

NOTE FOR RECORD

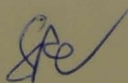
Copies to The Governor
 The Deputy Governor
 Mr Fforde
 Mr Dow
 Mr Blunden
 Mr Page
 Mr Loehnis
 Sir Jasper Hollom
 Mr Coleby
 Mr Flemming
 Mr George
 Mr Goodhart
 Mr Walker
 Mr Quinn

EMS

A meeting has been arranged at 3.15 pm (on call) on Tuesday 11 November to prepare the ground for the meeting with the Chancellor on Wednesday. The following papers are relevant and are attached except where previously circulated -

- 1 Britton and Lomax's "thirty-nine steps" (papers by Britton, 31.10, and Lomax, 29.10), attached *YSD*
- 2 Middleton - JSFf, 7.11, attached - *FSD*
- 3 Deputy Governor - Wass, 7.11, attached
- 4 JSFf - Middleton, 10.11, attached - *FSD*
- 5 CAEG, "More Flexible Money Market Operations; A Cover Note", 7.11 attached (which covers JSFf "Increasing the Flexibility of Official Operations in Money Markets", 5.11, already *FSD* circulated) *(copy attached)*
- 6 EAJG, "Restricted Indexed Gilts", 6.11, *(copy attached)* already circulated
- 7 Gordon Pepper, "A View of the Financial Framework in the 1980s", attached
- 8 Malcolm Crawford, "Sunday Times", 9.11, attached.

Governor's Office HO-P
 10 November 1980
 S P Collins (4421)



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The Governor

OK 11/11

1. May I confirm
8.45 for Friday's ^{Done}
meeting please? It
could, I think, be a little
later if you prefer.

2. The large Treasury
contingent envisaged
was put forward despite
my passing on your
preference for a small
meeting.

DB
11/11

NOTE FOR RECORD

Copies to

- The Governor
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- Mr Blunden
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- Mr Cooke
- Mr Flemming
- Mr George
- Mr Goodhart
- Mr Walker
- Mr Quinn

1 The meeting previously planned between the Governor and the Chancellor for 4.30 pm on Wednesday 12 November will not now take place.

2 Instead the Deputy Governor, accompanied by JSFf, EAJG, CAEG and ALC, will meet again on Wednesday afternoon with Sir Douglas Wass and his officials, *at 4.30 pm - 541*

3 A further meeting has been provisionally arranged between the Governor and the Chancellor at 8.45 am on Friday 14 November. The Chancellor's Office tell me that it is envisaged that the Chancellor will be accompanied by the Chief Secretary, the Financial Secretary, Wass, Middleton, Ryrie and perhaps Burns. *meeting took place*

as usual
4 The meeting with the Prime Minister remains at 3.00 pm on Tuesday 18 November.

T E Allen

Governor's Office HO-P
11 November 1980
T E Allen (4121)



The Governor *✓* cc. The Deputy Governor
 Mr. Fforde
 Mr. Dow
 Mr. Lockhart
 Mr. Coleby
 Mr. George
 Mr. Goodhart

NOTE OF A MEETING HELD IN THE CHANCELLOR OF THE EXCHEQUER'S ROOM, H.M. TREASURY AT 8.45 AM ON FRIDAY 14TH NOVEMBER, 1980

G.S.

Present:

Chancellor of the Exchequer (in the Chair)	Governor of the Bank of England
Financial Secretary	Deputy Governor
Sir Douglas Wass	Mr. Fforde
Mr. Burns	Mr. Coleby
Mr. Ryrie	Mr. George
Mr. Middleton	Mr. Goodhart
Mr. Britton	
Mr. Monck	

MONETARY CONTROL : THE NOVEMBER STATEMENT

The meeting had before it the note of the issues which might be covered in the November statement on monetary control submitted by Mr. Britton on 13 November. This note embodied the results of discussions with the Bank during the preceding week aimed at defining the area of agreement and clarifying the differences of view between the Treasury and the Bank.

2. Sir Douglas Wass defined the differences in view between the Treasury and the Bank on the following lines. The Bank were anxious to avoid multiple targeting, and would not wish to operate a system which involved short-run targets for the monetary base and somewhat longer term targets for sterling M3. They were willing to move to a more flexible system of determining short-term interest rates, which would involve limiting access to the discount window; but they would want to operate by reference to a variety of economic factors, while the Treasury would like the guiding light to be a relatively narrow monetary aggregate - ideally this might be M_2 , but there was no statistical series available, so perhaps in the interim M_0 might be used instead. For the time being sterling M3



would remain the broad aggregate to which attention was paid, but over time the main focus might move towards M_0 . On the determination of short-term interest rates, the question was whether the market should have greater influence by reference to the path of M_0 . On the marketing of long-term debt, if short-term rates were related to M_0 , there would be a need for more flexible arrangements for debt sales so as to achieve the objective for sterling M3; this might involve some combination of more aggressive marketing, some use of the auction technique, and perhaps the issue of RIGs. The attraction of the RIG was that it would make it possible for debt to be sold in market conditions when no-one would buy conventional gilts. For their part, however, the Bank did not believe that conventional gilts could be sold more aggressively - this they thought would have a perverse and damaging effect on the financial markets.

