

THE GOVERNOR

Copy to Mr. McMahon

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MEETING WITH THE CHANCELLOR
9.30 A.M. 22ND FEBRUARY
AT HMT

*— led. CWM accompanied
The Governor, JB 22/2*

It may be helpful for me to set out a list of the points that you may wish to cover with the Chancellor - some are perhaps somewhat marginal given the items at the top of the list. I attach relevant documents, as well as (at the front of the wallet) the usual market reports.

- (1) Banks' profits. *pps - safe*
- (2) The Budget. *pps - safe*
- (3) The medium term financial plan. *- pps - mc does*
- (4) The monetary targets and the corset.
- (5) The consultative document. *- pps - mc does*
- (6) The exchange rate - ?including EMS. *- Establishment of ERM - pps 7/5*
- (7) ?NEDC - the next meeting is on Wednesday, 5th March.
- (8) ?Your visit to Saudi Arabia and Kuwait.
- (9) ?The Prime Minister's meeting with Milton Friedman next Wednesday.
- (10) ?Building Societies.

J.S. Beverly (4121),
Governors' Office.
21st February 1980.

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Mr. Frisde
Mr. Dow
The Chief Cashier
Mr. Walker
Mr. Epsom

NOTE OF A MEETING HELD IN THE CHANCELLOR OF THE EXCHEQUER'S ROOM
HM TREASURY AT 9.30 A.M. ON FRIDAY, 22nd FEBRUARY 1980

Present:-

Chancellor of the Exchequer
Governor of the Bank of England
Sir Douglas Wass
Mr. MacMahon

Mr. George
(cum has his own copy) JB 26/2

MONETARY ISSUES

Bank Profits

? The Governor reported that he had seen the Chairmen and Chief Executive Officers of the main London clearers on two occasions, and that he had subsequently seen Sir Jeremy Morse separately. Sir Jeremy Morse had undertaken to give particular emphasis in the presentation of Lloyds' results to the CCA rather than the historic cost profits.

2. The Chancellor reiterated his concern about the behaviour of the Clearing Banks. There was widespread political worry about the size of their profits, which were all the more embarrassing given that the banks in practice paid no tax (although they showed tax accruals in their accounts). In discussion at Cabinet yesterday, the possibility of some kind of levy on windfall profits had been mentioned; although he had deliberately not commented on this himself, more would undoubtedly be heard of this proposal. The Governor emphasised the cyclical nature of banks profits, although this was less so now than formerly because of the growth of international business; moreover, bank profits were likely to increase at the time the rest of the economy turned down. Thus in 1973 profits had

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been very high because interest rates were high whilst GDP was growing rapidly; profits fell in 1974 as the economy turned down, and then fell further subsequently as interest rates fell. And unlike that of manufacturing industry, most of the banks' capital was tied up in claims denominated in money terms rather than in investment goods and stocks which might be expected to maintain their values in real terms; as a result the capital base of banks was particularly subject to erosion by inflation, with the result that substantial retentions were needed out of historic cost profits in order to maintain a constant capital base in real terms. Despite their high visibility, Banks' premises represented only a very small part of their total balance sheets. The Governor reiterated his opposition to any sort of windfall profits tax imposed on the banks.

3. The Chancellor observed that the intention of the authorities in increasing interest rates was certainly not to increase bank profits. The Governor saw great difficulty in determining what an appropriate benchmark level of interest rates would be, which could be used to determine the appropriate level of Bank profits - and would the Government contemplate offering special tax reliefs to Banks if interest rates fell below the reference level? He attached particular importance to the Banks maintaining adequate ratios of free capital to deposits. There was no question that the retentions from the 1979 profits would boost the capital ratios to unnecessarily high levels, although if there were several years of very large profits, it might be appropriate to reconsider the possibility of some action. Mr. MacMahon noted that Bank profits were generally expected to fall in 1980 as the growth in bank lending decelerated.

4. The Chancellor remained worried at the insensitivity of the banks to their public image. The increase recently made by Lloyds in money transmission charges was a case in point;



and more generally the banks seem to be making no serious effort to restrain their lending in line with the Government's objectives. Sir Douglas Wass said that he had received the same message from recent contacts with industrialists; only one (whose company was probably a questionable risk) reported any difficulty in raising bank finance. The Governor noted that personal sector borrowing, including that on credit cards, was probably falling; but company sector borrowing was probably being maintained at a high level as a result of involuntary stock building. The Chancellor asked whether the banks were not making the eventual adjustment even more difficult by continuing to lend in the present circumstances; in particular high bank lending was probably helping to sustain the continued trend of excessive pay settlements. He wondered whether it would be useful if he were to see the Clearing Bank Chairmen to emphasise his concern. The Governor suggested that there would be very great difficulties in manufacturing industry if the banks were now to try to cut back hard on overdraft facilities, etc. He expected the growth of bank lending to slow down fairly soon as companies found ways to reduce their stocks.

5. The Governor, returning to the subject of the level of bank profits, noted that the Clearing Banks had looked at the possibilities of establishing both profits equalisation reserves and capital protection. However, they had taken the view, supported by their professional advisers, that steps of this kind would be clearly seen to be presentational only and to achieve nothing in practice. The Governor thought the essential point to get across was that real profits (as under ED24, and adjusted for inflation) were very much smaller than historic cost profits in money terms. He hoped to be able to let the Treasury have later to-day some revised figures about the aggregate of Clearing Banks profits.



