The Governor o/r

cc. The Deputy Governor
Mr. Loehnis
Mr. George o/r
Mr. Fforde o/r
Mr. Dow o/r
Mr. Coleby
Mr. Goodhart
Mr. Plenderleith.
GPS

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MINUTES OF A MEETING HELD IN NO 11 DOWNING STREET
ON FRIDAY 30 JULY 1982 AT 0915

Those Present:

Chancellor of the Exchequer
Economic Secretary
Sir Douglas Wass
Mr Burns
Mr Middleton
Mr Monck
Mr Turnbull
Mr Kerr
Mr Davies

The Governor Bank of England
Mr Coleby

Lord Cromwell Government Broker

Prof. Walters 10 Downing Street

FUNDING POLICY AND INTEREST RATES

a. Interest Rates

1. The Chancellor said that his intention was to establish broad guidelines for funding policy over the coming weeks; this was especially important in view of his and the Governor's projected absences. He agreed with the aims set out in Mr Middleton's minute of 29 July. We should endeavour to maintain downward movement in interest rates as rapidly, and as far, as was consistent with keeping the target aggregates on course. In this we should not be inhibited by any target for the exchange rate. Funding policy should be made consistent with this overrriding objective.

2. The Governor agreed that this was the background against which funding policy should be assessed. We had moved rates down several times in a relatively short period, and were currently engaged in another 'nudging' operation. So far the clearers had not moved, but they were bound to do so soon [base rates were lowered by ½ per cent to 11½ per cent that afternoon]. These moves had been engineered in spite of unhelpful developments in the US. The gilt-edged market had performed satisfactorily though unspectacularly. In the last few days recent gains had been consolidated under the shadow cast by the performance of the US bond market. The effective rate had remained firm although on the previous day there had been a short-lived move against the dollar after a large IMM selling order. But there were arguments for caution. In particular the massive US Treasury funding programme would weigh heavily on the markets in coming months.

3. Mr Burns drew attention to the improved outlook for inflation. Prices were rising more slowly than expected so that the underlying rate of increase in the RPI was now around 7%. Export and import prices had been rising at an annual rate of only 2% in the last 6 months. Sir Douglas Wass said this meant that real interest rates were higher than forecast which argued for further downward moves. The Economic Secretary thought that the continued strong growth in bank lending, particularly at the end of banking July, justified sounding a cautious note. But Mr Turnbull argued that the fifth week's growth had merely brought growth over the month as a whole back to the forecast level.

4. Mr Middleton said that the overall financial position was better than usual for the time of year. There were two potential danger signals - the narrow aggregates had started to show some growth, and bank lending was still rising quite rapidly, but neither seemed now to threaten the policy of lowering interest rates. Prof. Walters interpreted the recent behaviour of the narrow aggregates as still indicating a degree of tightness. They were well below the target range, and although as interest rates fell we could expect some resurgence there was considerable leeway. Steady downward pressure on interest rates was the correct response in current circumstances.

b. Funding policy

5. The Chancellor said he was persuaded by the case for further downward progress. But if that was the intention we should be careful to avoid any faltering in the funding programme which could cause difficulties on the monetary front. The question was, therefore, if we wanted to make headway on interest rates what level of funding should we try to achieve? He thought that the objectives set out in the latest forecast, and referred to by Mr Middleton in his note of 29 July, were reasonable. The Governor agreed. We should aim to fund in such a way that we avoided any awkward developments in the broad aggregates which could make the interest rate policy harder to pursue.

6. The Chancellor recalled that although there was general agreement on the desired scale of funding the previous week's discussions on the Bank's latest proposals had revealed some disagreement about the types of stocks it was appropriate to issue at the present time. He did not propose to initiate a fundamental reappraisal of the principles on which our gilt-edged funding was based but he was anxious to establish some guidelines which could help market operators during the coming weeks. His own view was that Mr Middleton's conclusion was about right. We should concentrate on shorts and long IGs but without completely excluding the possibility of conventional longs, with maturities in the next century if necessary.

7. The Governor thought that the precise mix of funding instruments to be used would need to be decided in the light of market developments. We could not hope to meet our objectives for August and September relying exclusively on short-dated conventional stock, and indexed gilts were selling slowly. We would be able to sell more IGs in due course but it would be important not to saturate the market. Small tranches from time to time was probably the best tactic, but we would need to pause after exhaustion of the existing stocks. This meant that we would need to issue some long conventionals. For some time we had tried to avoid issuing stock maturing in the next century, and this had created an imbalance in the structure of maturing debt. As Mr Middleton's note pointed out the average of maturing debt in the late 90s was around £4½ billion, dropping sharply to perhaps £1½ billion after the year 2000. There was, therefore, a good case for issuing a 21st century stock when the 1998 stock was exhausted. The argument for an ultra-long stock, as the Bank had proposed the previous week, was one of cost. The yield curve dropped away after 30 years or so.

8. Prof. Walters, on the other hand, thought we should concentrate on the shorter stocks. The lump in the yield curve started in the late 80s. Before then it was as cheap to fund short as very long. If we believed in the success of the Government's anti-inflation policy we should avoid conventionals longer than, say, 7 years and confine our long funding to IGs. Although he accepted that the 1990s had been heavily tapped there were years in the mid-1980s with relatively small maturities. The real yield implied by the prices of the long conventionals now was extremely high. There was a case, indeed, for a conversion on the lines of the 1932 operation perhaps involving an offer of long IGs to holders of long conventionals. But The Governor saw the question as not so much whether one believed inflation would fall, but what judgement one made of the stock the market would accept at current yields. He thought it most unlikely that we could fund adequately relying exclusively on short-dated stock, particularly when the National Savings contribution seemed likely to be very small.

9. Sir Douglas Wass thought that in some years the redemption problem looked difficult. And he saw the danger of creating excessively liquid conditions in future years if we issued large quantities of short gilts. Mr Middleton, too, believed that we could not entirely eschew long conventionals, though he had some sympathy with Prof. Walters' arguments. We must look at what the market could take in present circumstances. Mr Burns, however, considered it important to give an impression of resistance to market demands. We did not need to be excessively concerned about the danger of a funding pause; we were already well ahead of the

game. He did not wish to reopen the question of what we should aim for in August and September, but there was no need to go further than this, and it might be sensible on occasion not to offer the institutions precisely what they wanted.

10. Summing up the discussion <u>The Chancellor</u> said that there was a considerable measure of agreement on the overall objectives but clear differences of emphasis on the appropriate funding mix. For the time being he thought that the line set out in Mr Middleton's minute was the one to follow. In other words, if the Economic Secretary, after consulting the market operators, thought it necessary to issue a long conventional, perhaps maturing in the early years of the next century, to meet our targets for August and September, he would be content. In a slightly longer timescale we should aim to discuss further Prof. Walters' views, particularly the idea of a large-scale conversion.

Howard Davies

H J DAVIES
3 August 1982

cc those present:

Sir K.Couzens
Mr George o/r
Mr Sedgwick