

NOTE FOR RECORD

Copies to: Mr.Fforde
 Mr.Dow
 Mr.Page
 Mr.Loehnis
 Sir Henry Benson
 Mr.George
 Mr.Goodhart
 Mr.Walker
 GPS

7/3

The Governor saw the Chancellor this morning, Wass and I were present.

We started with some discussion about exchange markets and prospects for interest rates abroad. Wass confirmed, in the light of a meeting he had attended in Brussels on Monday, the impression the Governor gained in Basle that there was growing nervousness and tension about international interest rates and a feeling that the world might be tipped into a more serious recession than had hitherto been expected. The Governor commented that the Americans in particular, however, felt that this was probably necessary and might as well be got on with.

There was a brief discussion on EMS in the light of the Armstrong meeting. The Governor made the point that we had to work on the basis that we would join sometime but the Chancellor commented that not everybody was yet convinced that EMS would itself be permanent. Wass indicated to me privately that on the basis of a 6% band he might not be so antagonistic as he had previously been to UK entry. There was a reference in the end to the likelihood of a Prime Ministerial "seminar" next week. Schmidt is coming here on Friday, 28th March, the day before the Council.

On targetry the Chancellor confirmed that he was fully content with a February base, a 7-11% target and the abolition of the corset in June. However, as JSff had learned last night, he wanted to offset any appearance of laxity in choosing a February base by formally announcing that re-intermediation would have to be included within the target. We pointed out the difficulties this could cause if re-intermediation were substantial immediately

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after abolition: one might at worst have another six months without getting in the range. It was quickly agreed, however, that the Treasury and the Bank would get together to see if agreement could be reached on this question and a form of words produced for the Budget speech.

There was then some discussion on the bank profits. The Chancellor referred to continuing pressure on him not merely from the left but from his own party and from the bulk of the press to tax the present level of profits. He said he would have to say something about it in the Budget speech even if only to foreshadow the possibility that something would be done if interest rates went higher. (He said flatly that if they did go higher he believed it would be politically impossible to avoid a tax). To all this the Governor replied that these political pressures blew over in time and the important thing was to look at the real situation, i.e., adjustment for inflation and the need for the banks to have an adequate capital base. The Chancellor then handed over a memorandum prepared in the Treasury setting out two possible schemes for imposing a levy on the banks. The Governor promised we would look at this quickly and carry forward discussion with the Treasury with a view to producing at the very least a form of words for the Budget speech. [One omission from the discussion was any reference to the coming negotiations on pay: if there is to be a tax it would presumably be preferable to have it known before the wage settlement was reached rather than after.] Wass gave it as his view that he would prefer that the banks took action themselves in the form of paying interest on current accounts.

The Chancellor reported that the medium-term financial strategy had given rise to a very intelligent debate in Cabinet. All the worries, including those expressed by the Bank, had been aired but in the end and on balance it had been agreed to go forward.

There was finally some discussion over the future chairmanship of CFI.

Cwm

14th March 1980.

54/1



A good note, subject to the small amendment I have made on para 8.

NOTE OF A MEETING IN THE CHANCELLOR'S ROOM, HM TREASURY
ON FRIDAY 14 MARCH 1980 AT 9.45 AM

Present:

Chancellor of the Exchequer (in the Chair)
Governor of the Bank of England
Deputy Governor
Sir Douglas Wass

on 4/3 or
Copied to Deputy Governor
Mrifforde
Mr Row
Mr Rowden
Mr Page
Mr Boehme
Mr George
Mr Goodhart
Mr Coleby
Mr Walker

MONETARY AFFAIRS

External Developments

The Governor referred to the sharp upward movement in the dollar, which had been more marked against continental currencies than against sterling. This reflected expectations about the US anti-inflationary package, as well as continuing upward pressure on interest rates. The markets were expecting the US authorities to impose a substantial increase in the discount rate (perhaps as much as 2%), although the Chairman of the Federal Reserve was opposed to credit controls. If the President's package, when announced, satisfied or exceeded expectations, the interest rate differentials now established between dollar assets and those denominated in other currencies would be likely to result in further appreciation of the dollar. In the short run it seemed likely that the deutschemark, Swiss franc and yen would be more affected than sterling.

/2. The worries



2. The worries of the Italians and some of the small European countries about rapidly rising interest rates in the main financial centres were noted. In the case of Belgium a very high PSBR, corresponding to 10% of GDP, coupled with interest rate changes sufficient to maintain the position of the Belgian franc in the EMS had led to a real interest rate of 8%, and this was bound to have a very serious impact on the Belgian economy. In these circumstances there was some general fear of a downward spiral in economic activity; but the major countries seemed inclined to agree with the US view that it would be better to get this over quickly, and this was broadly the UK position.

3. The Governor mentioned the increasing emphasis placed in other countries on fiscal and other policies, rather than on monetary policy. Even Messrs Pechman and Okun were critical of the size of the US deficit, and the need for a cautious fiscal stance was a general theme. A further round of public expenditure reductions was awaited in Denmark, while the Dutch were talking about statutory wage and price controls. The Chancellor noted the importance of reducing unreal expectations in all industrial countries.