3. Sir Douglas Wass confirmed that the Treasury were no longer contemplating a move to a mandatory Monetary Base Control (MBC) system directed towards M_2 , which would involve a cash requirement far above $1\frac{1}{2}$ per cent of eligible liabilities; experience with such a system would not tell us how a non-mandatory MBC system would work. The Treasury now envisaged using the system which would emerge from the abolition of the reserve asset ratio (RAR) and the more flexible management of short-term interest rates as a half-way house which might in time lead to a non-mandatory MBC system; but there was no question of taking a decision now whether or not to take this further step. It was to be noted that the interim stage would only yield useful information about M_0 as an eventual possible target if the banks were left to set their own cash holdings - and this meant that the requirement for the clearing banks to hold $1\frac{1}{2}$ per cent of their eligible liabilities in the form of interest-free deposits with the Bank of England would have to be removed. However, abolition left the major problem that this would call into question a substantial part of the Bank of England's present income; it seemed quite probable that the



banks, left to themselves, would hold significantly less than 1½ per cent of eligible liabilities in the form of deposits with the Bank, so that if the change were to be made, some alternative means of guaranteeing the Bank's income would have to be found.

4. The Deputy Governor agreed generally with Sir Douglas Wass' statement of the differences in approach between the Treasury and the Bank. The Bank were concerned that a situation might develop in which short-term interest rates were directed towards an M_0 objective, while fiscal policy was directed towards sterling M_3 ; this would leave bank lending to the private sector - usually the largest counterpart to monetary growth - in a sort of limbo. Insofar as instruments were available to influence bank lending, the most important was short-term interest rates, and it would therefore be a mistake to try to compartmentalise particular instruments and policy objectives. The Bank agreed that any mandatory ratio imposed on the banking system could lead to disintermediation; nor was it possible for the time being to avoid the problem by distinguishing between wholesale and retail deposits in setting monetary targets. So far as debt sales were concerned, the Bank did not believe that changes in technique would make it possible for the authorities to achieve a significant increase in the take-up of gilts; fundamental problems could not be solved by technical devices. More generally Mr. McMahon suggested that the statement of the issues should make clearer what the immediate position reached would be; if we were to concentrate on that, the theoretical differences of approach between the Treasury and the Bank would matter much less.

5. Given that policy would continue to be directed towards a broad monetary aggregate, the discussion focused on the position created in the money markets by the abolition of the reserve asset ratio and the more flexible regime for determining short-term rates, and on arrangements for selling Government debt.



Money markets

6. The following main points were made in relation to the money markets:-

- (i) The Governor could not agree to the announcement of the disappearance of the present $1\frac{1}{2}$ per cent cash ratio unless it was clear how the Bank's income was to be assured. This was an issue which he would have to discuss with the Court.
- (ii) A zero cash ratio would have the advantage that it removed an inducement to the growth of the euro-sterling market.
- (iii) Greater flexibility in short-term interest rates, which would tend to "de-politicise" MLR, was desirable in its own right; that - if the cash ratio were abolished - it should be possible to learn about the possible scope for operating in future by reference to an M_2 target was a useful by-product.
- (iv) Although the changes envisaged should be presented as not ruling out a subsequent move to non-mandatory MBC, there should be no presumption that this step would be taken - until some experience was gained in operating a system with a zero cash ratio, it was not possible to say whether or not a clear relationship between the monetary base, the price level and the level of activity would emerge.

Debt sales

7. The following main points were made about sales of public sector debt outside the banking system:-

- (i) During the interim period when there was no question of using short-term rates to hit an M_0 target, the authorities would in practice be able to make discretionary changes in the level of short-term



interest rates as a means of stimulating gilt sales in exactly the same way as they have done hitherto.

- (ii) It was common ground that present debt marketing methods did not make it possible to achieve precise control of sterling M3 in the short run. The Bank were confident, however, that they would be able to achieve realistic objectives for total debt sales over a period through the use of existing marketing techniques, although actual sales were likely to diverge from desired sales in particular months. It should in any event be made clear that the authorities were not trying to control sterling M3 in the short run.
- (iii) The authorities had recently been relying on gilt sales to "over-fund" the PSBR, in order to offset the impact of high bank lending to the private sector on the monetary aggregates. However, this could not continue indefinitely, since it implied a steady deterioration in the quality of banks' balance sheets.
- (iv) Work would continue on possible ways of making debt marketing more flexible, but there was no question of decisions being reached in time for a statement during the week beginning 24 November. Among the possibilities under consideration were more aggressive use of the part-payment technique, and the issue of nationalised industry stocks (which the Government would guarantee) by auction.
- (v) The Financial Secretary saw the particular advantage of the RIG as being that it would enable the authorities to achieve a continuing flow of debt sales despite adverse conditions in the market for conventional gilts. This would be particularly important if the system evolved



to a point where short-term rates were directed towards M_0 , while the Government still set an objective for sterling M_3 in the medium term.

- (vi) The Governor said the Bank would be prepared to sell RIGs if the Government so decided. However, his personal view remained against taking this step, which he thought would give the impression that the Government were surrendering to inflation. Moreover, he thought that once RIGs began to be issued, there could well be undesired pauses in conventional funding as some of the market operators sought to manoeuvre the authorities into a position where they had to offer more RIGs. Although the announcement of the early issue of a tranche of RIGs would fit in with the general approach to be outlined in the Chancellor's statement about monetary control, the statement could be perfectly coherent and consistent without it.

Conclusion

8. The Chancellor, concluding the discussion, said his instinct remained favourable towards gradual rather than quick and radical change. He asked Treasury and Bank officials to revise the note on the issues for immediate submission to the Prime Minister, together with an annotated agenda for the Prime Minister's meeting on 18 November. Treasury officials should meanwhile be preparing a first draft of the sort of statement he might make, in the light of the discussion.

JW

A.J. WIGGINS

18 November 1980

 Distribution:

	Chief Secretary	Sir Kenneth Couzens	Mr. Monck
	Financial Secretary	Sir Anthony Rawlinson	Mr. Unwin
		Mr. Ryrie	Mrs Lomax
PS/Governor, B/E	Sir Douglas Wass	Mr. Middleton	Mr. Riley
	Mr. Burns	Mr. Britton	Mr. Ridley
		Mr. Lavelle	