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I passed JSFf's comments to Wiggins by 'phone 5/9

4.9.80

PS / Governor

8/9

NOTE OF A MEETING HELD AT NO.11 DOWNING STREET AT 9.30 A.M. ON WEDNESDAY 3 SEPTEMBER 1980

Copied to the Deputy Governor, Mr Dow, Mr Loehnis, Mr George, Mr Walker

Present:

Chancellor of the Exchequer (In the Chair)
Governor of the Bank of England
Copy to Mr J S Fforde 5/9.
Mr C A E Goodhart
Mr Middleton

MONETARY AFFAIRS

Monetary Situation

The Chancellor says he expected the Prime Minister, at her meeting on 3 September, to express concern about the apparent lack of control over the PSBR and Bank lending. She was clearly unhappy that the monetary situation seemed to have gone wrong, and would be looking for reassurance that the Treasury and the Bank had a grip on the situation.

2. The Governor began by surveying the situation in the Financial Markets. The markets were clearly inhibited by the fact that they no longer knew where they were on the map; the monetary statistics were undoubtedly in disarray, while the PSBR figures made it difficult for the authorities to carry conviction in arguing that the time profile of public sector borrowing was skewed to such an extent that the original forecast of £8½ billion for 1980/81 was likely to be realised. Against this background the gilts market had remained surprisingly strong, despite the July money figures and the prospect - as perceived by the market - of a further 3% increase in £M3 in August; there was even some possibility that the Bank might be called upon to respond to bids for Government stock in advance of the

/Eligible Liability

JSFf 5/9

Eligible Liability figures on 9 September. Meanwhile a decision was needed in the course of the day whether to roll over the gilts sale and repurchase facility maturing on 8 September; the amount in question was 1% of Eligible Liabilities, or £500 million. The natural course would be for the Bank to announce this at 3.30 p.m. on 3 September, but the announcement could be postponed if necessary until 10.00 a.m. on 4 September so as to give the Prime Minister an opportunity to express her views. The Bank's intention would be to present the roll-over in as low a key as possible.

3. The Governor commented on the divergence between developments in the "real economy" and in the financial markets. Undoubtedly this divergence made for presentational and political difficulties, given the Government's commitment to monetary targets. But he saw the present situation as promising better for the final objective of policy - a reduction in the inflation rate - than for the intermediate objective (the monetary aggregate). Although monetary growth had apparently been much faster than the authorities had intended, the economy nevertheless was exhibiting the symptoms of a tight monetary squeeze (as well as those of earnings having grown much too rapidly). There was no sign of monetary laxity, except perhaps that the PSBR remained too high; the Chancellor suggested that, allowing for the oddities of the time profile, there was no reason to think the PSBR wildly out of line as a proportion of GDP with what would be appropriate during a recession.

4. The Governor saw the behaviour of the exchange rate as a very clear indication of the tightness of monetary policy. Although upward pressures on the price of oil had for the time being disappeared, the exchange rate remained much higher than previously expected. Its present level was

about 25% higher

about 25% higher than had been forecast in the summer of 1979, and 5% higher than had been expected at the time of the 1980 Budget, and this meant that its deflationary effect was proving much sharper than had been envisaged at the time when the monetary target was set. Substantially because of the movement of the exchange rate the momentum of the recession now looked greater than had been forecast; consumption had been falling while stocks were running off, but the current account had been stronger than expected. Nevertheless - as had been emphasised in the sessions with the Treasury Committee - competitiveness was now estimated to be more than 50% worse than in the latter part of 1976.

