M. Middleton

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NOTE OF A MEETING

MONETARY AFFAIRS

The Governor of the Bank of England called on the Chancellor at No.11 Downing Street on Wednesday 11 February 1981 at 11.30 a.m. Sir Douglas Wass was also present.

2. The Governor reported that there had been a great deal of concern among EC central bank Governors about the impact of US monetary policy. It appeared from reports of the US situation that monetary policy would have to remain very tight, since there was little prospect of an early reduction in the rate of inflation, and the prospects for US fiscal policy were very uncertain. The Commission and the Belgians in particular complained about the consequent impact of high dollar interest rates on Europe and the third world; the Governor thought they were inclined to give inadequate recognition to the US current account surplus, and to blame the strength of the dollar too much on high interest rates. Nevertheless European countries faced difficult policy problems; the Germans after a very long period during which their external position remained strong now faced a contracting domestic economy and a large current deficit, with any action taken to meet one of these problems tending to exacerbate the other. It was likely to prove very difficult for the German authorities now to achieve a substantial tightening of monetary policy, and he had been asked whether the UK could help ease the strains in the foreign exchange markets either by reducing interest rates or intervening to contain upward pressure on the exchange rate.

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3. The Governor of the Swiss National Bank had told the Governor of a paper prepared by Professor Niehans about the present UK situation for the Centre for Policy Studies. Its conclusions - which Leutwiler apparently shared - were that the monetary base had been growing too slowly, and that the exchange rate was too high. Leutwiler compared the UK situation with that of Switzerland in 1978, when he had thought it imperative to act with great speed to prevent further appreciation of the Swiss franc, despite the fact that this meant abandoning the monetary target. He had commented that he thought sound functioning of the economy even more important than price stability.

4. The Governor commented that he had been disappointed by Press reports over the last few days on the UK monetary situation and the attitude of the authorities towards it. Last week the gilts market had been strong, in anticipation of a possible reduction in MLR; but now financial markets and commentators seemed to have taken up the position that this was ruled out, and the climate for a change was now much less favourable. The Chancellor said he shared the Governor's dislike of recent Press reports; but it was not possible to pretend that the policy dilemmas did not exist, or to stop people altogether from speculating about them. It was nonetheless regrettable that such speculation tended to "politicise" MLR to an undesirable extent.

5. On the substance of the issue, the Governor said that he was anxious to get MLR down; this would be consistent with moves which had already taken place in market rates. He thought such a move the right and proper course, but it could not be made unless a way could be found of presenting it which would be wholly consistent with the approach the Government would now be following on monetary policy. It would not be possible to justify an MLR reduction if

/£M3 were to remain

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£M3 were to remain the sole and unconditional target; this would be the case both immediately and at the time of the Budget, given that the outlook for the PSBR (even with some contractionary fiscal action) would hardly be consistent with £M3 growth in the range 6-10 per cent in the months from April onwards. If, therefore, lower interest rates were to be justified, this would have to be done by reference to some other tests. Essentially these tests would have to relate to the narrower monetary aggregates (M1 had increased at an annual rate of 8.4 per cent since February 1980, and at about 9 per cent a year over the last three months, while the wide monetary base had increased by only 3.4 per cent at an annual rate since last February, and had been contracting at an annual rate of about 9 per cent over the last three months) and to the exchange rate. If any move were to be made in MLR, it was essential to have a "right and accepted" form of words with which the Chancellor was in total agreement.

6. The Chancellor remained very worried by the reality of the continuing high PSBR; in view of this, was there not a danger that a move on MLR now would seem to be inconsistent with the picture of the economy which he would have to present in the Budget? The Press reactions to the preliminary February money figures tended to confirm his worries. It did not appear that we had at present available the arguments which had been used to justify last year's MLR reductions - slow monetary growth during the first part of the financial year, and reasonable grounds for believing in an imminent improvement in the PSBR position around the turn of the year.

7. The Governor said he remained convinced that last year's MLR reductions were right. There was now clear evidence of a deceleration in the growth of bank credit to the private sector, and all the monetary aggregates (with the possible exception of M1) were tending

/to decelerate.

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to decelerate. Meanwhile the exchange rate was much higher than any forecasts had previously indicated, while new forecasts suggested that it would remain at an uncomfortably high level. He saw no risk that a small reduction in interest rates would relieve UK industry of the pressure to resist inflation. With the world recession now tending to look deeper, while the UK outlook on inflation was better, he favoured an immediate move on MLR.

8. Sir Douglas Wass saw the issue as more finely balanced. The monetary trend had been improving, but the near term forecasts still suggested increases in £M3 in February and March of more than 1 per cent in each month. If MLR were to be reduced, some acceleration could be expected in M1. The outlook for wholesale prices was now less good, and any further deceleration in the inflation rate was likely to be only slow. Meanwhile UK industry seemed to have adapted to the high exchange rate and the present level of interest rates to a surprising degree, and there were now signs of an improvement in industrial confidence. These considerations suggested that the need for a reduction in MLR might be less urgent than the Governor had suggested. The Governor, however, was more pessimistic about the UK industrial outlook. Although the impact of de-stocking might now be coming to an end, recession was likely to continue as investment and exports fell away; he saw no sign of a recovery in output either in 1981 or in 1982.

