Econ Pol
Monetary Policy

Prime Minister ②

MCS 29/1

RECORD OF A MEETING IN THE CHANCELLOR'S ROOM, TREASURY CHAMBERS, AT 15.00 ON 21 JANUARY 1982

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Present:

Chancellor of the Exchequer	Mr Althaus,	Pember and Boyle
Chief Secretary	Mr Congdon,	Messels
Economic Secretary	Prof. Eltis,	Exeter College
Sir K Couzens	Mr Gilchrist,	Union Discount
Mr Ryrie	Prof. Griffiths,	City University
Mr Burns	Mr Hamilton,	Fielding, Newson, Smith
Mr Middleton		
Mr Ridley	Prof. Minford,	Liverpool University
Mr Kerr	Mr Pepper,	Greenwells
Mr H Davies	Prof. Rose,	Barclays
	Prof. Walters,	10 Downing St.

MS

MONETARY ISSUES

The Chancellor reminded participants that the proceedings were private. Mr Kerr's letter of 18 January had set out a number of questions, which he proposed to take in order.

(a) Current financial conditions - tight or loose?

2. Professor Griffiths said that the broad and narrow aggregates told rather different stories. From the recent behaviour of the monetary base and M1 one might judge that policy had been tight, whereas £M3 and PSL2 (which was more useful in view of the current distortions to £M3) had been growing more rapidly - and of course their record as predictors of inflation was better. But to judge the tightness of policy one needed to make an assumption about objectives. If the aim was to have inflation in single figures in 18 months time the policy was rather loose. If we were focussing on the pace of recovery it was tight. Mr Pepper saw the experience of the last two years as exceptional. The growth rates of £M3 had been badly distorted for a number of reasons. It was dangerous to put too much weight on the narrow aggregates - they had given the wrong signal in 1972/3 - but one should not ignore them in current circumstances. He saw a danger that policy could become too tight and thereby threaten the recovery. The major difficulty we faced was that unless an alternative source

of finance for companies could be found their demand for bank lending would be incompatible with modest growth of broad money. Mr Congdon also thought policy had been quite tight. The recent sharp and unprecedented drop in house prices was a good indicator. PSL2 had grown quite slowly in recent months. But there remained strong demand for credit, particularly in the form of leasing, where the implied interest costs remained low. He agreed with Mr Pepper about bank lending to the private sector. The problem was that in the face of the growth of leasing through bank subsidiaries the debenture market could not get off the ground.

3. Professor Minford saw a number of indications of tightness. M1 and the monetary base were more reliable indicators in current conditions. Developments in the labour market were a good indicator of inflationary expectations, and recent claims had been relatively modest. Real interest rates were exceptionally high. A controlled recovery was in process, but we should not be tempted to loosen policy now. If we held on, £M3 would come back into line. Professor Eltis believed the existing policy stance was about right. PSL2 was the best indicator. We need not be worried by a growth rate of 12 per cent. Professor Rose agreed. £M3 was still growing rapidly, but it had been badly distorted. He thought there had been more round-tripping than was generally recognised. Messrs Gilchrist and Althaus, on the other hand, were more concerned about the excess growth of £M3. They saw a danger of resurgence of inflation, particularly if interest rates were allowed to drop too far.

NO

(b) Influence of International Developments

4. In a brief discussion most participants said they believed that developments in the US would continue to exert a strong influence on the UK, particularly on interest rates. The Americans were still trying to pursue an expansionary fiscal policy alongside a restrictive monetary policy. There were different views about the likely depth of the US recession, but agreement that the net influence of the US in the coming year would be contractionary. The German outlook was more promising, as was the Japanese.

(c) Future Monetary Policy

5. The Chancellor said that his overall objective had been stated, not once, but many times, as maintaining steady but not excessive downward pressure on the monetary aggregates. The aim was to stop inflation rising again and to create the conditions for real growth within the assumed growth of money GDP. He was interested in participants' views on the way the policy should be presented in the Budget.

6. Professor Minford thought that the £M3 targets should be retained, but supplemented with targets for the monetary base and M1, which he thought provided better guidance for short term decisions. Ranges of 3-7 per cent for M1 and 2-6 per cent for Mo should be feasible. It was important to keep the numbers low to consolidate the change in expectations that had already been achieved. The exchange rate had been a useful guide through the fog of the last few months but it should gradually be relinquished. The decline in UK relative labour costs implied an upward movement for sterling, which should not be resisted. On the other hand, a fall should be resisted, with the floor an effective rate of about 90. Professor Eltis disagreed. It was important to recognise the deflationary impact of another year in which the Government aimed at lower monetary growth. The effect of announcing such a low target, and the fiscal stance which could be expected to accompany it, would be to depress activity further. The objective should be to restrict PSL2 to about 10 per cent. He did not think this would cause major problems for sterling. It might drop to $1.70 or so, but would recover. We should not try to stop it falling. As for an M1 target, he thought what Professor Minford proposed was unrealistic. As the recovery gathered steam M1 could be expected to grow more quickly. Professor Rose also opposed an M1 target. M1 was far too sensitive to nominal interest rates. Targeting M1 was indistinguishable from operating a simple interest rate policy.