5. The Governor saw output and employment as rather less buoyant than had previously been expected; but the prospects were better for lower inflation, because of the exchange rate and the competitive pressures on manufacturing industry. There had been a sharp deceleration in the RPI, with the three months to July showing an annualised rate of increase of only 11.3%. Although this picture was clouded by the prospect of further substantial price increases by the nationalised industries, and by the uncertainties surrounding the next wage round, the recent Lucas settlement had been a good sign. The Governor pointed to the particular importance of avoiding sharp increases in pay in the public sector and in those parts of the private sector producing non-tradable goods and services. The Chancellor endorsed the importance of pay restraint; an alternative way of looking at the prices picture described by the Governor was provided by the fact that "prices in the shops" had increased by only about 12% over the last year, while nationalised industry prices and rents had increased by about 25%. The fact that house and agricultural land prices were no longer pressing upwards was a further pointer towards slower inflation in the period ahead.

/So far as the

6. So far as the monetary picture was concerned, it was noted that the most significant divergence from the forecast had concerned the PSBR, which seemed likely to show an excess of £2 billion over the first half of 1980-81. It was not easy to disentagle how far this excess was the result of public spending not being sufficiently controlled, and how far it was simply the result of a deeper-than-expected recession. Particular uncertainty surrounded the borrowing by local authorities, and the prospects for that during the months immediately ahead. Against this background it would be hard to carry conviction that the PSBR would be held for 1980/81 as a whole to a figure near the forecast of £8½ billion. Representatives of industry were likely to criticise the Government for failing to control their own expenditure, and thus putting all the burden of adjustment on UK business. Gilt sales so far this year have been slightly better than forecast, although present uncertainties made the prospect of further early sales rather doubtful; on the other hand National Savings and Certificates of Tax Deposit had yielded less than previously forecast. [The growth] ~~Movements~~ in bank lending [had been running at 800/900 per month [illegible] in excess of forecast] ~~were broadly consistent with the forecast growth of £800-£900 million a month~~; this level of lending had continued despite the high PSBR, the improvement in the current account and the substantial de-stocking; on the other hand the recession was proving more severe, and it could still be some months before companies were able to contain the involuntary increase in their borrowing from the banks.

7. The Governor emphasised the importance of the very large company sector financial deficit (£11 billion in 1980/81, about £6 billion in 1981/82 and about £5½ billion in 1982/83, according to recent forecasts); the monthly company sector deficit was currently larger than the rate of monetary growth compatible

/with the present

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In addition to the contractual savings through life & pension funds

with the present target, while the banks were practically the only available source through which the deficit could be financed (capital issues during 1980-81 were currently expected to be less than 1 month's bank borrowing). The Governor saw great difficulty in trying to reduce the present rate of bank lending to industry - in the absence of any other way of financing the company sector deficit, the only result would be to increase interest rates and force more companies out of business. The present large public and company sector deficits were the obverse of a very large financial ~~sector~~ surplus in the personal sector, a large part of which was inevitably held in the form of savings deposits in banks and building societies; this being so the banks were playing an essential role in recycling the personal sector surplus back to the company sector (the Governor suggested a parallel between the behaviour of OPEC and that of the UK working population, with the banking system in each case recycling the surpluses created by high oil prices and high earnings). What was needed now was a means of ~~inducing~~ channeling more the personal sector's surplus to ~~lend~~ directly to companies, preferably at long maturities - in the absence of such a development "over-funding" of the public sector would have to continue, with the authorities lending the money back to the banking system for on-lending to companies.

8. It was noted that neither action in the fiscal field nor increases in interest rates were likely to be very effective in strengthening monetary control in the very short run. A move to monetary base control (MBC) could not be made very quickly, and even if it could an attempt to reduce monetary growth through it would only increase interest rates sharply. Companies, whose borrowing was largely involuntary, would not be able to reduce their drawings in response to higher interest rates. And if short term market rates were to be forced up, MLR would have to follow.

