S E C R E T

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CH/EX. REF. NO. A07NB(79)

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NOTE OF A MEETING HELD IN THE TREASURY AT 4.30 P.M. ON WEDNESDAY, 7TH NOVEMBER, 1979

Copies to The Deputy Governor
Mr. Flemde
Mr. Dow

Present:

Chancellor of the Exchequer
Chief Secretary
Financial Secretary
Sir Douglas Wass
Sir Lawrence Airey
Sir Kenneth Couzens
Mr. Middleton
Mr. Bridgeman
Mr. Unwin

Governor of the Bank of England
Mr. McMahon
Mr. Page
Mr. Goodhart

MONETARY SITUATION

The meeting resumed the discussion which had taken place at 10.45 a.m. on Monday, 5th November in a smaller group.

General Situation

2. The following main elements in the monetary situation were acknowledged in the course of a general discussion of the short-term outlook:

(a) PSBR This had deteriorated. The central forecast was now for a PSBR for 1979/80 around £9¼ billion compared with the £8.3 billion estimate at the time of the Budget. Although the best central estimate, some thought the risk of exceeding that figure greater than that of falling short. The latest NIF range was £9-9½ billion. The unadjusted CGBR for end of December could be as high as £9 billion, on the optimistic assumption that the current VAT shortfall is by then recouped.

(b) Bank lending could well not fall from its present high level until some time into the New Year, depending on the onset of the recession. The level of bank lending had dropped from the £1100/£1200 million a month in the summer to somewhere around £800 million currently; but this was still some way from the £600 million figure earlier forecast. With the present buoyancy of incomes bank lending might even increase slightly in the initial stages of the downturn.

(c) Money Supply. At more than 14 per cent the annualised rate was running well above the target range, and was not expected to come below 13 per cent on present policies by the end of January; allowing for disintermediation this latter figure might well represent a true underlying growth of 17 per cent. In forecasting the short-term outlook it was assumed that short and long interest rates would remain at about their present level, with MLR rising to validate the present market rate structure. With inflationary expectations, the outlook for 1980/81 was not encouraging, but would depend on the Budget.

(d) Causes of the deterioration. On the one hand, it was argued that underlying economic conditions had not changed greatly in recent weeks, and that current figures simply reflected better information. The PSBR deterioration reflected changes over a wide front: higher local authority and public corporation borrowing; slower accrual of revenues; and reduced expectation of public expenditure shortfall. On the other hand, internationally economic activity was holding up longer than expected; inflationary pressures had increased; and overseas interest rates had risen sharply. Whatever the extent of changes in the underlying factors the risks in the present situation had increased.

Timing Considerations

3. The Chancellor asked how long decisions on the SSD scheme and the roll-over of monetary targets could be prudently delayed. The Chief Cashier thought that the clearers needed to know the future of the corset at latest by end November, since by the November makeup day they would need to be looking forward also to the January make-up. There was also an expectation that the Government would roll-forward the monetary targets within the same timescale, though this was theoretically the most detachable part of the package. A 15th November announcement, when the October money supply figures were published, was the obvious choice, though a further week's delay would not be serious.

4. The meeting noted that there were clear presentational advantages in associating an MLR change with a monetary package which included the roll-forward and an announcement about the future of the SSD scheme. Separation of the various elements risked loss of impact, and increased the risk of market uncertainty and the danger of further interest moves later. Against that, a week's delay was bound to involve its own risks. The Governor said that if action was taken this week, he would have to advise that MLR should move to 16 per cent. There was bound to be some risk that the figure would need to be higher in a week's time. This was not so much a direct consequence of not moving this week as the danger that some unforeseen piece of news might unsettle both the domestic and foreign exchange markets. Sterling was particularly vulnerable to some piece of unexpected news which

could reverse the temporary renewed strength of the pound because of Middle East oil developments. Nevertheless, the strength of sterling helped to justify waiting another week, though Mr. McMahon thought it might shade a little if MLR was not increased the following day.

