

TOP IN BUDGET FILE (JMS')

5/11

to Governor

cc.

The Deputy Governor *

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Mr. Fudge

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Mr. Lochies

Mr. Dow *

Mr. George *

Mr. Coleby

Mr. Walker

Mr. Fleming

Mr. Goodhart

GPS

OR 13/2

* Already have copies



NOTE OF A MEETING HELD IN THE CHANCELLOR OF THE EXCHEQUER'S ROOM,
H.M. TREASURY ON THURSDAY, 4 FEBRUARY, 1982

Present:

Chancellor of the Exchequer
 Chief Secretary
 Economic Secretary
 Sir Douglas Wass
 Mr. Ryrie
 Mr. Burns
 Mr. Middleton

Governor of the Bank of
 England —
 Deputy Governor
 Mr. George - Bank of England
 Mr. Dow
 Professor Walters - No.10

 MONETARY AND EXCHANGE RATE POLICY

The meeting had before it a letter dated 26 January from the Governor to the Chancellor.

2. The Governor said that the analysis of monetary policy in his letter concluded in favour of announcing a less specific target for $\pounds 3$ than hitherto; it might be described as a guideline or "an expected range"; and it might be right to go for a wider (PSL2) and a narrower aggregate (M1) in addition. It was important to describe any change made very carefully to make clear the reasons for it.

3. The Chancellor said he broadly agreed with this analysis; the system might be described as one where the range for the broad monetary aggregates was $\pounds 3$ with PSL2 as a checking parallel. This would retain the leading role, but one would also look at the narrower aggregate, M1. It would be right to have a target or bracket for the broader aggregates, but he was less sure in relation to the narrower aggregate.



4. In discussion it was suggested that there was a case for having numerical guidelines for both the broad and narrow aggregate. The range should ideally be broad enough to encompass both M3 and PSL2; it would be too much of a refinement to have different targets for each.

5. It was pointed out that M1 tended to provide poor and contradictory signals, and while it should be considered alongside the broad aggregates, it could be a mistake to give it equal status. The aim of the exercise should be to produce a realistic and credible map of the terrain, showing the routes, and giving an indication when there was a significant deviation. This should ring an alarm bell which triggered thought rather than necessarily action.

6. Professor Walters suggested that part of the aim in adhering to monetary targets was to convince the markets that the Government had a real discipline and was following it. The other part was to sustain steady but not excessive downward pressure in practice. He agreed that there had to be a reasonable latitude for interpretation where the evidence was unreliable.

7. The Chancellor summing up this part of the discussion, said that there was broad agreement with the approach on monetary policy described in the Governor's letter, and with the need, as the Governor had suggested, to ensure careful presentation of the change. A Treasury paper was under preparation and would be available shortly.

8. Turning to exchange rate policy, the Governor said that he argued in his letter for making more explicit, at least internally, the Government's exchange rate objectives; or put another way the exchange rate criteria underlying decisions on short-term interest rates. Part of the thought here was that the move to a less specific monetary target might be read as indicating some softening in discipline, which could be counter-balanced by a firmer "anchor" on the exchange rate side. He suggested therefore that, for 1982



there might be an effective rate range of perhaps 88 to 92. He was not saying this should be locked in cement, since obviously external circumstances could change in ways that could not be anticipated; but he did believe there was a case for having clearly worked out and understood objectives. The underlying aim should be to maintain a real counter-inflationary thrust in order to get inflation falling again in the year to come.

9. In discussion it was argued that there were dangers in being tied to a particular exchange rate band because of the unpredictability of external events. Certainly it would be wrong to react without analysing very carefully the reason for pressure in a particular case. For example if the dollar strengthened, but commodity prices weakened, it might be right to let the pound trade down in line with EMS currencies rather than to try to prevent that happening.

10. It was suggested that there might be some attraction in linking exchange rate policy explicitly to counter-inflationary objectives. The public presentation might be to the effect that alongside monetary policy, account was also taken of the exchange rate, paying particular attention to counter-inflationary objectives.

11. On the other hand such a formula might be taken as meaning that upward pressure on the exchange rate was accepted and even welcomed. Beyond a certain point, this was surely not right, as it implied a willingness to allow the rate to go through the roof.

12. It was argued that in any case the exchange rate was a very much a day-to-day phenomenon, and because external circumstances could change so radically it was not feasible or wise to take a view - publicly or privately - for as much as a year ahead. What was regarded as reasonable or "about right" now might suddenly become unreasonable because of external shifts.



13. The Chancellor, summing up, said there was general agreement that the exchange rate would continue to be a most important indicator or alarm bell in the coming year, not least because of continued difficulty in interpreting the monetary figures. There were dangers in trying to establish too rigid a target range, because of the possibility of marked shifts in external circumstances, but nonetheless there was a feeling that there was a case for developing more explicit exchange rate objectives linked, though not exclusively, to the need to maintain the counter-inflationary thrust of policy.

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P.S. JENKINS

5 February 1982

Distribution:

Those present
Sir Kenneth Couzens
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