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MONETARY AFFAIRS

The Governor of the Bank of England called on the Chancellor at 11, Downing Street on Monday, 23 February, 1981 at 9.00 a.m. Sir Douglas Wass was also present.

2. The Governor said that, following his conversation with the Chancellor about exchange rate movements, he had looked again at recent movements in commodity prices. The sterling prices of commodities had moved up during the period 10-17 February, as the £ fell against the $, but they remained below their peak levels of last autumn. Sir Douglas Wass said he expected food prices to continue to harden during 1981, but those of other commodities and raw materials to remain weak.

Income of the Bank of England

3. The Governor emphasised the importance of this issue to the Bank; he had to be as sure as possible of his ground before taking any initiative. It was essential to ensure an income for the Bank which was both adequate and certain; how this was done inevitably had implications for the Bank's standing and independence. The Bank's real capital and reserves (excluding real property) had been falling for the last 10 years; the Governor thought this could not be right in the long run, and suggested that for the future the Bank should aim to keep its capital and reserves steady in real terms. The present 1½ per cent non interest-bearing balances kept with the Bank by the clearing banks had represented an important element in the Bank's income during the 1970s; since these balances were kept in accordance with an agreement concluded in the context of Competition and Credit Control, they provided the Bank with a source of income which was certain as well as adequate.

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4. The Governor noted that most central banks secured their income from the note issue. The division of the Bank of England into the Banking and Issue Departments was unusual; and under present arrangements the proceeds of the Issue Department were handed over to the Government with the minimum of delay, and more quickly than the Treasury Minute currently inforce required. He had considered whether a sufficient income for the Bank could be provided by delaying paying over the proceeds of the Issue Department, but had concluded that this approach to the problem would not be satisfactory. He now proposed an arrangement whereby all recognised banks - but not licensed deposit-takers - would keep non interest-bearing deposits with the Bank of England equivalent to a minimum of ¾ per cent of their eligible liabilities.

5. The Governor said he found it hard to find an absolutely cast-iron justification for requiring all recognised banks to keep such balances, although it might be possible to construct a sort of justification based on the banks' needs for "liquidity". The lack of any statutory authority could prove a problem, since it could not be excluded that some banks - and particularly foreign banks - might refuse to co-operate. The dividend paid by the Bank to the Treasury could constitute a further problem, in that the banks might object to providing the Bank of England with an income, part of which was at once paid over to the Government. The Governor therefore asked the Chancellor

(i) to indicate publicly that the Government would if necessary enact legislation requiring all recognised banks to make deposits with the Bank of England; and

(ii) to agree to accept only the minimum statutory dividend for an indefinite period.

6. Sir Douglas Wass said he would need to give further thought to an arrangement whereby Parliament would be imposing a tax,

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the proceeds of which were not paid to the Consolidated Fund. Although this should not prove an insuperable obstacle, it would need careful thought. It was noted in discussion that the arrangements for the Potato Marketing Board and the Horse Race Betting Levy might serve as precedents. On the question of powers to enable the Bank to require recognised banks to place deposits with it, it was agreed that it was strongly desirable, if possible, to avoid actually having to make good the threat; defining the powers of the Bank in this way inevitably restricted them, and made it more difficult to deal with new situations not foreseen at the time the legislation was enacted.

7. In further discussion the Governor emphasied the clearing banks' increasing reluctance to maintain the deposits under the present agreement; it would not be possible to oblige them to bear the whole burden under the new arrangements for monetary control. It was suggested that the Bank might represent the deposits required under the proposed new arrangements as a payment for services rendered. Just as the scale of the deposits was likely to be constrained by banks' reluctance to finance dividends paid to the Treasury, it would also have to take into account their probable unwillingness to pay for additions to the Bank's capital and reserves.

8. The Chancellor pointed to the need for him to be able to indicate clearly the approach followed by the authorities in the course of his Budget Speech. The Governor said he was anxious to avoid leaks in advance of the Budget, but would be urgently carrying on exploratory conversations in the period up to 10 March. He had already spoken to some of the Accepting Houses. Although it would not be possible to reach definite agreement with all recognised banks individually by 10 March, the Governor hoped to make substantial progress in discussion with representative bodies; whether it would be possible to reach agreement, at least in outline, would depend on the extent of any opposition he might meet.

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Financial futures

9. The Governor reported that the Bank had told a City Working Party on financial futures they saw no objection to an attempt to establish a financial futures market. It was, however, not yet clear whether those who wanted to establish this market would be able to find the "risk takers" required. It was difficult to foresee what the results of such a market would be, for example in the area of long gilts; but since the market could be established in any event offshore, it seemed better to allow it to be set up where it would be under the supervision of the UK authorities. The Chancellor noted the position. The Governor, in response to a suggestion by Sir Douglas Wass, undertook to ensure that the Department of Trade (which had an important interest in relation to life assurance) was fully informed of these developments.

Medium Term Financial Strategy

10. The Governor had read the draft paragraphs on the MTFS discussed at the Financial Secretary's meeting on 20 February. He wondered whether the Government were well advised to commit themselves to a new series of precise numbers; would it not be better to re-assert the thrust of the Strategy in more general terms? The Governor thought the figures given for public expenditure and £M3 (particularly if there were to be the 1 per cent a year clawback of the 1980-81 overshoot) could attract unnecessary attention, and could make it all the more difficult to justify early reductions in MLR. He thought too that the implication for the rate of economic growth towards the end of the period might seem like wishful thinking.

11. Sir Douglas Wass noted that successive Government had provided much of this material for several years, and that if the Government did not publish figures with the Budget, the Treasury and Civil Service Committee would extract them from the Treasury thereafter. It would not be possible to divert attention away from the path of public spending, which would be

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shown clearly in the Public Expenditure White Paper. Finally, if economic recovery were to become established, the 3 per cent a year growth in 1983-84 would be relatively moderate by comparison with previous recoveries from recession.

JW

(A.J. WIGGINS)
23 February 1981

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