/In this situation

In this situation it was difficult to avoid operating in the short run as though the authorities were pursuing an interest rate objective. On reasonable assumptions about spreading back the reintermediation following the ending of the corset, it appeared that the underlying rate of monetary growth had been in the region of 15-16% throughout the last two years; there was some prospect of a deceleration over the next few months, with lower public sector borrowing and some fall of the company borrowing from the banks, although this latter prospect could not be relied on. Any attempt to reduce monetary growth by putting up interest rates was unlikely to have any significant impact on the wider monetary aggregates, while it would tend to make the problem of the exchange rate even worse. The only favourable indicator was £M1 which had fallen in real terms by about 10% over the last year - a much sharper contraction than in other industrial countries. Mr Goodhart commented that changes in £M3 were not reliably related to movements in the real economy; £M3 in recent years had been much influenced by structural shifts in the financial sector. In the UK M1 was currently behaving rather better, but the corresponding indicator had proved substantially misleading in the US and could not be relied on in the UK to give an adequate indication of the present situation or the immediate prospects for the economy.

9. Discussion then turned to the Government's policy stance. The Governor suggested that the £M3 excess would have somehow to be "disowned". If a new £M3 target were to be set, there would remain a risk that the authorities would again fail to meet it. On the other hand, if the £M3 target were to be "de-emphasised" there could still be difficulties with alternatives. Future movements in £M3 might in the event be much closer to the Government's target range without any further action on the part of the authorities; but for the time being it appeared

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/that we should have

This will relieve pressure on the gilt market & release institutional funds for real investment

in the Company Sector.

– mainly N Svgs –

that we should have rest heavily on a general assessment of movements in the real economy and of the way monetary forces were operating rather than on the current monetary figures. The Governor thought it important for the authorities to develop a sustained programme to attract a much larger share of the personal sector surplus directly into public sector debt - mainly national savings. The sooner some move could be announced in this field, the better. He suggested that further consideration be given to possible ways of restraining public expenditure, and in particular securing more effective control over local authority borrowing. Consideration would also be needed of the further scope for prudent reductions in interest rates which would help the company sector and reduce upward pressure on the exchange rate. The Governor thought the position of the exchange rate quite intolerable - if companies thought the rate would stay at or above $2.40 for any considerable time, there could be substantial further UK production cut-backs, as "unprofitable" exports were phased out. It was noted that a reduction in interest rates would be difficult to present against the background of the August figures; it would be preferable to look for action during the next few days on index-linked national savings, with further consideration given (if the position could be held for a few weeks) to the appropriate level of interest rates in the context of the roll-over of the monetary target in October.

10. The Chancellor pointed to the need for very careful briefing to be available with the Eligible Liability figures on 9 September. It might be appropriate for him to make some kind of statement setting out the authorities' diagnosis of the underlying rate of monetary growth, and emphasising the essential continuity of the Government's policy, either immediately on 9 September or shortly thereafter in response to market movements. The Chancellor emphasised the

/need for the

need for the authorities to improve their intelligence about market developments; we should do everything we could to avoid being surprised again about the extent to which gilts had been taken up by the Banks, to give the most striking recent example. The Governor said he would ~~be pursuing this~~ have the opportunity ~~question at a very~~ early meeting with the Chairmen of the London Clearing Banks bizarre development, although he expected them to maintain that they were not doing anything unusual. Although "round-tripping" was disadvantageous to them, they found it very hard to determine how far drawings on overdraft facilities at any given time were occasioned by companies' desire to redeposit at higher interest rates. The Chancellor emphasised the need for the authorities to be absolutely sure the Banks were not seeking aggressively to expand their lending, if the present interest rate structure were to be maintained. The point was made that, with inflation falling, and company profits depressed, the real post-tax interest rates implied by present nominal rates were rising sharply.

11. On immediate monetary decisions, it was agreed that the roll-over of the gilts sale and repurchase arrangements due to expire on 8 September (1% of Eligible Liabilities, or £500 million) should be announced following the meeting with the Prime Minister in the afternoon of 3 September. It was noted that the problem of over funding/bank liquidity would continue as long as the monthly increase in bank lending to the private sector exceeded the acceptable monthly increase in £M3 (to the extent that non-residents sterling deposits - not in £M3 - increased, this constraint would, of course, be reduced). Meanwhile work should be pressed ahead very urgently with a view to the announcement in the course of next week of an expansion of index-linked national savings; it was noted that the Financial Secretary would be holding a further meeting with those concerned in the course of the day.