Foreign Exchange Markets and the Exchange Rate

6. The Chancellor noted that there now seemed to be less prospect that the US Embassy hostages would be quickly released, so that it might still be some time before the US unblocked Iranian funds. However, when this eventually happens, what contingency plans were being made for "re-entry" ? Would the UK be required to take part in some kind of a joint defence of the Dollar ? And how far should we be contemplating intervening in the meanwhile to hold down the Sterling/Dollar rate ? Mr. MacMahon said that he thought it more likely the Iranians would move their funds outside US Banks rather than out of the Dollar altogether. If they tried to realise all their Dollar holdings, they would shift the market sharply against themselves.
7. The Chancellor asked about recent signs of net additions to official sterling balances. The Governor and Mr. MacMahon confirmed that the Bank were continuing to press their customers not to add to their sterling balances, and to keep only working balances. At the end of December 1979 the sterling value of the official sterling balances was the same as at the beginning of 1977, although there had been some net increase in the last two months. The Bank were also trying to stop any build up of official sterling holdings masquerading as private funds. Nevertheless they accepted that the large increases now in prospect in the OPEC surpluses would add to the problem of restraining the total of official sterling balances. In reply to a question from the Chancellor, Mr. MacMahon confirmed that the agreement about the amounts of official sterling balances covered those held through the Euro markets as well as those held directly in the UK; but data about Euro balances tended to be late and incomplete.
8. The Governor said the exchange rate gave rise to two different sorts of problems for industrialists: uncertainty and variability added to their risks, while at the same time



they found great difficulty in adjusting quickly to the sharp appreciation in the rate in real terms. There was widespread complaint that the present level of the exchange rate was greatly helping competing imports, as well as discouraging UK exports; the US were at present particularly competitive. Mr. MacMahon noted that the level of the exchange rate was a natural result of the monetary policy followed by the Government, and that the reduction in inflationary pressures as a result of the appreciating exchange rate was one of the ways in which the Government's policy made its desired impact on inflation.

9. The Chancellor asked whether the Bank's operations in moderating upward movements of the exchange rate might not in themselves be aggravating the problems of an appreciating exchange rate and inflows adding to the money supply. If the Bank were seen to be intervening in market, would this not encourage market operators to try to purchase additional Sterling? The Governor said that recent City comment suggesting that there had been massive intervention which was associated with a substantial external component in the growth of the money supply was almost wholly misconceived; purchases of sterling by the Bank's customers broadly offset the foreign currency payments the Government had to make, while market intervention in both directions since the exchange rate peak in July 1979 netted out broadly at zero. There was no question, as market gossip sometimes suggested, that the Bank were trying to defend any particular exchange rate - that the rate had never gone far above \$2.30 was purely coincidental.

The Budget Judgment and the Monetary Target

10. The Governor mentioned that he was sending the Chancellor a general letter about the Budget judgment and the roll-over of the monetary target. He hoped there would be an opportunity



next week for an exchange of views about the broad Budget arithmetic, and some more detailed discussions later.

Medium Term Financial Strategy

11. The Governor was anxious to have an opportunity to contribute views and comments. The medium term financial strategy was of vital concern to the Bank, and he was surprised that the Prime Minister should have been shown a draft before the Bank had been fully consulted. For his part he had serious reservations about the credibility of the sort of document produced and about the wisdom of publishing it; he was particularly concerned that the Government should not adopt a posture of complete inflexibility about the monetary targets to be followed in each successive year. Changes in "monetary technology" could well require substantial revisions to the figures.

12. Sir Douglas Wass commented that the Governor had taken part in the discussion with outside "experts", and had seen the illustrative document prepared in the light of that discussion. Sir Douglas's view, like that of the Governor, had been that this earlier document would not have formed a suitable basis for a published medium term financial strategy; but the latest version had overcome a good many of the doubts. It had not been possible to produce the latest version, which the Governor had now seen, until the public expenditure decisions had been taken and the latest forecast was substantially complete. The Prime Minister's intention had been that the proposed publication of the medium-term financial strategy should be discussed at Cabinet on 6th March; it would be very helpful to have comments from the Bank as soon as possible with a view to a discussion perhaps on Wednesday afternoon next week.

Consultative Document on Monetary Base Control

13. The Governor noted that a draft of half the Consultative

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Document was now available, but that a good deal of work was still needed before this would be suitable for publication. He doubted whether the present Treasury draft had a sufficiently clear statement of a plan of monetary base control, and it also included a description of a mechanism for the automatic generation of interest rates which recent Government actions had shown would not be acceptable. The Chancellor emphasised the need to finalise the Consultative Document in the very near future; he had been pressed in Cabinet, in Parliament, at a meeting of Junior Ministers and at the 1922 Committee to get the document out well in advance of the Budget. If the Bank had detailed suggestions for changes in the material already produced, it was essential that the Treasury should have them in the very near future.

JW

A. J. WIGGINS
25th February 1980

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PS/Governor, Bank of England (2 copies)