we still

had to form a judgement

whether monetary base control would help the authorities to live with their problems a little more easily, even though it would not solve them. Decisions were also required on the arrangements for the consultations; the Treasury would want to be involved intimately in the discussions with the financial institutions and others concerned. The consultative document would, after all, be jointly prepared by the Treasury and the Bank, and would need to be presented to Parliament under cover of a prefatory note by himself. Some close Treasury involvement with the consultations was, therefore, essential. The Governor foresaw certain difficulties in the Treasury involvement with the consultations, but accepted that they would have to be confronted.

Management of the Gilts Market

8. The Governor accepted that, although the consultative document would not include any extended discussion of the gilts market management issues, these issues could not be regarded as closed. For his part he ~~saw~~ could see the argument that the auction technique might afford ~~as~~ a means of stabilising the flow of sales of gilt edged stock; but such a move would not help to secure a pattern of gilt sales which would offset a fluctuating central Government borrowing requirement. Moreover, reliance on the auction technique would have substantial implications for the structure of the gilts market, and in particular for the position of the jobbers. He thought it important that changes should be avoided which would put in jeopardy the continuance of the momentum of funding achieved in recent years.

9. The Chancellor asked about the relevance of indexed stocks to debt management. Should the authorities be moving towards issuing such stocks? The Governor saw three groups of questions associated with indexation:

(i) Questions about the mechanics of the sales of such stocks, and the real interest rates which would need to be paid in relation to real interest rates on conventional stocks.

(ii) The implications for other borrowers and lenders of the Government issuing indexed stocks.

(iii) The implications for the economy generally if indexation were to spread very widely.

The Governor questioned whether it would be right to give any particular group in the economy preferential access to assets with guaranteed real values. Sir Douglas Wass mentioned that a Treasury study of these wider questions was currently in progress.

10. The Chancellor commented that, abstracting from these wider issues, there was a case for an immediate study of the practical aspects of issuing an indexed stock. The question whether or not to do this would not be an appropriate one for the public debate on the consultative document; rather it should be regarded as an operational question for decision at the appropriate time. The Governor noted that much conventional Government stock had recently been sold at apparently negative real rates of interest, and that it was impossible to predict what the required real rates of return on indexed stocks would be as they emerged from the auctions. It was by no means impossible that in the long run indexed stock would be more disadvantageous to Government than conventional issues. In addition to the various implications for financial markets, there were fiscal aspects of indexed stock which needed thorough examination, and it would be important to bring together the work currently under way in the Bank and the Treasury.

Consumer Credit

11. The Chancellor referred to the difficulty of justifying the maintenance of very high interest rates for industrial and housing borrowers, when these high interest rates were seen as in part made necessary by the absence of any restraint on the volume of consumer credit lending. He accepted that this was essentially a political point, and that it had little real substance; but the absence of any control on consumer credit might prove a real obstacle to the securing of adequate reductions in public expenditure. In the long run there might be some scope for taxing consumer credit borrowers; but it would seem sensible if, in the meanwhile, a package of restraints on consumer lending, and, in particular, on the use of credit cards, could be put together for use if necessary. It was noteworthy that the Scottish Clearing Banks had recently complained that their London counterparts were making no real effort to observe the Bank's directional guidance which urged banks to show restraint in making loans to consumers.

12. It was recognised in discussion that in sophisticated financial markets it was unlikely that restraint applied to one segment only which would, in practice, prove effective; and it was doubtful whether there were adequate powers to maintain any sort of effective control over the whole range of consumer credit. The Governor agreed that price was a blunt (non-selective) instrument; but in the UK financial markets, other instruments did not work. Nevertheless he agreed that further consideration should be given to the preparation of a package of restraints on consumer credit, which could help to make the Government's restraint on public expenditure more acceptable.

rather 'accepted without commitment'

Bank Profits

13. The Chancellor accepted that the arguments were conclusive against a

retrospective tax on bank profits. However, the size of the 1979 bank profits declared in 1980 would undoubtedly be a serious political problem, and the Government might need to look at the possibility of some sort of a once for all surcharge on 1980 profits. The banks could help by focussing more attention on inflation-adjusted profits, which would be much smaller than historic cost profits, and by avoiding sharp increases in transaction charges at a time when the actual profits were going rapidly for other reasons. Meanwhile, every opportunity should be taken to discourage the banks from conceding inflationary wage increases; Sir Douglas Wass would take this up with the Chairman of the Midland Bank later this week, and the Governor would speak similarly to the Chairmen concerned as appropriate opportunities offered.

Wider use of the Banking System

14. The Chancellor referred to the need to promote the wider use of the banking system with wages paid monthly by cheque/bank transfer rather than weekly in cash. Useful administrative savings might be achieved by the Government if social security payments were treated in the same way. This subject would best be pursued through NEDC.

NEDC

15. The Governor said he would be willing to serve as a member of the Council if the Chancellor wished, although he would like to be able, on occasion, to send the Deputy in his place. He suggested that the questions of his membership and the future membership of Lord Roll should be kept separate. It was noted that the Prime Minister would need to be consulted about the Governor's membership, following further consultations Sir Douglas Wass would have with the CBI and TUC.

DISTRIBUTION:

JW

Financial Secretary
Sir Douglas Wass
Mr Ryrie
Mr Littler
Mr Bridgeman
Mr Hancock
Mr Middleton
Mrs Gilmore
Mr Riley

A. J. WIGGINS
17th January, 1980