The Governor

cc. The Deputy Governor
Mr. Blunden
Mr. Loehnis
Mr. George (own copy)
Mr. Walker
Mr. Dow
Mr. Fforde
Mr. Cooke
Mr. Balfour
Mr. Coleby
Mr. Goodhart
Mr. Holland
Mr. Quinn
GPS

EAJG

12.7.82

NOTE OF A DISCUSSION BETWEEN THE CHANCELLOR AND THE GOVERNOR AT THE TREASURY AT 2.45 PM ON 8 JULY

Present:-

Chancellor	Governor	Mr Burns
Economic Secretary	Mr George	Mr Littler
Sir Douglas Wass		Mr Middleton
Mr Ridley		Mr Monck
Mr Kerr		Professor Walters (No 10)

International Financial Issues

The meeting considered Sir Kenneth Couzens' papers of 25 June and 1 July on 'international financial disaster' and 'a US interest rate shock'.

2. The Governor gave a *tour d'horizon* of current threats to international financial stability. He referred to Germany, and the turbulence created by the difficulties of the Dresdener Bank (largely springing from AEG problems), and the difficulties of the Hessische Landesbank and some others over exchange losses; to the United States, and the collapse of the Penn Square bank of Oklahoma, and the problems being faced by Continental Illinois of Chicago, and by Chase Manhattan, and others; to Canada, and the yawning gap between the promises and the performance of Trudeau's economic management; to Eastern Europe, where the likelihood of defaults had somewhat receded, though rumours that Secretary Reagan was talking about the necessity of some defaults were hardly reassuring; and to Latin America where the position of Brazil was reasonably satisfactory, but the problem of the Argentine remained, and some consolidation of Mexico's short term debt was urgently required. Without doubt the single most potent cause of actual and threatened world financial instability was the high level of US interest rates and the consequent strength of the dollar. The figuring underlying the prospective $105 billion deficit was highly suspect, as was the likelihood of the Administration taking the necessary measures to hold the deficit to this level. And the prospect of the $90/100 billion financing which the Administration would require to get through the rest of the year was deeply disturbing.

3. The Chancellor wondered whether there was any scope for UK action to influence US thinking. Would a special early visit for talks with

Reagan and Volcker do any good? And could one suggest to Volcker that the monetary stance might now be a little too tight? The Economic Secretary expressed doubts about the political wisdom of an early visit, and Professor Walters about its likely efficacy: the Chancellor agreed. The Governor said that Volcker had, in his recent speeches, prepared the ground for some loosening of monetary policy by referring to structural changes. But he did not share Sprinkel's faith in the benefits which contemporaneous reserve accounting might bring. Professor Walters agreed that there was no convincing evidence that the introduction of contemporaneous reserve accounting from May 1983 would make much difference.

4. The Chancellor concluded that the risks of an open demarche to the Administration outweighed the possible advantages. Sir Kenneth Couzens would be taking whatever opportunities for private pressure might arise during his current visit to the United States, and the Governor would keep in close touch with Volcker. Realistically, our best hope however lay in achieving whatever partial insulation we could from US interest rates, which might stay rather high for some time. He and the Governor agreed on the need to maintain a close dialogue with the Germans: in addition to the Governor's contacts with Herr Poehl, Sir K Couzens might be in touch with him.

UK interest rates, and the exchange rate

5. The Economic Secretary argued that, with US interest rates likely to stay high, we might be ill-advised to let ours fall to a level which would not be sustainable in the face of further shocks from across the Atlantic. Moreover, it was worrying to see sterling dropping against the dollar, and rising against the European currencies, given that opposite movements would be more beneficial to us. It was also important to scotch Press speculation that the Bank were fighting to keep interest rates up in order to hold the exchange rate, while the Treasury wished to see a downward movement of both interest rates and the exchange rate.