/Work should also

Work should also go ahead on an index-linked security restricted to certain institutions, but it was agreed that it would be difficult to introduce such an instrument in present monetary circumstances. A particular factor in the markets' response to the August figures was that, although an increase in £M3 of 3% was already expected, the CGBR figure would be higher and that for bank lending lower than the markets had been envisaging. (The £2 billion CGBR figure for August had nevertheless been expected by the authorities, and the Chancellor confirmed that the Treasury's latest projection for the PSBR for 1980/81 as a whole remained in the region of £9-9½ billion.) The Governor thought it important to achieve a further reduction in interest rates as soon as possible, and emphasised the increasing difficulties encountered by manufacturing industry; however the discussion suggested that it would be difficult to contemplate any initiative in this direction by the authorities until the September money figures were available and full consideration had been given to the way the Government's monetary target should be expressed in the context of the forthcoming roll-over.

12. On the issue of the appropriate technique of monetary control, it was agreed that there was no question of any early radical change. The consultations about monetary base control needed to be brought to a conclusion, while it would be desirable for the Bank's Cash Ratio Consultative Document to be issued as soon as possible (it was noted that a fresh draft ~~was~~ had been being sent to the Treasury at the end of August on 3 September). Although an argument could be mounted against the UK authorities for the way in which they had relieved liquidity pressures which would otherwise have produced increases in short term interest rates last Spring, parallels with the US situation were likely to prove misleading; US interest rates had fallen back as a result of a sharp collapse in consumer demand, and there was no sign of any such development in the UK. Meanwhile, pending decisions on future arrangements for monetary control, no steps

/should be taken

should be taken to abolish the present reserve assets ratio. Nor would it be appropriate for the authorities to take any initiative designed to hasten the break-up of the building societies' cartel and make them more competitive with each other - with the consequence of a further upward pressure on interest rates.

Conclusions

13. It was agreed that work should be pressed ahead urgently

i. on the preparation of material for use, whether in briefing or in a ministerial statement, on the occasion of the publication of the August Eligible Liability figures on 9 September. This would set out the authorities' analysis of the present underlying monetary situation, comment on recent experience and prospects for public sector borrowing during the current financial year, and reaffirm the Government's broad commitment to the monetary strategy set out in the MTFS;

ii. on the preparation of proposals designed to attract substantial additional funds into national savings (particularly index-linked instruments) for announcement during the week beginning 8 September.

JW

A J WIGGINS
4 September 1980

Distribution:

PS/Financial Secretary
Sir Douglas Wass
Mr Burns
Sir Kenneth Couzens
Mr Ryrie o/r
Mr Middleton
Mr Britton
Mr Monck
Mr Ryrie
Mr Ridley
PS/Governor

Subst copy 541/1
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Received 10/9 p.m.

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

5 September 1980

Para 8 in particular
[illegible] 11/9

Copies to the Deputy Governor
Mr Fforde
Mr Dow
Mr Loehnis
Mr Cooke
Mr George
Mr Goodhart
GPS

C. Whitmore, Esq.,
Private Secretary,
10, Downing Street

Dear Clive,

Mike Pattison's letter to me of 3 September reported the Prime Minister's discussion about monetary developments with the Chancellor and Governor, and asked for a further note about the handling of the banking figures to be announced on 9 September.

Accordingly we shall be sending over to you on Monday morning, 8 September the note on the August eligible liability figures and their presentation in relation to the Government's monetary strategy. Meanwhile the Prime Minister may like to have a note summarising the different pieces of work now being undertaken by the Treasury and the Bank on a number of topics which were discussed at her meeting on 3 September, together with an indication of the timing in each case.

