



NOTE OF A DISCUSSION BETWEEN THE CHANCELLOR AND THE GOVERNOR
AT NO.11 DOWNING STREET AT 4 P.M. ON THURSDAY, 26 AUGUST 1982

Present:-

Chancellor
Sir Douglas Wass
Mr. Kerr

Governor
Mr. McMahon

World scene

The Governor said that the massive surge in the US markets had reflected and fuelled a feeling that a major change had taken place. Some claimed to detect a U-turn by the Fed: it was however more plausible to suppose that Volcker, in response to the flatness of the US real economy, had decided to loosen the monetary stance pragmatically. It was highly unlikely that the Americans would cease to pay attention to the monetary aggregates. The President's achievement on tax increases was real, but was being over-sold. And how far the downward path in US interest rates would prove sustainable was still in doubt.

Interest rates

2. Reactions in the UK markets to US developments had combined a great sense of relief with considerable confusion. Clearly the fall in US interest rates was good news, but the Bank had thought it right in the previous week to moderate the euphoria, for what we must work to achieve was a durable downward progression in UK rates. This week, there had been three separate reductions of $\frac{1}{8}$ in all four bands, and the signal had been correctly interpreted in the markets: clearly a base rate cut would come soon, though probably not before the weekend. The Belgians and Italians, Germans, Swiss and Dutch had already moved.



3. The Governor thought it important to try to reach an early judgement on how far we could and should go on bringing interest rates down. We had been operating with considerable success but in very favourable circumstances - with a strong exchange rate, declining inflation, and recently falling US rates. However, the monetary aggregates, and in particular M1, were now showing signs of faster growth, and the downward movement in the US could be reversed.

4. The Chancellor said that the inflation picture was continuing to look good, and the exchange rate to remain strong. There was a potential future worry about the monetary aggregates, but no reason for present concern about their readings. And the performance of the real economy strongly suggested that the pressure for further reductions in interest rates should be maintained. He was anxious for further steady, and if possible slightly more rapid, progress.

5. Sir Douglas Wass, while accepting that it would be right to set up a collaborative HMT/Bank exercise to consider how far we might hope to go this autumn, thought that it would inevitably be rather "by and large". Whether we attained, or indeed improved upon, any "target" exchange rate this autumn would be affected by developments abroad. The Governor however thought that it would be valuable, soon after Toronto, for him and the Chancellor to have another word about the desirable aim; and it was agreed that this should be on the basis of a jointly produced paper.

Exchange rates

6. The Governor said that the current strength of sterling owed something not only to the effects on the dollar of the recent falls in US interest rates, but also to the current travails of the franc. The French had in the current week spent about \$1.25 billion worth, most of it in Dm, defending the franc against speculation fuelled by rumours of a departure from the EMS and/or



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minutes been 'creaming'
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Dec 4/8 was
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and we had one

government changes. The Chancellor said that he would certainly have no worries about some fall in sterling's effective rate - indeed he would prefer a rate of 89 to the current 92. It would of course be important not to be seen to be promoting a fall. He also thought that it would be good if we could at present rates recoup some of the reserve losses from earlier in the year. (The Governor confirmed that some 'skimming off' was now being done.)

Funding

7. The Governor said that he detected from the discussions on funding which had taken place in his and the Chancellor's absence, that there was some difference of emphasis between the Bank and HMT. Given that the aim was to fund the borrowing requirement, the question was whether a risk of over-shooting was preferable to one of under-shooting. The Bank thought that it was: the Treasury disagreed. Some in the Treasury clearly also thought that if the Bank created more stock, they'd sell it; and the Governor acknowledged that there was an element of truth in that. The difference of emphasis was not operationally significant at present, but he himself felt it important to err, if at all, on the side of over-funding in the latter part of this year, particularly given the huge redemptions due in early 1984.

pleased, as I was, but
we were receiving more
rather reserve
losses.

8. The Chancellor said that his previous inclination, e.g. in the discussions in late July - had been to share the Governor's view that, while the aim should be neither to over-fund or under-fund, under-funding was particularly unattractive. He had been impressed with the arguments for keeping up the momentum of the funding programme. He was however now inclined to think that, in current circumstances, the case for erring on the side of under-funding was rather stronger.

9. It was agreed that Mr. George would discuss with Mr. Middleton, on the latter's return, appropriate ground rules for subsequent discussion between the Chancellor and the Governor.

10. The Chancellor noted that the question of long-dated



conventional gilts was also not of current operational significance. But he thought that the Governor should be aware that, whereas the Treasury, while reluctant to see any conventional issues at the long end, had not ruled the idea out altogether, it had become clear that the Prime Minister was still very strongly opposed to any long-dated conventional issues.

11. The meeting ended at 4.45 p.m., and was followed by a wider discussion, separately recorded, on international banking issues.

J.O.K.

J.O. KERR

Distribution:

Chief Secretary
Financial Secretary
Economic Secretary
Sir Douglas Wass
Sir Kenneth Couzens
Mr. Burns
Mr. Middleton (o/r)
Mr. Lavelle
Mr. Peretz
Mr. Turnbull

Mr Ridley

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PS / Governor ←