SECRET

31.10.80

NOTE FOR RECORD

Copies to The Governor
The Deputy Governor
Mr Fforde
Mr Dow
Mr Blunden
Mr Page
Mr Loehnis
Mr Coleby
Mr Cooke
Mr Flemming
Mr George
Mr Goodhart
Mr Walker

A meeting has been arranged at the Chancellor's request for 4.15 pm on Thursday 6 November in the Chancellor's room at the Treasury, in order to prepare for the Prime Minister's meeting on Wednesday 12 November.

John Wiggins envisages that the subjects would be Monetary Control Techniques and the Rollover (which, he says, is bound to come up on 12 November, and to be carried further forward, if not resolved).

Those present from the Treasury side are likely to be the Chancellor, the Financial Secretary, perhaps the Chief Secretary, Wass, Burns, Middleton, Monck, Britton and Ryrie.

I told Wiggins, and he quite accepted, that drafts of the Bank's two papers would probably not be available until Thursday.

Governor's Office HO-P
31 October 1980

T E Allen (4121)

S41/1

SECRET 6.11.80

NOTE FOR RECORD

Copies to The Governor
The Deputy Governor
Mr Fforde
Mr Dow
Mr Blunden
Mr Page
Mr Loehnis
ONLY

The meeting took place. 7/11

It has been provisionally arranged that the Governor should call on the Chancellor tomorrow, Friday 7 November, at 8.45 am at No 11 for a private discussion. Wiggins will confirm this afternoon.

Governor's Office HO-P
6 November 1980

T E Allen (4121)

SECRET

COPY FILED HPDOSS

Copy to: The Governor
The Deputy Governor
Mr. Fforde
Mr. Dow
Mr. Page
Mr. Blunden
Mr. Loehnis
Sir Jasper Hollom
Mr. Coleby
Mr. Fleming
Mr. George
Mr. Goodhart
Mr. Walker
Mr. Quinn

NOTE OF A MEETING HELD IN THE CHANCELLOR OF THE EXCHEQUER'S ROOM, H.M. TREASURY ON THURSDAY, 6 NOVEMBER, 1980 AT 4.30 P.M.

Present:

Chancellor of the Exchequer	Governor of the Bank of England
Financial Secretary	Deputy Governor
Sir Douglas Wass	Mr. Fforde
Mr. Burns	Mr. Coleby
Mr. Middleton	Mr. George
Mr. Britton	Mr. Goodhart
Mr. Monck	
Mr. Unwin	

MONETARY AFFAIRS

Roll-forward of the monetary target

The meeting considered first the roll-forward of the monetary target due this month. The Governor asked what other economic policy announcements would be made at the same time. The Chancellor indicated that there would be announcements about certain cash limits (including the factors to be assumed for increases in pay and prices) the external financing limits for the nationalised industries, an overview of the Cabinet's decisions on the public expenditure plans, and the Industry Act forecast (which would include an indication about the prospects for next year's PSBR, although this would probably not be quantified exactly). It was noted that an announcement would also be expected of the Government's conclusions about monetary control, while there could be advantage in further announcements about national savings and perhaps also techniques of gilts marketing (the point was made, however, that a restricted indexed gilt (RIG) could not be announced until the authorities were ready to issue it, since otherwise institutional investers would hold back in the meanwhile from buying conventional gilts).

2. It was noted that, in the light of the October money figures, it would no longer be possible for the Government to say that

they expected to be within the present monetary target by April next year. This meant that, although the options remained the same as they had been a few weeks ago, they were now more difficult. Essentially the choice lay between postponing any roll-forward until both the monetary situation and the prospects for the real economy were clearer (which would mean waiting until next year's Budget), or continuing the present 7-11 target to cover the whole 18 month period to October 1981. The difficulty about the latter course was that total allowable growth from now on would be very small - around 4-5 per cent over the next year - and the Industry Act forecast would lend no support to expectations of such a sharp deceleration in monetary growth. The problem of the high company sector financial deficit would remain, and it was hard to see where sufficient gilt sales were going to come from to achieve to make possible such a deceleration.

3. In further discussion it was noted that, despite continuing high measured growth in both sterling M3 and the wider aggregates, monetary policy was perceived in the corporate sector to be very tight. To some degree recent monetary developments reflected the financial imbalance between the personal and company sectors, and it might be that in this situation the deceleration in velocity recently observed would not constitute any serious inflationary threat for the future.

4. It was recognised that ways had to be found to help the company sector which would not give further impetus to monetary growth. The proposed change in stock relief could form one element in this, while changes in the tax treatment of indexed bonds issued by companies might help them to draw funds directly from the capital markets instead of having to rely on the intermediation of the banks. Other possibilities were further encouragement to the banks to undertake long-term borrowing (where the liabilities issued by the banks would not count as money) to support their own long-term lending programmes.

