TOP IN P.M. SEM. DOSS

SECRET (Sec. 23)

15. 7.81

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THE GOVERNORS
VIA MR FFORDE

Copies to: Mr Coleby
Mr George
Mr Goodhart

A PRE-SEMINAR MEETING WITH WASS

A Bank team led by the Deputy Governor met Sir Douglas Wass, Burns and a number of Treasury officials yesterday to discuss the papers being submitted by HMT (but largely agreed with the Bank) to the Prime Minister's seminar on monetary control later this month.

Wass began with a series of questions aimed at establishing what elements of discretion the Bank would have in operating the new undisclosed interest rate band and what would be referred to Ministers. The discussion was not helped by two misunderstandings. Wass had clearly not appreciated that the new system was intended to leave market forces a greater role in setting the term structure of interest rates but that the very short rates would still be heavily influenced by the authorities; Middleton for his part, brought up the subject of the discretion left to the Bank by virtue of its ability to aim for any point in the band rather than for the centre, although he has been told on a number of occasions that all such talk is premature until we see what degree of control we can achieve under the new arrangements.

Nevertheless, it was possible for the Bank to make clear that we would not welcome day to day intervention from HMT and for their officials to repudiate any suggestion that this was what they wanted. There was also provisional agreement that Ministers should generally be involved only when there was pressure for a change in the centre point of the band. These were welcome developments from the Bank's point of view; but, of course, it remains to be seen how the processes of consultation and delegation will work in practice.

Wass then turned to the question of MLR. The Deputy Governor explained that the Bank were reluctant to let MLR go. Couzens was obviously of the same mind. But, as rapidly emerged in discussion, there were a number of ways of leaving MLR with a place in the system, each of which might have different presentational and practical effects, and Wass urged the Bank to be very specific in its proposal, if it wished to support retention of MLR. Wass himself was apparently of the view that the benefits of MLR as a signal at times of crisis could just as well be achieved without it, by means of a public announcement of the authorities' general wishes supported by prompt open market operations.

The final topic touched on was how short-term interest rates should be set under the new arrangements. There was a general welcome for the pragmatism of Andrew Britton's paper on this subject but Burns clearly wishes to move away from £M3 towards M1 as the main short-term quantitative guideline. He was not able to explain how he would set a figure for this guideline, but "it should be the figure which is compatible with the same inflation objective as the £M3 target is being set to achieve". As was obvious yesterday, just one or two remarks of this kind rapidly threaten to produce both a "cross-eyed controller" (aiming for incompatible short-term targets) and some very muddy analytical water for him to flounder in.

Gilt-Edged Division HO-G
15 July 1981

M D K W Foot (4086) Michael Foot

TOP FILED IN P.M. SEM. DOSS.
(Sec. 23.)

15. 7.81

NOTE FOR RECORD

GR 17/7.

Copies to The Governor
Mr Fforde
Mr Coleby
Mr George
Mr Goodhart
Mr Foot

I spoke to Wass on the telephone today as a follow up to yesterday's pre-seminar meeting. They had not in fact had a meeting with the Chancellor on this subject this afternoon as planned but Wass hoped to speak to him about them tomorrow (16. 7.81).

On the substance of the discussion he agreed with my view that we had pretty much sorted out the degree of ministerial involvement (or lack of it) in the way the system should work. On the future of MLR we both agreed that we needed to do some more work on what meaning should be attached to the phrase "the suspension of MLR" and more generally what provision should be made for the appropriate retention of some degree of precise discretionary control by the authorities. I told him that the Chancellor should know that the Governor believed that it would be unwise to relinquish the power of using MLR after 20 August, at least for some time. As he knew, my view was similar. Certainly I thought that, as a minimum, the authorities should retain the explicit possibility of moving interest rates on occasion further and more quickly than normal operation of our proposed system might allow.

Wass said that he was personally rather doubtful of the whole move to the new system, but granted that we were going to do it - largely, he believed, for political and presentational reasons - we should go the whole hog and effectively abolish MLR.

He also told me that at long last the Chancellor had sparked on the Wass report on funding techniques. He now wanted a meeting with Treasury officials and presumably one with us; and that he then wanted it placed on the agenda for the seminar. I sighed at this but Wass' view was that the events since the report was written (the success we have achieved in funding, the innovations we have made, and the lessons to be drawn about auctions etc). would enable us to persuade rather easily first the Chancellor and then the Prime Minister to accept the report.

CWM

15 July 1981

16.7.81

THE GOVERNOR

Copies to
The Deputy Governor
Mr Fforde
Mr Blunden
Mr Page
Mr Loehnis
Mr Dow
Mr Coleby
Mr Cooke
Mr Flemming
Mr George
Mr Goodhart
Mr Gill
Mr M D K W Foot

The Chancellor wants to hold a meeting with you and your team on Wednesday 22 July at 2.30 pm (for c. 1½ hours) in his room at HMT to discuss, first, the papers for the Seminar and then, perhaps, other policy issues, such as bank lending. The Treasury team is as yet uncertain, but will probably include the ~~Financial Secretary~~, Wass, Ryrie, Middleton, Monck and perhaps the ~~Chief Secretary~~.
Your programme is free that afternoon except for the Banking Supervision Review meeting which can be changed.

May I confirm the timing please?

The Governor
I have told the Chancellor's Office that 4.00 on Friday 24 wd. be v. inconvenient & that you wd. prefer to stick to Wed 22 at 2.30.

M P Stafford.

Governor's Office HO-P
16 July 1981

Miss M P Stafford (4421)

[initials]
16/7

The Governor
The Chancellor's office rang to say that the FS will now be in Brussels on 22/23 July. They would like to re-arrange the mtg for Friday 24/7 @ 4.00 pm - if you are agreeable.

