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P E Middleton

Deputy Secretary

17 November 1980

T Lankester Esq  
10 Downing Street

Dear Mr Lankester

(12)

I attach a note which may help with tomorrow's discussion.

I am sending a copy to Sir Robert Armstrong.

Yours sincerely

B. A. Clarke

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Agenda for Tuesday's Meeting

1. The objective at the last meeting was to get the Bank to provide a workable set of proposals to improve the present system of monetary control - consistent with and preferably as a step towards monetary base control.

Relevant to this:

2. The Bank have produced 2 papers;
- a. Funding techniques
  - b. Increasing the flexibility of official operations in the money markets.

The papers are covered by a personal letter from the Governor.

3. The Treasury have produced papers on:
- a. Smoothing the PSBR
  - b. National Savings
  - c. A Restricted Indexed Gilt.
4. You also have a joint Treasury Bank paper on Monetary Control, setting out the outstanding issues, and highlighting points on which there is still disagreement. It is covered by a brief summary of the main points for discussion which you could use as an agenda for this part of the Seminar.

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5. The objective of Tuesday's meeting is to take decisions which will enable the Chancellor to make a clear statement about monetary control in his announcement next week. There are a number of practical issues to be resolved. Commentators will also be expecting him to say something about the authorities' longer term intentions, notably on monetary base control.

## The PSBR

6. It would be best to deal with the PSBR first. The prospect, consistent with the regular note on the monthly CGBR which you received last week is for a PSBR in 1980-81 of £11½ bn equivalent to 5% of GDP (the same proportion as last year). The Treasury have identified some areas for smoothing the path of the PSBR, mainly on the revenue side; you will wish to instruct them to press on urgently with this work.

## Money Market Operations

7. The Bank have made some constructive suggestions to modify lender of last resort facilities and permit interest rates to fluctuate more - though still determined by the present discretionary system. These consist of:

- i. Abolition of the Reserve Asset Ratio when consultations on prudential control are complete (by the Budget) - and its immediate modification to greatly reduce the need for special assistance.

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ii. Modification of Lender of Last Resort - after consultations but also in time for the Budget. The Bank's proposals would allow interest rates to be free to move within a predetermined (but unannounced range). This system need have no posted MLR like the present one.

8. It is agreed that this would be an improvement. But you will want to press for details on:

i. The timetable for phasing out the Reserve Asset Ratio.

ii. The form of the new guidelines for short term interest rates.

## Funding

9. Methods of Funding come next

a. More debt to persons. It is proposed to announce a further stage of National Savings. Plans are well advanced. The Financial Secretary has been supervising this work. You may wish to probe the question of indexed bonds for young people.

b. Restricted Indexed Gilt (RIG). All the necessary preparations have been made. We need to decide whether to go ahead and whether to announce it in the Chancellor's statement at the end of the month. The Governor advises against. The Financial Secretary has been supervising this work.

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c. New Methods of Debt Marketing. The Bank paper resists changes in existing techniques but offers to experiment with short term bonds (when the reserve asset ratio has gone), nationalised industry issues (with HMG guarantee) and the Restricted Indexed Gilt. But as the Bank oppose the RIG and none of the others are immediate starters, there may be nothing we can announce by way of a change. The Governor is unlikely to change his strong opposition to changes in the Bank's traditional methods.

10. Decisions are needed on:

- a. Whether Restricted Indexed Gilts should be issued (ever)
- b. if so, whether now is the right time to do so
- c. what else can be said about funding techniques in the statement.

## Monetary Base Control

11. The Treasury would like to be able to announce our intention to change the present system so that it could, if we chose, evolve in the direction of monetary base control. The choice between mandatory and non-mandatory systems would be left open at this stage. The immediate aim would be to find out more about the banks demand for base. The changes to money market

operations proposed by the Bank would fit well with an eventual move to MBC. Other necessary changes, to be decided in detail between now and the Budget, would include:-

i. Abolishing the 1½% cash ratio. This has no monetary control function but it provides the Bank with revenue. If an alternative source of revenue could be found to make good any shortfall it would be possible to abolish this ratio. This would mean we could study the properties of a non-mandatory system which depends on the banks' own requirement for reserves. This is the sort of system recommended by Karl Brunner and his colleagues. The Bank are willing to discuss this with us but may not be willing to have it announced as a possibility.

ii. Compiling a New Series for Retail Deposits (M2) This was suggested by the Treasury as the possible basis for a mandatory system - one in which the authorities lay down the amount of reserves to be held. The numbers do not exist at present and need to be collected.

The Bank are apprehensive about i. and reluctant to ask the banks for ii. But the Governor will probably agree to both provided he is not committed to changes until alternative sources of revenue are found. Decisions of principle are needed on both points at Tuesday's meeting.

12. You might conclude by asking the Chancellor to summarise how he proposes to deal with these issues when he makes his announcements next week.

Monetary Policy Issues

13. The Chancellor has sent you a minute about the measures he might announce next week including the rollover of the £M3 target and the related question of a reduction in interest rates. It would be best not to discuss these at such a large meeting.

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