File RAM

4

cc MASTER SET

10 DOWNING STREET

From the Private Secretary

16 July, 1985

Dear Rachel,

MONETARY POLICY

The Prime Minister held a meeting today to discuss various issues of monetary policy. Present were the Chancellor of the Exchequer, the Economic Secretary, Sir Peter Middleton, Sir Terry Burns, Mr. Cassell, Governor of the Bank of England, Deputy Governor Mr. George, and Mr. Flemming, Sir Alan Walters and Mr. Willetts.

Over-funding and £M3

The Chancellor said he believed that over-funding was no longer helpful in maintaining monetary control. He therefore recommended that funding should not exceed what was necessary to meet the PSBR. This would not represent a new policy but a decision to put into effect the policy he had announced in his 1983 Mansion House speech.

In discussion it was argued that cumulative over-funding over an extended period was likely to become less and less effective. Financial flows would adjust to off-set the initial impact. While ending over-funding might have little effect on the control of £M3 in the long run it was, however, likely to produce a period in which the growth of £M3 accelerated. Financial commentators were increasingly down-grading the importance of £M3 which had been growing very rapidly in recent months. The strength of the exchange rate gave assurance to the markets that monetary conditions were not too loose. A corollary of ending over-funding was that short-term interest rates would have to be somewhat higher than would otherwise have been the case.

Summing up this part of the discussion, the Prime Minister said it was agreed that funding as defined in the Treasury/Bank paper should be cut back to no more than was necessary to cover the PSBR. This would not be the subject of an early announcement (though markets were likely to detect a change in approach by the Government Broker). The Chancellor should consider setting out the background to the change in policy in his Mansion House speech in October.

Reducing the Bill Mountain

It was pointed out that over-funding was not the only factor behind the growth of the bill mountain. Another factor was the extent to which other parts of the public sector borrowed from the banks rather than from central government. The Treasury and Bank were seeking to improve NLF/PWLB facilities to reverse this trend. Even when the bill mountain had been prevented from growing the problem of rolling over the existing stock of £17 billion would remain. This would continue to distort money market operations. One possibility was for the Bank to replace its holdings of bills with deposits with the banking system. There were, however, a number of difficulties with this proposals. The Bank would be making unsecured deposits and would need to ensure that they were made only with financially sound banks. The process of selecting such banks would, however, be seen as conferring a seal of approval on them. It was agreed that the Treasury and Bank should examine further how such an arrangement might work.

Money Market Operations

It was agreed that the objective should be to return as far as possible to the spirit of the 1981 arrangements, under which the Bank confined its operations to short-dated bills. It was recognised that this could not be achieved immediately but was dependent upon first ending the growth in the bill mountain and secondly on reducing it.

It was argued that within the 1981 arrangements there was already provision for assistance to be made available on penalty rates, when appropriate. For example, the facilities for borrowing from the Bank late in the day were available only on terms which were less favourable than those in the market generally.

Sir Alan Walters said it had originally been envisaged that the 1981 arrangements could be further developed and he suggested that work should be undertaken to design a system which would place greater reliance on retaining money market assistance. Under such a system short-term interest rates could at times rise very sharply which would encourage banks to hold greater operational balances with the Bank.

It was noted, however, that such a system could not be introduced immediately, even if the authorities wanted to, as they would not have an adequate basis for assessing the demand for operational balances and hence for the money market assistance that should be supplied.

Summing up this part of the discussion, the Prime Minister said the aim should be to return as far as possible to the 1981 arrangements in which the Bank operated mainly at the short-term end of the market. Within those arrangements an element of penalty should be retained where market participants sought late assistance. In conjunction with the study of measures to reduce the bill mountain, the Treasury and Bank should examine whether there were any features of money market operations in the United States or Germany which could be adopted to improve monetary control in Britain.

I am copying this letter to John Bartlett (Bank of England) and Sir Alan Walters.

Yours sincerely
Andrew

(Andrew Turnbull)

Mrs R. Lomax,
HM Treasury.