6. The Chancellor, agreeing with this last point, thought that the Press speculation was both ill-founded and potentially damaging. It could, if interest rates were again to move down, create an expectation of a fall in sterling. Mr Middleton thought it best to counter the

Press speculation by deeds, not words; and the Governor pointed out that observers would in the last few days have seen the Bank edging rates down, signalling to the markets, and encouraging the expectation of a ½ per cent fall in base rate. He thought it important that the market trend should be quietly encouraged, and not rail-roaded.

7. Asked whether he accepted this analysis, Professor Walters said that he agreed that it would be right to get a ½ per cent fall now, and try again later for more. The way in which the Bank had managed the last interest rate reduction had been very satisfactory. Monetary growth remained well below target, and the conditions for a further fall were now right. Mr Ridley wondered whether the second ½ per cent fall might be achieved by early August; but the Governor thought it was too soon to say. He recognised the force of the Economic Secretary's worry about a reversal, if there were to be a further surge in US rates. But his present judgement was that we could achieve an early ½ per cent fall, and then be on secure ground.

8. Mr Burns, while agreeing with the Chancellor that it was important that a downward interest rate movement should not, as a result of past Press speculation, lead to an expectation of a downward exchange rate movement, conversely thought it important to avoid suggestions that interest rates would only be moved down when the authorities were certain that there would be no consequent downward exchange rate movement. Any such suggestions would merely confirm the misapprehension that we were applying an exchange rate target. Professor Walters thought that much would in practice depend on how sterling moved against particular currencies: we would not, for example, wish to take any action to correct any small fall on the effective rate, say to 88, which involved the Deutschemark rate falling to 4.00. All that we should say about the exchange rate was that we regarded it as an important measure of monetary conditions. The Governor said that we certainly should not suggest that we would like the effective rate to fall to 88.

9. It was agreed that the Bank should, if conditions allowed, continue to work to secure an early ½ per cent fall in base rate, using the discreet techniques currently being practised.

National Savings

10. Sir Douglas Wass pointed out that a $\frac{1}{2}$ per cent reduction in base rate would be beneficial to National Savings. The Economic Secretary, agreeing, said that he had accepted the case for doubling the £5,000 holdings limit for indexed certificates and for introducing a new income bond with an interest rate 1% above INVAC. But he had been doubtful about the proposal to issue a new conventional certificate with a yield to maturity $\frac{3}{4}$-1 per cent higher than the current 24th issue. There were obvious disadvantages in issuing a higher coupon certificate. However, this might be rather easier against the background of a general fall in interest rates. The Governor thought it important to reactivate funding through National Savings, so as to be able to take a pause in the Bank's funding operations, if we were to hit a shoal. The Chancellor agreed.

Hire Purchase Controls

11. The Chancellor referred to Lord Cockfield's letter of 28 June arguing for the abolition of higher purchase controls. The Governor agreed with Lord Cockfield's proposal, and thought that it might be right also to withdraw the Bank's general directional guidance, while making it clear that guidance on specific subjects would still be issued from time to time. The Economic Secretary had doubts about withdrawing the general directional guidance: his impression was that it was more honoured in the breach than the observance. The Governor thought this an excellent reason for withdrawing it. Sir Douglas Wass wondered whether recent bad import figures made the time right for withdrawal of HP controls; but Mr Burns pointed out that the overall balance of payments position was good, and the recent monetary figure excellent.

12. The Chancellor thought that HP controls had outlived their usefulness: it would be good to remove them, but important to do so in a way which would give the right signal. It was agreed that it would be best to act before the House rose, and that the Bank and the Treasury should be in touch about modalities and presentation.

Bulldog Issues

13. After a very short discussion, it was agreed that the Bank should have continued Ministerial authority for the policy of

limiting foreign issues. Their informal guidance should be designed to avoid any appearance of discrimination.

J O KERR
12 July 1982

Circulation:

Those present
Chief Secretary
Financial Secretary
Sir K Couzens
Sir W Ryrie
Mr Kemp
Mr Lavelle
Mr Pirie
Mr Hall