7. Mr Congdon favoured continuing with a £M3 target with numbers as close as possible to those in the original MTFS. The target should be consistent and simple, and related to an objective for

growth of nominal income. We could clearly not tolerate 15 per cent growth of £M3 for ever, but there was a case for accepting the excess growth that had been observed and simply building it into the base. That should allow us to get back to single figures next year. Prof. Rose saw dangers in this approach. Better pitch the target range higher and stay within it for once. Professor Griffiths thought the designation of the target was not very important. Mr Gilchrist however, believed it was vital for the gilt market. To go explicitly for a higher number next year, or to abandon a target altogether, could create very difficult conditions.

8. Mr Pepper thought that it was the attempt to simplify the presentation of the MTFS that had led us astray. He had recently reread the introduction to the Green Paper on monetary control and found the argument still persuasive. But we had put too much weight on a single £M3 number. He would be alarmed if we now moved to M1 and made the same mistake. It was vital to monitor all the aggregates and reach a considered judgement. We would need to pay some attention to the exchange rate, also. But we should distinguish between a weak pound and a strong dollar. There was a risk of another period of very tight US policy which could push the dollar up. If sterling were reasonably strong against the European currencies we should not respond. Professor Minford said the key was to create a policy environment which influenced expectations. Complexity was not a problem. It had been necessary to analyse policy in spite of £M3. It would be easy to present a network of target bands convincingly. The Fed did.

(d) Indexed Gilts

9. Commenting on the future course of policy Professor Minford said greater emphasis should be placed on index-linked stocks. He was alarmed that there had been no further issues since July. It was foolish to rely on conventional funding at present. But Mr Althaus pointed out that the existing restricted market had been over-supplied early last year. We should widen eligibility. The yield would then fall. Messrs Gilchrist and Congdon agreed. They had never seen the point of the restrictions.

Professor Rose thought IGs could be particularly important as the election approached. They would be an alternative to foreign investments for those concerned about the outcome.

10. Mr Pepper, on the other hand, saw some dangers in unrestricted IGs. They could make it even more difficult for industry to raise equity finance, since the Government would be competing for a limited pool of risk capital. He favoured a short derestricted IG. Mr Hamilton did not think that IGs would in the event reduce the amount of money available for the equity market. Investment managers would not in practice reduce equity holdings to buy them. It was the total quantity of Government borrowing that was important.

(e) Fiscal Policy

11. The Chancellor asked for participants' views on the size of PSBR he should try to achieve in the coming year. Mr Althaus said that if the Government wanted lower interest rates they would need to conduct a responsible fiscal policy. He thought that on unchanged policies the PSBR would be around £8 billion. Anything higher would be a mistake. Mr Congdon thought the exact number chosen was not too important, given the margin of error. He favoured continued restraint, however, and a PSBR no higher than the 81/82 outturn, which he thought would be around £10 billion. The lesson of this year had been that interest rates were the most powerful influence on the economy. In spite of a very brave budget in fiscal terms the interest rate cut had moved the economy more. It would be important to maintain consistency between fiscal and monetary decisions. Professor Rose agreed that the economy was now very sensitive to interest rates. As for the PSBR, he thought a number close to the 81-82 outturn would be satisfactory.

12. Professor Eltis favoured a PSBR roughly the same size as this year. But there was a chance that real growth might be 2% rather than 1%, if the strong export performance was maintained. If so, he would favour another £1 billion of tax cuts to offset the extra revenue that could be expected. Professor Minford said that according to his calculations the cyclically adjusted

PSBR was now lower than for some time at around 2% of GDP. This was good, but we must try to get even lower. In nominal terms a PSBR of £8-9 billion next year would maintain progress. If there were to be any room for manoeuvre we should use it to improve the tax structure. Mr Pepper said the objective should be a Public Sector Financial Deficit no higher than this year.

(f) Monetary Control

13. Professor Griffiths said he had been disappointed by the outcome of the Green Paper exercise. Two years work had come to nothing. The changes were meant to add flexibility to the Bank's operations in the bill markets but in reality little had changed. Our ability to control the money supply had not improved. Mr Congdon agreed there had been no major change. He was glad there hadn't. Mr Gilchrist said that in current circumstances the authorities did not know whether the discount market was bullish or bearish about interest rates. If the market can sell paper at ever higher prices to the Bank it will continue to do so whatever its overall view of the future course of interest rates. If the authorities want rates up they must act dramatically, as they did in September. Once they had given a lead then the market might give an indication of the extent of the rise needed. Mr Middleton agreed that at times when the authorities were operating throughout the yield curve, as at present in conditions of acute shortage, the yield move was not very informative. But in the normal way, when we were influencing only very short rates, we would expect to get information on the market's view from the behaviour of longer rates.

14. The Chancellor thanked the outside participants for their assistance. The meeting ended at 17.00.

Howard Davies

H J DAVIES

cc - See attached list

Copies:

Treasury Ministers and officials present
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Mr Monck
Mr Kemp
Mr Britton
Mr Turnbull
Mrs Gilmore
Mrs Lomax

Prof. Walters, 10 Downing Street
Mr Scholar " "