5. It was generally agreed in further discussion that the monetary target should not be rolled forward until the 1981 Budget. The question was raised whether this should be presented as "reaffirming" the present target (although it would be made clear that the authorities did not expect actually to get within the 7-11 per cent range), or whether we should say we were "suspending" the target. It was important not to say anything which would create expectations of a tightening of policy before the 1981 Budget; thus we should need to be careful not to say too strongly that we would act vigorously to get as close to the target range as possible. The Chancellor, concluding this part of the discussion, said that a roll-forward should be promised in the 1981 Budget; that we should emphasise the prospect of a sharp monetary deceleration in the months immediately ahead on the basis of present monetary and fiscal policies.

6. The Chancellor indicated that, in view of the very close agreement between the Treasury and the Bank on the question of the roll-forward, he would wish to clear this with the Prime Minister in advance of the meeting with her on monetary issues (which has now been re-scheduled for 18 November). He asked the HF group to let him have a draft minute for this purpose.

Monetary Control

7. The Chancellor emphasised the importance he attached to having something clear and positive to say in the debate on the Queen's Speech, which was likely to take place on 25 or 26 November. If there were to be no roll-forward of the monetary target - and no prospect of achieving the present target - material on monetary control, together with such announcements as could be made about public expenditure and tax changes, would be needed if the Government's statement were to carry conviction. Mr. Middleton suggested that two aspects of monetary control would need to be

covered in the statement: the Government's overall approach to monetary base control (MBC), and what would be put in place of the reserve assets ratio.

8. Mr. Fforde outlined the Bank's preferred approach. The reserve asset ratio would disappear eventually, and a cash ratio would play a key part in the authorities' operations to influence the behaviour of the banks. At the same time MLR would no longer be pegged by the Bank. This overall scheme posed a number of questions about the operation of markets: would the discount market continue to function, or would the authorities rely instead on the inter-bank market? How much more of a role would the market have in determining short-term interest rates than at present? The Bank's preference was for the retention of the discount market dealing in commercial paper, but the authorities should play a much less dominant role in the determination of short-term interest rates. Nevertheless guidelines would still be needed for the Bank's money market operators. Under these arrangements banks would do less round-tripping; but, it seemed likely that in other respects the changes would not help much towards the short-run control of sterling M3. The Bank's inclination would be to move to revised arrangements on these lines in the fairly near future; the decision could then be taken later on in the light of experience whether or not to move on to MBC, where the Bank preference was for a non-mandatory system.

9. In further discussion of the practical steps recommended by the Bank the following main points were noted:

(i) this would represent a sensible response to recent concerns about the impact of the reserve asset ratio and round-tripping (although it was recognised that these problems could in principle be dealt with within the ground rules of the present system).

(ii) The abolition of the reserve asset ratio would limit the size of the differential between different short rates, so reducing the scope for round-tripping. However, underlying money rates would themselves be floating, so that there would be substantial variability in the overall interest rates structure.

(iii) The Bank's discount window operations would enable the authorities to exert influence over money market rates, so that the overall system would be analogous to "dirty floating" in the foreign exchange markets.

10. Discussion then turned towards the longer-run objectives. The Treasury had suggested that, if there were to be a move to MBC, this would initially need to be towards a mandatory rather than a non-mandatory form. Such a system would require a relatively high cash ratio, and there would be a case for a denominator different from eligible liabilities (ELs) - retail deposits seemed likely to be more suitable as the denominator for the "fulcrum ratio". By contrast a low cash ratio as a proportion of ELs would be appropriate in the case of a non-mandatory system. Even with a mandatory system of this kind, it might be possible for sterling M3 to remain the operational target.

11. The Bank representatives argued strongly against making any judgements at this stage; despite the wish of the Treasury to have a clearer idea about the more distant objectives before the cash ratio paper was issued, the Bank thought it essential to see how the markets operated in response to the immediate changes on which both they and the Treasury were agreed. It was not clear whether under a mandatory system on the lines suggested by the Treasury it would be possible to achieve the gilt sales necessary to work to a sterling M3 target. (The

difficulty they saw was that sterling M3 could not be controlled by debt sales if short-term interest rates were exclusively determined in the financial markets.)

12. The Chancellor, summing up this part of the discussion, noted that it was impossible to resolve these various issues immediately; further technical discussion was needed to identify the areas of agreement and disagreement, as a preliminary to further discussion between himself and the Governor in advance of the scheduled meeting with the Prime Minister. In view of the wide measure of agreement on immediate practical steps, the Chancellor suggested that both sides should set out in summary form the kind of statement they envisaged him making in the debate on the Queen's Speech; a paper could then be prepared on the basis of these two alternative approaches for discussion between him and the Governor on Wednesday, 12 November.

JW

(A.J. WIGGINS)
10 November 1980

Distribution

Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr. Burns
Sir Kenneth Couzens
Mr. Ryrie
Mr. Middleton
Mr. Britton
Mr. Monck
Mr. Unwin
Mr. Riley
Mrs. Lomax
Mr. Ridley
PS/Governor of the
Bank of England