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From the Private Secretary

14 October 1980

Dear Tom,

As you know, the Prime Minister held a meeting yesterday afternoon to discuss domestic monetary policy and control. The following were present: the Chancellor of the Exchequer, Chief Secretary, Financial Secretary, Sir Douglas Wass, Mr. Burns, Mr. Middleton; the Governor and Deputy Governor of the Bank of England, Mr. George and Mr. Goodhart; Sir Robert Armstrong, Mr. Ibbs, Mr. Hoskyns, Mr. Wolfson and Mr. Whitmore. They had before them a series of papers from the Treasury (listed in the Chancellor's minute of 10 October), and a paper from the Bank (which the Governor sent over under cover of his letter of 10 October).

Referring to the Bank's paper, the Governor first described recent monetary developments as he saw them. Recent developments gave rise to considerable anxiety. The underlying growth of £M3 after allowing for the unwinding of the corset had accelerated in the late spring and summer to well outside the target range. The reasons for this were, firstly, the very high PSBR - which had been running at an annual rate of about £15 billion in the first half of the financial year. This had proved beyond the authorities' funding capacity, even though gilt sales to domestic non-banks had been very substantial. The Bank had hoped that the high PSBR in the first few months would be offset by lower figures in the second half of the financial year so that the Budget forecast was achieved. But it now seemed likely that, even though there should be lower figures from now on, the PSBR for the year would turn out at about £10½ billion. Secondly, external factors had turned positive as the current account had moved into surplus. Thirdly, lending to the private sector had continued on a heavy scale - reflecting the size of the company sector deficit and the absence of alternative sources of finance.

On the other hand, there was some cause for comfort in that there was a reasonable prospect that the growth rate of underlying £M3 over the present target period would come back to around 12 per cent by next April. Furthermore, the markets had accepted the recent high figures relatively calmly. There was also a great deal of evidence that - despite the figures - monetary policy had been and remained very restrictive. This was reflected particularly in the high exchange rate, the improvement in inflation, and the decline in company profits and in output and in employment. Wage increases over the last pay round had not been validated by monetary

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expansion, and this was reflected in the large financial imbalances between the corporate and personal sectors. By the same token, one of the reasons why £M3 had over-shot was the intermediation by the banks between the corporate and personal sectors.

The Governor said that he drew the following lessons from this recent experience. First, it threw some doubt on the suitability of £M3 as the appropriate target. While it had advantages conceptually, it was very difficult to control in the short run. Alternative aggregates had their own drawbacks; but it would be desirable in future not to focus too much on the one aggregate. Secondly, attempts to control the money supply in the very short term were not only unlikely to work, but were also not of the essence of successful monetary control. Third, from the recent experience of the corset, he was deeply sceptical of the value of direct controls.

Turning to the immediate situation and prospect and the policy choices facing the Government, the Governor said there seemed to be very little room for manoeuvre. On the one hand, £M3 was likely to rise fairly rapidly up to the end of the calendar year - possibly by 2½ per cent in the final quarter; and the growth of £M3 would only come back to around 12 per cent by April if the PSBR was substantially lower than so far. For 1981/82, the PSBR was forecast at £11¼ billion and this meant that continuing moderate growth of £M3 would depend on a high level of debt sales, continued high interest rates, and lower lending to the private sector. On the other hand, the Bank's forecast for the real economy was extremely pessimistic - and more pessimistic than the Treasury's. The recession was likely to intensify and continue into 1982. Their forecast of unemployment - though inevitably uncertain - showed a rise to nearly 3 million by end 1982. Because of our industry's loss of competitiveness, recovery in the UK looked far less certain than in other countries. The Bank had just completed their latest review of the industrial situation. From this it appeared that the corporate deficit was not as large as it had been in 1974; but in contrast, it was likely to continue at a high level. Profitability was at an appallingly low level: although pre-tax rates of return had fallen in all countries, in the UK it was only about half of what it was elsewhere. The Prime Minister would want to hear the views of the Department of Industry; but in the Bank's view, while collapse was not imminent, there was likely to be a continuing slide. So far industrial closures had largely taken place where, because of inefficiency, they should be happening anyway. But there was now a dangerous over-hang in terms of short-time working, and a serious risk that well-managed capacity would start to close down. Admittedly, in some cases capacity was being taken over by new managers; but in other areas there was a danger that the UK would lose industrial capacity altogether.

