SECRET

Copies to the Deputy Governor

Mr Fforde

Mr Dow

Mr Page / Mr Cooke (para 15 in particular)

Mr Loehnis

Mr Coleby

Mr George

Mr Goodhart

Mr Walker

Mr Quinn ONLY

NOTE OF A MEETING AT NO.11 DOWNING STREET AT 5.00 P.M. ON WEDNESDAY, 18 JUNE 1980

Present:

Chancellor of the Exchequer (in the Chair)
Governor of the Bank of England
Mr J S Fforde
Mr Ryrie

JSF has the top copy and is examining.

MONETARY AFFAIRS

TCSC Monetary Enquiry

It was noted that the Treasury reply to the Committee's Questionnaire took the form of an essay, while the Bank were intending to offer specific answers to each question as well as an introductory section. Both the Treasury and the Bank would need to look again at their advice in the light of those prepared by the other institution.

Chancellor's meeting with the Clearing Bank Chairman

2. The Governor reported that he would be arranging for the Clearing Bank Chairmen to come to talk to the Chancellor at No.11 Downing Street on Thursday 26 June at 5.00 p.m.

Yugoslavia

3. The Governor reported a number of approaches from representatives of the Yugoslav Government seeking help from the UK banking system. The Governor had talked to the Yugoslav Central Bank Governor and to the latter's predecessor; they had made the point that bad economic conditions could threaten the political stability of Yugoslavia, they admitted that Yugoslavia had previously been too ambitious about economic growth, and they now sought assistance from the US, Germany and the UK & some members of OPEC. (The Governor's understanding

/of the amount sought

(JSFf 23/6 16)

of the amount sought was $1.1 billion from the US, $0.4 billion from Germany, and $0.2 billion from the UK, of which half in 1980 and half in 1981.) The Governor had made it clear that neither the UK Government nor the Bank of England could assure the availability of finance, or guarantee lending to Yugoslavia by commercial banks; he had also told the Yugoslavs not to borrow in an unco-ordinated way through various different entities, since this had previously given rise to difficulty in international financial markets. The Yugoslav stabilisation programme was undoubtedly an ambitious one.

Monetary situation

4. The Governor surveyed the immediate operational problems. The May money figures would be published the next day, and it was necessary to decide how to present them. There would then be the question how to handle the money markets on 20 June in the light of the Treasury Bill tender, and what to do about the gilt edged market. In a slightly longer time horizon the authorities would need to decide how to deal with "reintermediation".

5. The Governor did not wish to extinguish any prospects of an early fall in interest rates, but he did not see how the authorities could at present deliberately encourage such a fall. The high CGBR figure for calendar May had already been published, but the financial markets were still likely to find the banking May figure surprising; they would find the external inflow puzzling, and they might see the bank lending figures as more hopeful than they actually were. For banking June £900 million gross gilt sales had been achieved, but these were offset by £400 million of cash redemptions and next maturities. The CGBR had again been relatively high, and after some respite in July there was the prospect of yet another very high figure in banking August.

/It seemed likely that

It seemed likely that the CGBR would be £1½ million above the NIF forecast for the June quarter, and - unlike last year - there were no obvious explanations why borrowing should be bunched in the earlier part of the year. The problem seemed to result from high spending spread across the whole range of government activity rather than from a revenue shortfall, while local authority borrowing also seemed to be running ahead. It would be desirable to make clear in briefing on the May money figures that the CGBR problem had continued beyond the end of calendar May.

6. In further discussion it was noted that, although the markets would need to be warned about the CGBR, this should not be done in too alarmist a way, since there was still a reasonable prospect that at least some of the June quarter excess was the result of timing factors. The Bank's briefing would make clear that the external inflow was an oddity, not indicating any particular trend, while on bank lending the point would be made that the underlying trend was somewhat higher than the May figure suggested. More generally we should not admit that the high May figures gave a fair representation of the underlying trend in monetary growth as a whole: emphasis should be put on the growth of sterling M3 over the last six months (9% as an annual rate).

7. It was noted that there might be considerable competition for Treasury Bills on 20 June, since the Discount Market had largely missed out at the previous week's tender. The Governor hoped, however, that there would not be too much enthusiasm; he would prefer the Bank to adopt a neutral stance, rather than that they should have to act vigorously to restrain a substantial fall in interest rates.

