

THE GOVERNOR

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THE ROLL-OVER AND POLICY GENERALLY: TOMORROW'S MEETING WITH
THE CHANCELLOR

On the immediate question, I still favour going for what EAJG described as the longest possible period with the maximum credible disinheritation of base drift at the beginning. This looks like extending the present period from the base of February 1980 to October 1981. It also seems right that the roll-over should not be announced until mid-November when it seems to me that to give it credibility we would need some announcement on public sector action (including public sector pay).

The forecasts may not suggest that just continuing the present target until April will be much tighter, but the fact of the matter is that with a short period we have a greater risk of using up the whole allowable increase in the first few months. Also, it is likely to put even greater strain than any other course, on the Budget decisions next spring. If we are already in the middle of a longer target when we come to the Budget in early March and only know the January figures, it may be sensible to delay a couple of months and go for a new period starting in April (which would be in line with the MTFS).

But, as became clear at your meeting this morning, choosing between these target periods is only playing at the fringes of the problem. The problem I take to be that monetary policy is in fact tight, that fiscal policy probably is too, that the exchange rate is intolerably high, and that the recession is going to get much worse than most people expect. At the same time, because of the amount of inflation still in the system and the effects of the automatic stabilisers, and perhaps the continuance of interest insensitive

distress lending, the public sector borrowing requirement is likely to be well above the illustrative figures in the MTF5 while EM3 (on the forecasts, which may be highly fallible) can only be brought towards the MTF5 path at the likely cost that interest rates stay at present levels, or even higher. In these circumstances and with the effects of the recession on the balance of payments, the exchange rate is likely to remain very high.

It seems to me totally incredible that we would wish or be able to keep interest rates at present levels for the next six or nine months given the likely course of the economy. Equally, though I can see the possibility of some early "demand-poor" action on the PSBR announced in November, I find it very hard to envisage (as the Treasury appear to envisage) serious increases in taxes in the next Budget.

There can be no question of reversing the broad thrust of the strategy: that would give us the worst of all worlds. But equally it seems to me that unless we are lucky with the numbers (as we may be - because we cannot forecast them at all well) we shall have to take risks with the short-term monetary targets and even consider the possibility of abandoning the MTF5. This last is too big a move to raise lightly. Indeed it is difficult to know how to raise it at all in Whitehall. But it seems to me it may be necessary tomorrow explicitly to envisage taking risks in the immediate future leaving the Government themselves to come to more realistic views about their strategy after a while.

Specifically the exchange rate surely now cries out for action. One option would be a 2% reduction of interest rates despite the money figures, presumably citing the exchange rate as overriding. Another option, which I think is more attractive, is to mount a substantial visible intervention onslaught. Of course, it could not be unlimited and of course, it might not work, but if we decided to spend \$200 mn in the course of a day we would at least register a shift in Government policy and might get an effect on the exchange rate which would hold the line against industrial criticism. Indeed, if it pushed the rate far enough (and left it there - which, of course, is a big query) it might obviate the need for a fall in interest rates and thereby go some way to

offset the damage to the money numbers from the intervention itself.

In any case, the situation seems to me so serious that we must be prepared to discuss options to offend against theology.

Cwm

21 October 1980