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NOTE OF A MEETING HELD AT NO.11 DOWNING STREET ON MONDAY, 23 FEBRUARY, 1981 AT 2.30 P.M.

Present:

Chancellor of the Exchequer (In the Chair)
Financial Secretary
Mr Burns
Mr Middleton
Mr Britton
Mr Monck
Mr Unwin

Governor - B/E
Mr Fforde)
Mr George) Bank of England
Mr Goodhart)

MONETARY AFFAIRS

Medium Term Financial Strategy

The Governor expressed his continuing anxiety about the quantification of the MTFS. He wondered whether the general thrust of the strategy could not be reaffirmed in the Chancellor's Budget Speech without the Government committing themselves to new figures. He noted that there was no longer any question of showing any clawback of the 1980-81 excess of monetary growth, and this made the position a little easier. But the growth prospect still seemed to him wishful thinking; public expenditure would be shown on a higher path throughout the period; and there was bound to be some question about the compatibility of the fiscal and monetary figures. In general the MTFS was now much less attractive than in 1980 - growth would be lower, and the fiscal adjustment would do not more than offset the contractionary effects of the 1981 Budget. The original idea of the MTFS had been a progressive strengthening of expectations of lower inflation, as the Government's targets were met; the fact that the targets had not been met now made credibility that much harder to sustain with new numbers. In further discussion it was noted that the first ten paragraphs of the draft of the 1981 MTFS explained why £M3 had been misleading; was there any reason to expect

/£M3 to be a better

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£M3 to be a better indicator in future? And if not, was it appropriate to base medium term policy on the same indicator as hitherto?

2. The Financial Secretary recognised the force of the Governor's points. But he saw no escape from providing new figures for the MTFS. Projections at any rate two years ahead of both expenditure and revenue had always been given in the Public Expenditure White Paper; the Government had already committed themselves to provide a medium term forecast of North Sea oil revenue, and it would hardly be possible to avoid giving other medium term revenue figures; and, more generally, failure to fill out the MTFS would inevitably be interpreted as a weakening of the Government's commitment to the strategy. Nor had experience so far been as unsatisfactory as the Governor implied; inflation had fallen sharply, and people's expectations had undoubtedly changed. The fact that the Government were imposing a sharply contractionary Budget at a time of deep recession would give added assurance that they took the problem of the PSBR seriously.

Interest Rates

3. The Governor said that the authorities would face a problem in relation to interest rates in the MTFS, in the specification of monetary targets, and in day to day operations in the money markets: what explanation would the Government give of their stance on interest rates? A 1-1½ per cent increase in £M3 was expected for banking February (published on Budget Day); M_0 and M1 were likely to accelerate, and £M3 would probably continue to overshoot. It would thus be necessary to make clear that decisions on interest rates would have regard to the inflation rate, real interest rates and the exchange rate; and it would probably be appropriate to make some mention of this in the MTFS. Against this background the Governor cautioned against an early announcement of the abolition or suspension of MLR; a situation could well arise in June in which it would be very useful to have MLR available. In further

/discussion it was

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discussion it was noted that the disappearance of MLR would deprive the Government of the "announcement effects" of a change - these effects could not be secured simply by varying the bands within which the authorities were from time to time operating. The further point was made that, in the absence of MLR, it might be difficult to ensure the desired movement of seven day rates through the new system of interest rate bands, and this could also have implications for the movement of banks' base rates which would be influenced exclusively by money market conditions.

4. The <u>Chancellor</u> said that his preference would be to make an administered change in MLR in the Budget, which would be the last change under the old system. The way would then be open for the new system to come into effect with interest rates at the "right" opening level; in the absence of such an administered change, it was not clear how and when interest rates would reach that right level. More generally, he emphasised the need to be seen to be making progress towards the new arrangements outlined in his 24 November statement - arrangements which the Bank had themselves agreed would be improvements.

5. In further discussion it was noted that the Government were not committed to introducing every aspect of the new arrangements with effect from Budget Day; and the Bank had already been changing the way in which they operated in the money markets, although important further changes were still in view. A separate question remained about the "right" level of interest rates after the Budget; a reduction in MLR of as much as 3 per cent could well prove to be unattainable.

6. The <u>Chancellor</u> asked Treasury and Bank officials to consider further the future arrangements for the determination of interest rates, against the text of the relevant draft section of his Budget

/Speech. He noted

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Speech. He noted that Mr Middleton had circulated some revised material, with which the Bank had indicated a broad measure of agreement on the topics to be covered and the general approach.

Reserve Asset Ratio

7. Mr George drew attention to the large shortage there would be in the money markets on 27 February and 2 March as a result of the PRT payments superimposed on a substantial call on a part-paid gilt. The Bank would have to relieve both the cash shortage and the reserve asset position of the banking system. It would not be possible to relieve the cash shortage by buying in bills, with the result that there would have to be some discount window lending. As to reserve assets, it would in principle be possible - at the cost of undesirable artificiality - to arrange for this to be covered by gilt sale and repurchase arrangements; a better alternative would be a temporary reduction in the reserve asset ratio, with the 10 per cent level restored on 11 March.

8. The Chancellor suggested that a temporary reduction in the RAR - with reversion to the previous level taking effect after the Budget - would look very odd, since the authorities had already indicated that the ratio would disappear. Would it not be more orderly to leave the ratio at the reduced level until it was finally phased out?

9. In further discussion the Bank representatives explained that, although the reserve asset ratio would have no further monetary significance, it would need to be retained as a prudential norm for an interim period, while new arrangements for the prudential supervision of Banks' liquidity were negotiated over the next six months with each of the main groups of banks. This process could not be embarked upon until the question of the cash ratio and the Bank's income had been settled; and the supervisory side of the Bank would not want their negotiating position prejudiced by a reduction in the liquidity norm in the meanwhile below what they might think prudent - for at least

/some groups of Banks -

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some groups of Banks - in the long run.

10. The Chancellor, concluding this part of the discussion, suggested that the Budget Speech should announce abolition of the RAR for monetary control purposes, while at the same time making clear that a 10 per cent liquidity norm would be retained on a temporary basis until the new prudential arrangements were in place. The Bank meanwhile undertook to explore ways of arranging for the RAR to revert to 10 per cent in advance of the Budget Speech rather than after it.

Levy on the Banks

11. The Chancellor told the Governor of his decision to impose a once-for-all levy on the Banks at a rate of 2½ per cent of non-interest-bearing deposits (including inter-bank deposits and 40 per cent of transit items).

JW

A J WIGGINS
24 February 1981

Distribution:

Those present
Chief Secretary
Sir D Wass
Mr Ryrie
Mr Ridley