All of this posed a difficult policy dilemma. The problem was to preserve the effectiveness of the monetary strategy at a time when there ought to be easing of the disproportionate burden being carried by industry. These countervailing considerations would have to be faced up to in deciding the £M3 roll-over (although an immediate decision was not required). From the standpoint of the anti-inflation strategy, it was clearly important to continue with a low target. At the same time, the target must be credible: there must be a conviction that the target could be achieved without imposing intolerable strains on the system. In his view, for the

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sake of the corporate sector, there would have to be some reduction in interest rates; but it was questionable whether this could be reconciled with sticking to the figures in the medium-term financial strategy (MTFS). The Bank's fear was that, with the corporate deficit in prospect, the pressure on bank lending would remain high; and in these circumstances, for the existing medium-term targets to be achieved could require even higher interest rates. It was because of continued borrowing pressure up to now that the Bank had felt obliged to ease the clearers' liquidity; otherwise, interest rates would certainly have risen further.

The Governor went on to say that in order to make the MTFS at all feasible while at the same time easing the pressure on the corporate sector, the following actions were desirable. First, the PSBR had to be reduced - though this would need to be done in ways which would not further hurt the private sector. The private sector would benefit especially if public expenditure could be held back by moderate pay settlements in the public sector. Secondly, there needed to be some switching of resources from the personal and financial and oil sectors to the manufacturing sector. For example, greater attempts should be made to encourage long-term company borrowing: in order to re-activate the corporate bond market, the Bank had suggested an interest rate subsidy. Thirdly, further measures should be taken to encourage private savings into Government debt. The recent extension of "Granny Bonds" was a useful start, but this needed to be followed up.

Finally, the Governor summarised very briefly the Bank's views on the monetary base control (MBC) proposals. While there were theoretical attractions in some of the proposals, no one could ignore the practical difficulty that - if MBC or a variant of it were to be introduced now - interest rates would undoubtedly have to rise. This would put further pressure on the exchange rate and add to the pressure on industry. It was hard to see how this would be an appropriate response to the present conjuncture. Indeed, if it was decided on industrial grounds that interest rates should be reduced, this could only be achieved by an administered reduction. The critics of the present system argued that the money supply could not be controlled unless interest rates went up. The Bank's response to them was that, provided the fiscal balance was right, the present system was capable of producing a satisfactory £M3 profile.

The Chancellor said that he agreed with the Governor's basic diagnosis of recent developments and the immediate prospect. He also understood the Governor's concern about the pressures on industry. The question the Government had to face was whether to relax the monetary strategy in order to provide some relief to industry, or whether this would simply increase inflation and postpone long term recovery. He agreed that there would be increasing pressure on the Government to reduce interest rates. But if even the 12 per cent forecast for monetary growth up to April 1981 was to be achieved, it was doubtful whether any

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reduction could be justified; or at any rate, there would be significant risks. It was also clear that fiscal action would be needed to bring down the PSBR in 1981/82 and to switch funds from the personal to the corporate sector. There would have to be further public expenditure cuts, and it was crucial that the pay element in expenditure should be kept down. On the revenue side, he was reviewing the North Sea tax regime and considering the possibilities for raising money from the personal sector - for example by increasing the employee national insurance contribution and the national health contribution. In addition, he was considering what could be done for the corporate sector - either by way of tax relief or by encouraging the reactivation of the bond market. Keeping to the existing monetary targets could also be eased by encouraging the sale of more debt direct to persons. The Chancellor said that he was also concerned about the effect of the exchange rate on industry. But short of intervention on a major scale, the exchange rate seemed more difficult to influence than any other variable. It was quite possible that a fall in interest rates would not have much effect. Moreover, the further Treasury work on inflow controls persuaded him that they were unlikely to have much effect either - though he would not rule out altogether some inflow control measure if only for presentational reasons.