8. It was pointed out that there was no need for any public statement on reintermediation until the banking July figures were published.

/To insist that all

To insist that all reintermediation must be accommodated within the 7-11% target range now seemed likely to require too strict a policy, but the issue should be left open a little longer. We should certainly want to point to the impact of identified reintermediation as it occurred. If monetary growth continued rapidly for reasons other than reintermediation, the authorities would have to take a less relaxed view of the overall situation; in that event remedial action would probably need to be fiscal rather than monetary.

9. The Governor indicated that the June increase in sterling M3 now seemed likely to be in the 1-1½% range, rather than 1½% or more as had seemed possible before the latest bout of gilt sales. For July a 2% increase in sterling M3 seemed in prospect if there were no further gilt sales (1½% after deducting the allowance for reintermediation). For the time being the gilts market remained very strong, with domestic buyers spurred into action by foreign interest in gilts and their wish to avoid being left behind. Now that the signs of the recession were becoming much clearer, there were prospects of substantially lower interest rates; but if rates fell too quickly, subsequent bad money figures could then sour the atmosphere in the financial markets. However if considerable further gilt sales could be achieved in the near future, much better monetary control would be assured over the months immediately ahead, and this would give added security to the financial markets.

10. The point was made that the Government had not been "over-funding" in May and June, given the high CGBRs; there was no prospect of a fall in interest rates sufficient to induce companies to issue fixed rate debentures, and in these circumstances if no attempt were made to achieve further gilt sales (in the hope of encouraging interest rates downwards), the prospects for interest rates could

/actually worsen.

actually worsen. The pace of funding could be reduced later, if the trends in the CGBR and bank lending warranted this.

11. The Governor acknowledged that the dominance of the authorities in the capital markets inevitably tended to crowd out private sector borrowers. It would in principle be better if the government were able to place less reliance on gilts, and secure additional funds direct from the personal sector, eg through national savings. However, Notwithstanding that although he admitted an early move to change the balance between gilts and national savings would be bound to present serious difficulties for the building societies, who had held their rates below market-clearing levels, The Governor urged it was agreed ~~It was agreed~~ that the Bank and Treasury should look again at the balance between the personal sector and the capital markets in the financing of the Government's borrowing requirement.

12. The Governor suggested that, to maintain adequate monetary control through July and August a further £600 million gross of gilt sales would be needed in July (£750 million of receipts were already assured), and a further £1,000 million in August (£260 million were already assured). This implied a need for two new stocks totalling £1.6 - £1.8 billion. If the market responded well to the new stocks now suggested, short term interest rates might be allowed to come down by about 1%.

13. On the precise details of the new stocks, it was noted that the shorter dated a stock was, the more attractive it would be to non-residents. For domestic institutional investors, stocks with a maturity of 20 years or more were the most attractive. In these circumstances the Governor's preference was for a "long" short (1985 or 1986) and a long stock maturing in 2000. The amounts might be £0.8 billion and £1.0 billion respectively. Mr Fforde

/explained that the

explained that the choice of maturities reflected the need, when funding on a rising market, to vary the maturities; there was an upward bulge in the yield curve in the 1990-95 area as a result of the authorities' recent concentration on those years. Varying the maturity dates offered the best prospect of keeping the markets on a rising trend.

14. The Chancellor indicated that he was broadly content with the Governor's proposals for new Stocks. He also agreed that the authorities should not seek to lead interest rates down, although he saw advantage in a 1% reduction in rates initiated by the financial markets, provided they acted in the knowledge that the CGBR was continuing to run at a rather high level.

Cash ratios

15. The Governor referred to the difficulty of achieving the desired outcome with the cash ratio consultative document. It had to be recognised that it would also be a negotiating document, and it would be damaging to make too much of the authorities' lack of commitment to it since this might encourage some parts of the banking system to reject it altogether. It was noted that, although the document was written illustratively in terms of a single ratio applicable to all banks, it did not preclude the possibility of a two tier system emerging from the consultations. The Governor undertook to show a further draft of the consultative document to the Chancellor; he recognised the political and presentational problems involved, and the need for the support of the Prime Minister and the Chancellor if the new arrangements were to be successfully implemented.

JW

(A.J. WIGGINS)
20th June, 1980

Distribution

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