EMS

4. The Governor said the Bank had always been more favourably disposed towards EMS than the Treasury; given the importance of European Community solidarity and the fact of the existence of the EMS, he thought it inevitable that, sooner or later, the UK would have to join. The system had not produced as many tensions as might have been predicted, although the MCAs added a further dimension to the difficulties of securing currency realignments for the

/larger country



larger country members - and for this purpose sterling was a major currency. Mr McMahon agreed with this analysis, but thought the UK should delay going into EMS until there had been a significant fall in the sterling exchange rate.

Monetary target

5. It was generally agreed that the SSD scheme should come to an end in June, and that the new monetary target should be 7-11% on a February 1980 base. However, there was at any rate a difference of emphasis on the treatment of 'reintermediation' following the ending of the corset. The Governor said there was no way of measuring how much disintermediation there had been, or of predicting when or how far this would be reversed. If it were unwound rapidly, we could find ourselves annualising what were in effect step changes in the monetary aggregates, and this could result in monetary growth appearing to be outside the target range for several months at a time. Sir Douglas Wass wondered whether reintermediation would all happen at once; surely the market in acceptances would continue, and changes would come about only gradually? Moreover, the Government were bound to be asked whether or not the new target allowed for the effect of the ending of the corset; we could not simply leave this in the air. The Governor recognised the problem, and suggested that it be remitted for further discussion between Treasury and Bank officials, on the basis of the draft section of the Chancellor's Budget Speech submitted by Mr Bridgeman on 13 March. This was agreed.

/Bank profits

Bank profits

6. The Chancellor drew attention to the political pressure on the Government to take some action against the profits made by the banks and the oil companies. He was himself very disinclined to take any hasty action which was all too likely to prove ill-considered; but if interest rates had to move up further it could prove very difficult indeed to avoid taking some action. The Governor emphasised that, in forming a view about bank profits he was concerned only to assess the facts; he should not be regarded as in any sense the spokesman of the banks, although he had emphasised to them the importance of making the best presentation they could of the reasons and justification for their present profit levels. Inflation and very high interest rates helped banks to the extent that money piled up at the short end; but at the same time banks were particularly adversely affected by the impact of inflation on their capital base, since their assets were mostly denominated in fixed money terms.

7. Sir Douglas Wass said he would himself prefer the banks to solve the problem themselves by paying interest on current accounts rather than attempting to deal with it through fiscal means. The argument that the Government needed money and the banks had substantial amounts of it for the taking smelt strongly of the policy followed by Henry VIII. The Governor thought the problem would eventually go away if the authorities simply sat it out - and in any event analysis should be directed at real rather than nominal profits. However, he accepted that if real profits, actual and prospective, were shown to be on a sharp upward trend, then there could be a case for some action. But the difficulty would remain of determining a 'normal' level of profit by reference to which liability to any special levy or tax could be established. It would be necessary to take into account both nominal and real interest rate levels

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(and the impact of inflation on the real value of capital assets denominated in fixed money terms). The Minister of State (Lords)'s alternative suggestion that tax liability might be calculated by reference to the normal spread between deposit rates and banks' costs of operation, was noted.

8. The Chancellor emphasised again the importance of ensuring that the Government were in a position to make the most sensible response, if political pressures eventually required some action following further increases in interest rates. Meanwhile he could not avoid making some mention of bank profits in his Budget Speech. The Governor agreed that Bank officials would work together with their Treasury and Inland Revenue counterparts on possible ways of securing additional revenue from the banking system; and the Bank would consider further with the Treasury what sort of a reference the Chancellor might make in the Budget Speech to the question of bank profits.

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the paper handed
to him*

Chairmanship of Committee on Finance for Industry

9. The Governor once again urged the merits of Lord Croham as the best candidate for this post. He was a good chairman, he had the necessary political understanding, and he had enough free time. The City would provide the necessary technical expertise. Sir Douglas Wass remarked that Mr Murray would be content with this, as would Mr Chandler; but Sir John Methven had been worried about the appearance of a 'take over' - the Governor becoming a member of NEDC, Sir Jasper Hollom Chairman of the Take Over Panel, and now Lord Croham Chairman of the Committee on Finance for Industry. He had hoped that further discussion

/between

S E C R E T



between Mr Chandler and the Governor would identify a suitable private sector financial market expert. The Governor noted that the Committee had tended to run out of steam in recent months, but it had served a useful purpose in educating the TUC, and it would be better not to leave the Committee in limbo until after the publication of the Wilson Report. Sir Douglas Wass said he would take further soundings about the Chairmanship in the Group of Four; if Sir John Methven maintained his opposition to Lord Croham, the Chancellor would look to the Governor to find alternative names.

JW

(A.J. WIGGINS)
17th March, 1980

cc Financial Secretary
Sir Douglas Wass
Mr Ryrie
Mr Middleton
Mr Barratt
Mr Hancock
Mr Bridgeman
Mr Britton
Mrs Hedley-Miller
Mr Lavelle
PS/Governor of the Bank of England