As for monetary control, the Chancellor said that he would be hesitant about making the major institutional change to MBC at the present time but there were several changes which could, and should, be introduced to improve the present system - and which would be consistent with a move to MBC if it was eventually decided that that was our objective. The following steps were needed:-

(a) The PSBR needed to be smoother. The Treasury were urgently considering this.

(b) More debt needed to be sold direct to persons. This meant the extension of "Granny Bonds" and national savings. The Treasury were looking at all the possibilities, though there would be risks to the building societies and staff costs for the Department of National Savings.

(c) Work on the restricted indexed gilt should be pressed forward.

(d) New methods of marketing debt needed to be looked at. It was crucial to improve the present system so that the authorities could sell debt when they needed to, and so as to avoid having to make big changes in the price of gilts. It would be helpful if the Bank could produce early proposals for selling the desired quantity of debt as the need arises.

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(e) The Reserve Asset Ratio (RAR) should be abolished and, if considered desirable, replaced by something more appropriate. This was already an agreed recommendation in the Green Paper on monetary control; it was necessary now for the Bank to carry the recommendation forward. One of the advantages of abolishing the RAR would be that Treasury bills would lose their reserve asset status and this would increase the range of debt instruments available to be sold to the public.

(f) The Lender of Last Resort (LLR) function of the Bank needed to be modified. The present system did not engage the banks in curtailing the rate of monetary growth: on the contrary, they benefited from seeing their lending expand, and by in effect acting as "Lender of First Resort" the Bank were accommodating this. At least, the Bank ought urgently to consider ways of making the LLR function less as a matter of course.

The discussion which followed focussed on the monetary control issues. The Prime Minister said that the present system was plainly not working adequately and that it had to be improved. She was most concerned about the apparent loss of control of the monetary aggregates over the summer, which could put at risk the Government's anti-inflation strategy. She was keen to pursue each of the six proposals mentioned by the Chancellor. In view of the recent distortions caused by the corset, she also wondered whether our monetary statistics were adequate. The Chief Secretary commented that the fundamental problem was excessive spending and an excessive PSBR: he did not think changes in technique, however desirable, were likely to have much effect.

In response to the statistics point, it was noted the abolition of the corset would itself result in an improvement in the quality of the statistics: it was partly because the corset had so distorted £M3 figures that it had been abolished. But there would still remain the problem of Euro-sterling lending: the statistics for this were patchy and delayed. As regards the Chancellor's proposals, the following points were made:

(a) Smooth the PSBR. Achieving this would be by no means easy, but certain improvements could almost certainly be made. The Treasury Working Party would, if possible, produce a paper within a month.

(b) Selling more debt to persons. The most hopeful prospect was extending the "Granny Bond" to other age ranges. About £1½ billion was expected from the existing "Granny Bond"; if the further work was to be pushed ahead fast, additional funds could be secured for the current financial year. Commenting on the question of DNS staffing, the Prime Minister said that - if necessary - they would have to be provided with extra staff notwithstanding the Civil Service manpower cuts exercise. She also suggested that the banks should be encouraged to sell "Granny Bonds".

(c) Restricted Indexed Gilt. The proposal was to restrict this to the pension funds and possibly to the life offices. The Bank were working on a prospectus.

(d) New methods of marketing debt. The Governor said it was a mistake to believe that debt sales could only be achieved with changes in MLR: huge gilt sales had been achieved over the last year when MLR had only moved down one point. Moreover, if, as the Treasury were arguing, the authorities were to go for debt sales when needed, interest rates would be bound to fluctuate more - and borrowing become more expensive. Sir Douglas Wass commented that this question had been debated over a long period. The problem which they had to address was: how to sell Government debt when there was a "buyers strike" or inadequate sales to meet a particular borrowing requirement. The Treasury had offered various suggestions: one possibility was to market gilts by varying their relative yield, another would be to move towards auctioning on the US pattern. Against this, it was argued that, as long as the PSBR continued to fluctuate, a move to the US system would significantly add to the cost of borrowing. Unless the forecasts of borrowing were improved, an auction system could also lead to inadequate funding. The Prime Minister said that, despite the alleged problems of changing the present methods of marketing, she would like to have some concrete proposals from the Bank of what could be done to enable the authorities to sell debt according to need. This work would have to be associated with work on proposal (e): for the chance of a pre-determined programme of gilt sales under an auction system inflating the money supply would be lessened if Treasury bills lost their reserve asset status and thereby became less attractive to the banks.