Funding

5. The Chancellor asked about the prospects for renewed funding once MLR had been increased. He and the Financial Secretary urged the Bank to examine all possibilities for getting gilts sales moving again. A policy of aggressive selling would be needed. The Governor said that funding prospects depended critically on reasserting market confidence in the Government's ability and determination to control the situation. The Chief Cashier said there was no way of selling gilts in present circumstances until some other decisive action was taken. However, even if MLR was delayed a further week, two weeks of banking November would still remain in which, if conditions were right, large amounts of gilts could be sold. The Bank had a fair amount of stock available. Very little long dated stock had been sold since September and the institutions were likely to be fairly liquid. The main counter-factor was the risk of growing market perception of the underlying PSBR situation. Publication of unseasonal CGBR figures on Friday could begin to spark such a perception.

Fiscal Action

6. A number of points were made:

(a) PRT. The Financial Secretary had gained the impression from BP that advancing payment of PRT might not be wholly out of the question in present circumstances; others, however, doubted the oil companies' readiness to accept further calls on their liquidity. BP might have been suggesting advancing PRT payment as a better alternative to forward sales of oil.

(b) Forward Oil Sales. Sir Lawrence Airey mentioned that proposed BNOC forward oil sales were £100 million less than the oil theoretically available for such treatment - £600 million as against intended sales of £500 million. Knowledge of this difference had been obtained in strict confidence, and he would not wish it to be disclosed.

(c) The Regulator. Any decision to use the regulator would need to be taken quickly if it were to catch Christmas sales. But, since there was no question of applying the regulator to VAT, the maximum additional yield this year was unlikely to exceed £300 million, rather less in terms of PSBR effect. This was not an attractive option.

More generally, the Prime Minister's opposition to anything which approached a second Budget seemed to rule out the possibility of any early effective fiscal action.

The SSD Scheme

7. Discussion recognised that there were serious weaknesses to the present SSD scheme, exacerbated by the ending of exchange control. It did not stop leakages through offshore banking. The logical case for bringing the scheme to an end was strong. Nevertheless, there was equal recognition of the presentational difficulty of removing existing controls, in advance of considering the possibilities of an alternative monetary base system. Both the Governor and Sir Douglas Wass felt that it would be right to continue the present imperfect system for a further unspecified period. Removal of the corset so soon after ending exchange controls would put an unacceptably heavy weight of control on interest rates alone. Sir Kenneth Couzens thought it would be better to avoid bringing the corset to an end at a time when the Government was having to take action on MLR to correct an already difficult monetary situation

Conclusions

8. The Chief Secretary, who had to leave shortly before the end of the meeting, was inclined to favour increasing MLR the following day, unless the presentational advantages of a complete monetary package the following week were judged to be decisive.

9. The Chancellor, summing up, said that the choice of timing was an extremely difficult one. Nevertheless, on balance, the general view seemed to be in favour of waiting a week before increasing MLR. In present market conditions, the recommended increase would be to 16 per cent. He recognised the risks involved in deferring action a further 7 days, but they had concluded that it was not practicable to contemplate announcing a total package the following day. That being so, given the present breathing space provided by the strengh of sterling, he judged that the presentational advantages of waiting a further week outweighed the additional risks involved. There was a presumption that the announcement on 15th November would also include continuation of the SSD scheme, together with the roll-forward of the monetary targets. Reluctantly, they had been forced to conclude that no appropriate fiscal action was available to be taken on a sufficient scale. Assuming that the Prime Minister agreed with this assessment, every effort should be made to try to find ways of influencing the monetary figures for banking-November, and of mounting a vigorous and effective funding programme over the coming weeks. A repeat of bad monetary figures in November would face the Government with a very serious situation. Lastly, the programme for considering a system of monetary base control should be accelerated with a view to starting the process of public consultation with the minimum of delay. A draft minute should be prepared so that he could inform the Prime Minister of their conclusions. that evening.

(A.M.W. BATTISHILL)
8th November, 1979

CHANCELLOR OF THE EXCHEQUER

<u>Circulation</u>

Those present

Mr. Littler

Mr. Ridley