9. The Chancellor said he was inclined to accept that UK interest rates were probably on an unnecessarily high plateau, although he doubted whether a small reduction would have much impact on the exchange rate. Nevertheless he thought it risky at this stage to discount £M3 too far; although it might be possible to increase the size of the effect attributed to the ending of the corset, it would still be difficult, after adducing every possible explanation

/for the fall in

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for the fall in velocity, to explain a downward movement in MLR now. He accepted that, if a change were to be made, 12 February might well prove better than 19 February, in view of the risk that the deterioration in the PSBR prospect would become more widely known in the meanwhile. But he was not satisfied yet that the case for a reduction had been fully made out, while insofar as such a case could be sustained, the arguments for a change would still be valid on 19 February.

10. The Governor urged the desirability of the authorities seizing the initiative when the money and inflation indicators pointed in the right direction. It seemed unlikely that the Budget would provide a better opportunity to change MLR - and it was questionable whether changes in MLR announced in the Budget were consistent with the new approach now being developed towards monetary control. Moreover any delay would only tend to focus more attention on the difficulties with the PSBR and the monetary target as at present specified. The Governor emphasised again, however, that a reduction in MLR would not be consistent with a 6-10 per cent £M3 target for 1981-82, and that if the Prime Minister and the Chancellor were to agree to lower interest rates they would need to accept in advance that such a target could not be achieved over the months ahead.

11. In further discussion it was recognised that £M3 had not in practice been the authorities' only guide in setting interest rates; but the Chancellor could not contemplate entirely setting aside a target for £M3. It would still be necessary to worry about the broader monetary aggregates over the period of the Medium Term Financial Strategy, despite the divergence of £M3 and the PSBR from the expected path over the last year. Nor was it unambiguously clear that the present monetary situation was very tight; real

/interest rates in

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interest rates in the UK were well below those in the US and Germany, an
no-one was at present complaining that credit was unobtainable.
Sir Douglas Wass suggested that there should be no administered change in MLR either immediately or in the Budget; instead the Chancellor should announce the new arrangements for monetary control, including the intention of the authorities to allow the financial markets a more substantial role in the determination of interest rates within a given band. The way would then be open for interest rates to come down after the Budget, if market conditions favoured this.

12. The Governor cautioned against exaggerating the extent to which the authorities would be able to leave interest rates to the financial markets. The authorities would need to retain a substantial degree of discretion in the way they intervened in financial markets after 10 March, and decisions would still be needed about the interest rate bands within which rates would be allowed, from time to time, to fluctuate. He remained of the view that interest rates should be brought down, and offered the draft of a Note to Editors which sought to explain a decision in this sense. The Chancellor undertook to consider this further, in advance of the meeting he and the Governor were to have with the Prime Minister at 5.00 p.m. on 11 February.

13. Following an inconclusive meeting with the Prime Minister at 5.00 p.m., the Chancellor resumed his discussion with the Governor at 5.45 p.m. Mr Burns and Mr Middleton were also present.

14. Mr Middleton emphasised that a decision to move MLR now was not simply a decision to change a particular interest rate by 1 per cent, but a change in the way the Government approached monetary policy. It would be a deliberate move to attribute more weight to factors which had not hitherto been presented as of crucial importance

/and it would mean

and it would mean putting particular emphasis on the exchange rate. He doubted whether the Government would be well advised to make this radical move until they were much clearer about how monetary policy would be operated - and how interest rates would be set - over the coming year.

15. Mr Burns said he was inclining to the view that there should be some relaxation of monetary policy, essentially because of the unexpected appreciation of the exchange rate. If there were to be such a relaxation - which would have to be overt - then it would be better to have it sooner rather than later. If the exchange rate were to move down sharply, then it would be appropriate to tighten policy again. It was the fact that there seemed to be no prospect of an early reversal of the exchange rate movement, and thus every likelihood of continuing severe difficulties for UK industry, which led Mr Burns to take this position; in the absence of the external factor, he would not have thought that domestic monetary pressures called for any change in interest rates.

16. Mr Middleton suggested that lower interest rates seemed likely to offer the best available prospect for reducing the imbalances in the economy; the outlook for the PSBR was such that it was unlikely that significant fiscal help could be given to industry, while lower interest rates, both directly and through the exchange rate, would ease the position for industry, including tax-exhausted companies. Mr Burns noted that a good deal of the deterioration in the PSBR could be traced to the efforts of the company sector to use every device to get money from the Government; the difficulties companies faced tended to reduce revenue from indirect and corporation taxes, as well as leading to higher public expenditure on unemployment benefit and employment support. Against this background it would be extremely difficult to reduce the growth

/of £M3 to 8 per cent,

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of £M3 to 8 per cent, even given a very tight stance of both fiscal and monetary policy. He would arrange for an assessment to be made of the effect on the forecasts of the different monetary aggregates of interest rates moving down in line with inflation.

JW

A J WIGGINS
12 February 1981

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