[initials]

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16.7.81

GPS

The governor will wish to be aware of this

20.7.81

SECRET

THE PRIME MINISTER'S SEMINAR ON MONETARY CONTROL

Note of a meeting held in Sir Douglas Wass's office on Tuesday 14 July at 16.30.

Present:	Sir Douglas Wass (Chairman)	Mr McMahon	Bank of England
	Sir Kenneth Couzens	Mr Fforde	"
	Mr Burns	Mr George	"
	Mr Ryrie	Mr Goodhart	"
	Mr Middleton	Mr Coleby	"
	Mr Monck	Mr Foot	"
	Mr Davies (Secretary)		

Sir Douglas Wass said that he wanted to concentrate the discussion on three main subjects:

(i) How the band will be operated in practice

(ii) The future, if any, of MLR

and (iii) The factors influencing the determination of short-term interest rates.

(i) The Interest-Rate Band

2. Sir Douglas Wass thought it important for the Bank and the Treasury to reach a clear understanding, before the new system was put into operation, on the way it would operate in practice and, in particular, on the circumstances in which the Bank would refer to the Treasury for guidance on the degree of market intervention which would be acceptable. It was not yet entirely clear what the band was for, or what we meant by "allowing the market a greater role in the determination of the structure of short-term interest rates." What kind of market-determined factors could bring about a rise in interest rates within the band, and how would we decide whether to bring rates back towards the centre?

3. Mr McMahon said that in the Bank's view the purpose of the band was to give the market more scope for influencing rates. This did not mean that rates at the very short end would be market-determined - they would not be - but rates out to three months would be more influenced by market forces than they are now. There was also, of course, the agreed objective of depoliticisation. In practical terms the Bank expected that there would be periodic discussions on FOMC lines at which guidelines for the market

DG 17/7/16

operators would be developed. Thereafter they would not expect day to day guidance from the Treasury, though of course the existing regular informal consultations would continue. Mr George commented that from a market operator's point of view the band was essentially to accommodate noise in the system. They could not be sure of hitting the centre. Mr Coleby pointed out that under the new system the clearers' balances would be reduced and with them the cushion now available to the market. The Bank's ability to manage the overnight rate might thereby be reduced. If rates rose to the top of the band, or even temporarily above it, because of market shortages greater than estimated by the Bank it would be important first to try to identify the reasons for the shift. If a specific reason could be identified, perhaps an unexpected change in the Exchequer position, then the normal presumption would be that the Bank should relieve it. If not, and rates were still within the band, then it might be appropriate to leave them there. But it was important to remember that the overall objective was to achieve a particular money number and the degree of intervention over a period must be consistent with that objective.

4. Sir Douglas Wass said it was generally agreed that the band was a useful feature of the new system. But it was essentially an administrative convenience providing a framework within which officials and market operators could work without continual reference to Ministers, although the precise degree and timing of Ministerial involvement would need to be decided in the light of experience. It was clear that we could not move the band without Ministerial decision but as Mr Fforde pointed out there would be occasions when the important political decisions were taken before it was moved. As far as consultation between the Bank and Treasury, Mr Monck already talked frequently to Messrs Coleby and George. It would be particularly important to maintain these regular and informal contacts as the new system came into operation.

(ii) Minimum Lending Rate

5. Sir Douglas Wass said that since under normal circumstances MLR would have no role in the new system it might seem strange not to abolish it at once. To leave it in place could damage the public presentation of the new arrangements, and might suggest that we lacked confidence in them. Mr McMahon said that the Bank had not yet reached a final view. He was not in favour of abolition, since he could envisage circumstances in which we might need the announcement effect of a change in MLR. An exchange rate crisis was the

most obvious example. But he thought we could suspend it, on the understanding that it was a stick we might wish to bring out of the cupboard at some future date. Mr Fforde agreed. A glass fronted box would be the appropriate resting place, with a sign "In case of fire break glass". Mr George thought suspension could be dangerous. If we were obliged to reinvent MLR after a couple of months it would clearly signal the failure of the new system. There were considerable uncertainties about the way the system would operate in the first few months. The best solution might be to adjust MLR from time to time in response to interest rate changes generated by the new arrangements. Whilst the sign board could be removed from outside Mr Coleby's office, it would not be thrown away. Mr Ryrie thought that if there continued to be any number attracted to MLR, even adjusted ex post, it would continue to influence the banking system. He did not see how this could be reconciled with the new system. Mr Middleton was inclined to agree with Mr Fforde. He saw MLR as a stuffed bird in a cage but one not, perhaps, entirely incapable of flight.

6. Sir Douglas Wass continued to favour abolishing MLR or rather, in the words of the Budget speech, suspending it altogether. We should try to behave as if we believed the system would operate satisfactorily. It would be useful if the Bank could define their position carefully in advance of the Prime Minister's seminar.

(iii) The Determination of Short-Term Interest Rates

7. Mr McMahon said the Bank were generally content with Mr Britton's paper, which referred to all the factors which they wanted to see taken into account. Mr Burns was less happy with the position we had reached. In particular, he was not satisfied with the process whereby we derived the M1 forecast. Essentially the process started with an assumption for growth of £M3, from which we derived a path for short-term interest rates. This led us to a view of the M1 growth consistent with these rates. The process was not well understood, and the derivation of interest rates was particularly uncertain. He believed we must attempt to find a more direct route to an M1 target figure. Mr Goodhart argued that we would then be building inconsistency into the targets ex ante. Mr Burns recognised this danger. But what we should aim to find is an M1 figure consistent with the inflation rate consistent with the £M3 target. He accepted, however, that it would be difficult to get at the number and to present it publicly, particularly since as inflation drops we can expect M1 to grow faster than nominal incomes.