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Domestic Monetary Policy.

H M Treasury

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P E Middleton
Deputy
~~Under~~ Secretary

13 October 1980

T Lankester Esq
10 Downing Street

Meeting of Ministers 13/10. 14.30 hrs.

Dear Tim,

I attach the agenda which the Prime Minister requested for this afternoon's meeting.

I am sending a copy to Sir Robert Armstrong.

Yours ever,

Peter

P E MIDDLETON

Circulation List:

Chancellor of the Exchequer
Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr Burns
Mr Ridley

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AGENDA FOR THIS AFTERNOON'S MEETING

1. The Governor to be invited to speak first to his paper

2. The Chancellor to follow bringing out the monetary control issues

3. It is then desirable to take separately issues of:

   a. monetary policy
   b. monetary control

Monetary Control Issues

Timing is important because consultations on the Green Paper are now complete. The outcome is expected in the next few weeks. The Chancellor will wish to discuss this further with us. But the immediate objective is to get the Bank engaged urgently in producing a workable set of proposals to improve the present system - and which would be consistent with and, if need be, a step towards Monetary Base Control. The need for a change is to introduce a more quantitative element into methods of control and to reduce the risk that monetary growth accelerates so much in the short run that it prevents us controlling it in the longer run.

The steps which need to be taken are:

a. Smooth the PSBR - reduce the present skew profile if we can. Treasury is urgently considering. But it will be impossible to produce a completely smooth profile.

b. Sell more Debt Direct to Persons - more granny bonds and National Savings. No disagreement. But risks to Building Societies and staff costs for DNS. For the Treasury.

c. Press on with Restricted Indexed Gilt - Bank working on a prospectus. Need to press ahead urgently. An attractive bond which will make debt easier to sell in difficult times. Supervised by Financial Secretary.

d. New Methods of Marketing Debt. Essential to improve present system, regardless of other changes:

   i. so we can sell debt when PSBR/monetary growth accelerates rather than on the expectation of falling interest rates (the Grand Old Duke of York) when it is coming under control.

ii. in order to avoid having to make big changes in MLR to engineer small changes in price of gilts.

Bank to produce proposals for selling desired quantity of debt as need arises.

The above (together with the first stage in abolishing the Reserve Asset Ratio set out below) are all necessary in any event to improve the present system. But they do nothing about freeing MLR and short rates. Two other changes where action must be with the Bank are needed:

e. Abolish the Reserve Asset Ratio. An agreed recommendation in the Green Paper. Plays no part in monetary control. Abolition would immediately increase the range of debt instruments we can sell to the public because Treasury bills lose their reserve asset status:

i. If replaced by nothing we can still use existing methods of determining interest because the 1½% cash requirement for clearing banks is still in place.

ii. But it is also agreed that the cash ratio has to be revised and extended to a wider range of banks. The new cash ratio should be defined so that it could be used in a mandatory system of monetary base control if it was decided to move in that direction. It need not however be used as such.

iii. The Bank will in any case wish to sort out the prudential implications. They are in the midst of consultations. These are necessary but distinct. They must follow rather than determine monetary control requirements.

f. Modify Lender of Last Resort. Essential if wish to move to MBC and control supply of base to the banks. The Bank can pitch the rate to penalise the banks but avoid undue swings in interest rates. Critical Step towards a more flexible regime for short term interest rates which still maintains some control by the authorities. Banks less certain of being able to match advances with deposits if lender of last resort at Bank's discretion.

Treasury proposals are contained in the papers. Debt sales (para 69-76)

RAR and lender of last resort (illustrative scheme (Annex 1) para 3, 16-42). We now need the Bank to work up operational proposals preferably based on our work.

Monetary Policy Issues

a. The Prospect. Analysis

i. No real disagreement. But essential to sort out the nature of the squeeze. Is the recession the result of a tight monetary squeeze as suggested by the Bank? We disagree. If the Bank's analysis is accepted it has serious implications for our ability to restrain inflation when activity picks up. AskBurns to speak on this.

ii. Prospects for the monetary aggregates, interest rates and the exchange rate on the outlook shown by the Treasury and Bank forecasts.

iii. Prospects for the manufacturing sector and imbalance with personal sector.

b. Decisions Needed

i. Can anything be done about the exchange rate: inflow controls come at this point?

ii. Is a reduction in interest rates essential for psychological reasons - and to secure a successful outcome on public expenditure; what are the risks for the curent target and the MTFS?

iii. Is the imbalance between persons and comapnies best dealt with in the Budget - as suggested in the Chancellor's covering minute?

c. Thursday's Speeches

i. Do we reassert the MTFS?

ii. Do we say anything about monetary control?

This list does not include a specific request for a decision on the roll forward of this year's target which need not be discussed at today's meeting; there is little disagreement about this between the Treasury and the Bank. The roll forward does not need to be announced this week and the Chancellor can make recommendations when he has discussed it with the Governor.