(e) Abolish the Reserve Asset Ratio. One possibility was not to replace the RAR with anything, but to extend the 1½% cash requirement to the whole banking system. The new cash ratio could be defined so that it could be used in an MBC system if it was decided to move in that direction. There was also the related prudential issue on which the Bank were working. The Prime Minister said she would like the Bank to prepare an early paper on this whole subject.

(f) Modify Lender of Last Resort. It was argued that, although interest rates might rise in the short-term, the lending activities of the banks might be more likely to respond in a helpful way than under the present system; for they would have a positive incentive to hold back lending. The Prime Minister said that she would like the Bank to work up some operational proposals drawing on the Treasury's proposals in their paper on monetary control.

Summing up this part of the discussion, the Prime Minister said she would like the further work on the Chancellor's proposals which she had commissioned from the Bank to be completed in time for a further meeting in about a month's time.

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The discussion then turned to the monetary policy issues. Mr. Burns said that, in his view, a reduction in interest rates in the next few months would not be justifiable as long as the Government was trying to restrict monetary growth to no more than the forecast - i.e. 12 per cent up to next April. But there was no certainty about the forecast, and it was just possible that a fall in interest rates would be compatible if positive expectations allowed the authorities to sell gilts on a large scale. From an industrial standpoint, an interest rate reduction would clearly be desirable: the current squeeze on the corporate sector was indeed very tight. Mr. Middleton added that if MLR was reduced in the next few months, the monetary target might be more or less achieved for 1980/81; but it would restrict the Chancellor's room for manoeuvre in the Budget because lower interest rates certainly meant a more relaxed monetary stance in the longer term. Sir Douglas Wass commented that if - for example - Ministers were to decide to reduce MLR in November the markets might assume that the Government had the money supply under control. But one month's bad figures following could cause great difficulty, and even require an increase in interest rates again. Thus, there were considerable economic and political risks in going down this route. The Chancellor said that he doubted whether an MLR reduction could be justified on monetary grounds. But it might be necessary - on political grounds and in order to persuade colleagues to further cut public expenditure - to take the risk. The Governor said that he did not think that a continuation of the present high level of interest rates, as the Treasury papers seemed to be assuming, would be credible against the current industrial situation.

In further discussion, it was argued that the Government must do everything possible to ease interest rates while sticking to the monetary strategy by reducing public expenditure and the PSBR. It would be easier to justify an MLR cut if the Government were to take a tough line on public sector pay; anything that could be done to reduce the nationalised industries' call on funds would also help.

As regards the exchange rate, Mr. Ibbs argued that the extent of the damage being caused by it was still not being fully appreciated in industry. The risks of taking action to push the rate down needed to be set against the industrial risks of allowing it to stay at its present level. The Chancellor said that industry had unrealistic expectations of the possibility of getting interest rates down; for without a very substantial fall, the exchange rate was unlikely to be affected. Apart from considering the possibility of inflow controls, the Treasury had also considered "talking the rate down". On the whole, he was reluctant to adopt this approach - because it would probably either have no effect at all (in which case it would look futile) or it might result in an unacceptable fall in the rate. Rather than trying to help industry by pushing down the exchange rate, fiscal measures and a fall in interest rates was likely to be a more practicable approach.

In conclusion, the Prime Minister said that - notwithstanding the worries about industry - the Government should stick to the existing monetary strategy. The priority was to take whatever measures were needed to achieve this while taking the pressure off industry and providing the opportunity for a fall in interest rates.

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Accordingly, the Chancellor should re-assert the Government's commitment to the MTFS in his Mansion House speech. At the same time, the Bank and the Government would need to keep the position of the corporate sector under close review; and it would be necessary to think further about the possibility of pushing the exchange rate down.

I am sending a copy of this letter to Tim Allen (Governor's Office, Bank of England) and David Wright (Cabinet Office).

Yours ever,

Tim Lankester

A. J. Wiggins, Esq.,
H.M. Treasury.