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From the Private Secretary

3 August, 1981.

Dear John,

The Prime Minister held a seminar on monetary control here on Friday afternoon. The following were present: Chancellor of the Exchequer, Financial Secretary, Governor and Deputy Governor of the Bank of England, Sir Robert Armstrong, Sir Douglas Wass, and Messrs. Burns, Middleton, Monck , Britton, Fforde, George, Coleby and Walters. They had before them the papers circulated by Mr. Middleton on 24 July.

The seminar first discussed the new arrangements for improved monetary control due to come into operation on 20 August. Mr. Middleton said that they were agreed between the Bank, the Treasury, and Mr. Walters, including the suspension of MLR. The Govenor confirmed that this was the case. On the question of MLR, the Bank's view was that a continuous posted lending rate would be inconsistent with the other elements in the new system. At the same time, there would still be some occasions - for example, at the time of major economic policy change or pressure on the exchange rate - when the authorities might want to signal the minimum rate at which they would be prepared to lend to the market. The suspension of MLR would mean that the authorities would have less control over interest rates generally; for example, in current market conditions it would make an early increase in base rates rather more likely. In addition, the market would - at least initially - be unhappy with the greater uncertainty that the suspension of MLR would entail. It would be looking even more closely than ever at the authorities' actions for evidence of their intentions.

The Chancellor said that the Treasury had no difficulty with the proposition that, in certain special circumstances, the authorities would need to give an advance signal to the market on the rate at which they would lend. In response to a comment from the Prime Minister tha it might have been desirable to have retained a greater measure of influence over base rates, the Financial Secretary said that one of the purposes of suspending MLR was precisely to reduce the influence of the authorities, and increase that of the market, over the determination of interest rates. In future, there should be less biased delay in the movement of interest rates, and this should make monetary control easier. Sir Douglas Wass added that it would be vital in future, if the market was to play a bigger role, for Ministers to refuse to answer specific questions about interest rates.

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The Prime Minister said she accepted it was worth losing influence over interest rates if that would mean an improvement in monetary control. But in that case, with a rise in base rates now more likely, it was important to ensure that the resultant higher bank profits would also be reflected in a higher tax take. The Financial Secretary commented that the banks were already paying a special tax in 1981/82; the question of their future taxation would be covered in the Green Paper on Corporation Tax.

The Prime Minister noted that it was intended to announce the new arrangements on 5 August in separate statements from the Treasury and the Bank. She asked whether Parliament might not resent the announcement immediately after the start of the recess. The Chancellor said that all of the arrangements had been foreshadowed by statements he had already made in the House. He did not believe there would be any criticism.

The discussion then turned to the question of how the interest rate band should be set. There were two main options: either to set the band on the basis set out in the Budget - i.e., with regard to both the movement of £M3 compared with its annual target and to other factors such as the movement of the narrower monetary aggregates and other indicators of inflationary conditions; or to set the band with regard to M_1 or the wide monetary base, M_o.

It was argued that, although the M_3 figures were heavily distorted by the civil service strike, it would be a mistake to shift from the formula set out in the Budget. M_3 had been chosen as the target variable for good policy reasons. A shift to reliance on M_1 (which would itself be preferable on merits to M_o) would involve a more restrictive policy stance if the 6-10% target for 1981/82 were to remain unchanged, because M_1 was now rising faster than M_3. Furthermore, any change would cause confusion in the market. On the other hand, it was argued that the current distortionsin both the M_3 and M_1 figures were so large that it would be sensible to have greater regard for M_o. Against this, it was pointed out that the authorities were relying on adjusted M_3 figures which took into account the estimated effects of the strike, and the distortions were likely to have disappeared by the end of 1981/82.

Summing up, the Prime Minister said that the new arrangements, including the suspension of MLR, should be introduced on 20 August as proposed, and announced on 5 August. The question of whether to move in due course to a system of monetary base control should be kept open. Of the two options for setting the interest rate band, they were agreed that it should be done on the basis set out in the Budget. While the current and prospective trend of £M3 (for the time being in adjusted form) would be the primary determinant, other factors - including M_1, M_o, the exchange rate, the real level of interest rates, and general inflationary conditions - should be taken into account. In making the announcement on 5 August, attention should be given to ensuring that it was understood

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both by the experts and by the public generally: it was particularly important that the latter properly understood why MLR was being suspended. Finally, the Treasury should keep under review the taxation of bank profits so as to ensure that the Exchequer obtained an adequate increase in tax take if bank profits increased again in response to rising interest rates.

I am sending a copy of this letter to Tim Allen (Governor's Office) and David Wright (Cabinet Office).

Yours ever,

Tim Lankester

A.J. Wiggins, Esq.,
HM Treasury.