I am sending a copy of this letter to Roger Mayes at the Bank of England.

Yours ever

John Wiggins

A.J. WIGGINS

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PN1 8/9 16

1. Statement

A draft statement to accompany the EL figures and the August CGBR figures on Tuesday 9 September. To contain:

a. an analysis of the effects of the corset.

b. prospect for lower monetary growth for the rest of the target period. Sticking to Medium Term Financial Strategy.

c. profile of the PSBR.

d. announcement of National Savings package: main item is increase in limits on and entitlement to indexed linked certificates. Also intention to raise indexed SAYE limit to £50 as soon as possible.

Timing: draft to Treasury Ministers by the weekend
to the Prime Minister by lunchtime Monday 8 September.

2. CGBR

Arrange to let the Prime Minister have the 3 month forward estimate of the Central Government Borrowing Requirement each month, with a breakdown between the revenue, expenditure and Public Corporations' and Local Authorities' borrowing elements.

Timing: preliminary report on September very quickly.
- first full 3 monthly forecast next month with the revised forecast for the PSBR - quarter by quarter.

3. PSBR

Prepare new forecast of PSBR for Prime Minister. To be done as part of next forecast. Mr Burns will ensure that detailed attention is given to the quarterly path.

Timing: forecast ready early October

Note to the Prime Minister as soon after that as possible.

4. The Target and the Medium Term Strategy

Target has to be rolled forward from mid-October. Some adjustments will have to be made to allow for reintermediation, post corset as forshadowed in Budget Speech. Announcement does not need to be made in mid October. But need to have clear idea of where we are going by, at the latest, before the Mansion House speech on 16 October.

Timing: preliminary work being undertaken by Treasury and Bank now to set out options, consistent with medium term strategy.

- numbers to be finalised in early October after September money supply figures and next forecast available.

5. Monetary Control

Present state of play: Question of whether to move to monetary base is being carried forward towards a conclusion:

a. written comments on Green Paper have been received from main institutions and a lot of discussion already taken place.

b. seminar arranged with analysts of all opinions (academic, City, institutions) at Church House on 29 September to discuss Green Paper.

c. 4 supplementary papers:

i. measurement of capital - non controversial Bank document. To be issued tomorrow in final form.

ii. foreign exchange positions: draft under discussion with the banking system.

iii. Prudential Liquidity Document out and an intense debate taking place with the banking system. The ultimate objective is that a liquidity "norm" should replace the reserve asset ratio.

These concern the prudential control of the banks under the Banking Act. There is also:

iv. the paper about a new form of cash ratio which was promised in the Monetary Control Green Paper. This Paper is essentially about the way in which the Bank raises its revenue by taxing the banking system and about the way in which it influences short-term interest rates. This paper thus covers both banking regulation and monetary policy/and should be ready for issue before the end of this month.

It is essential to ensure that none of these proposals would prejudge decisions about moving towards more effective methods of monetary control. Prudential questions can be settled after we consider our attitude to changes in monetary control.

Timing: - potentially big institutional changes involved so we should seek to ensure that if any change were to be made this should be done so far as possible in a staged way.

- By mid October should assess the position about monetary base and other alternatives to present arrangements, and possible timescales.

- Assessment would include identification of half way stages which would give more flexibility to interest rates.

6. Reserve Assets and Special Assistance to the Banks

A related issue to be sorted out. Papers with the Financial Secretary who will take forward the extensive and continuing work already done on this.

7. Other Funding Ideas

National Savings decided, but other methods of funding might take pressure off conventional gilts and long rates of interest. Extensive analysis so far done suggests that indexed gilts restricted to institutions are a hopeful possibility. The Financial Secretary will be carrying forward this work.

8. Market Intelligence

Governor urgently looking into this and assessing how the banking system is likely to develop, post corset.