R.T.F.
S.41/1

SECRET
AND PERSONAL

The Governor / The Deputy Governor
Mr. Fforde
Mr. Loehnis
Mr. Dow
Mr. Coleby
Mr. Flemming
Mr. George
Mr. Goodhart
Mr. Walker
GPS

Gov mentioned Special Tax on Banking Deposits. 13.5.81 CEAK memo - F.S.O.

CR 17/5.

14.5.81

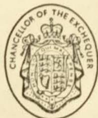
NOTE FOR THE RECORD

MONETARY AFFAIRS

The Governor of the Bank of England, accompanied by Mr Fforde, called on the Chancellor at No.11 Downing Street on Wednesday, 13 May, 1981 at 5.15 p.m. The Financial Secretary and Mr Ryrie were also present. The Governor said that further study of the latest figures had confirmed the broad picture he had given to the Chancellor the previous week. His overall impression was that £M3 would have grown at an annual rate of about 10 per cent from January to June, with perhaps some acceleration over this period. Total M3 was growing considerably faster than £M3. Sterling bank lending was turning out higher than had been expected, and higher than during the pre-Christmas trough; the underlying rate of increase seemed to have risen from £400 million a month to rather more than £600 million. There had been a modest rise in lending to companies and unincorporated businesses, while persons had been increasing their borrowing both for housing and for consumption. In part the latter development reflected the banks taking a larger share of the total personal lending business; but there seemed to have been some underlying recovery in borrowing by persons, perhaps as a response to lower than expected inflation and a better experience in terms of real income. Lower interest rates had also contributed by encouraging a recovery in the housing market.

2. The CGBR had fallen back in the earlier part of the year, and had been substantially over-funded. This had helped to keep £M3 within the target range despite the acceleration in bank lending. Meanwhile the pressure which this over-funding would otherwise have put on bank liquidity was being masked by the effects of the Civil Service dispute. Another potentially helpful factor was the considerable increase in the volume of rights issues. It now seemed

/possible that these

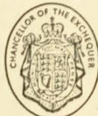


possible that these would amount to £2 billion in 1981-82, as against only £1 billion in 1980/81, and this would be useful in damping down bank lending. Although share prices had fallen back somewhat from their post-budget peak, this had not so far discouraged potential issuers. Despite this favourable development, the Governor remained rather anxious about the trend in bank lending; the domestic situation pointed against any early change in MLR. For the future the "fog" created by the Civil Service dispute would remain for an appreciable period; although the unsettling effect of the dispute had so far been minimised, it would become steadily more difficult to have much confidence in the pre-dispute forecast of the CGBR against which subsequent developments were being measured. There was a heavy programme of redemptions over the next few months, which would add to the burden on funding at a time when the markets might be rather uncertain; national savings, by contrast, had been doing exceptionally well.

3. The Chancellor noted that the Treasury paper suggested an annual rate of increase in £M3 of 12½ per cent for the five months Feburary to July. Was there any difference between the Treasury and bank views of the situation? It was noted in discussion that the outlook for July was particularly uncertain, and that even without the Civil Service dispute there were signs that the CGBR could prove to be substantially front-end loaded. There was thus some reason for thinking that 12½ per cent might exaggerate the underlying rate of monetary growth, although it seemed clear that growth was around the top end of the target range, and possibly accleerating.

4. The Financial Secretary noted that he would have favoured a reduction in MLR on the Thursday before Easter. However, once that window had been missed, he accepted that it would not now be sensible to look for a reduction in interest rates. He and Mr Ryrie both felt that the authorities should not be totally inhibited from future

/movement by the



movement by the statistical fog created by the Civil Service dispute. The settlement, when reached, would change the underlying situation, and would provide the occasion for a review of the authorities' stance; the direction of any movement would depend on the nature of the settlement.

5. The Chancellor mentioned the Prime Minister's worry that the authorities were not apparently doing anything to counter the monetary effects of the Civil Service dispute. There was likely to be a growing feeling that we should be doing something if all the monetary figures began to deteriorate markedly. It was noted that Treasury and bank officials had considered carefully what scope there might be for some special funding initiative, or for the introduction of a new instrument designed to mop up money which would otherwise have been paid to the Government. Given the firm view that the Civil Service dispute did not affect the underlying situation, there seemed to be no case for seeking to manipulate interest rates to achieve an acceleration in sales of long-term debt. A new short-term instrument would need to be something like a tax reserve certificate; but - paradoxically - the effect would be likely to be to discourage people from paying their taxes and to encourage them to hold the new instrument instead. For the time being the appropriate course seemed to be to adjust the Bill issue; this would also provide the means to unwind the effects of the dispute on financial flows once a settlement was reached. If at any point the banking system became excessively liquid, it would be possible to call for special deposits - such a step could be helpful in preventing short-term interest rates from falling too far. It was noted that there might also be some advantage in allowing companies to buy national savings; this would not need new legislation, and might perhaps be attractive to small companies.

6. On the external monetary scene, the Governor noted the further

/increases in dollar

increases in dollar and European interest rates, and the continuing appreciation of the dollar against all the European currencies, including sterling. French interest rates had moved sharply higher following the election, and there now seemed to be a question whether they would have to "take a congé" from the EMS. Although Switzerland had remained below their target for M_0 over 1980 and 1981, interest rates had nonetheless been increased as a move to contain inflationary pressures and downward movement in the exchange rate (inflation in Switzerland had risen to 6½ per cent). Canada had also been increasing interest rates as a response to heavy demand for credit and increasing inflation. So far as the US was concerned, the high interest rates were a response to the unexpected strength the economy was demonstrating: the scheduled increase in defence expenditure had yet to be felt, and would add a further boost.

JW

A J WIGGINS
14 May 1981

Distribution:

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Financial Secretary
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Sir K Couzens
Mr Ryrie
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PS/Governor