.541/1

The Governor ~~c.~~ The Deputy Governor*
Mr. Lochman*
Mr. George
Mr. Dow
Mr. Ffyrde
Mr. Coleby*
Mr. Flemming
Mr. Goodhart
CPS

* Already have copies.

NOTE OF A MEETING ON FRIDAY, 4 FEBRUARY, AT 12PM IN THE CHANCELLOR'S ROOM, No.11 DOWNING STREET

Present:	Chancellor	Governor
	Economic Secretary	Deputy Governor
	Sir Douglas Wass	Mr Loehnis
	Mr Burns	Mr Coleby
	Mr Littler	
	Mr Middleton	
	Mr Kerr	
	Mr Turnbull	

Or 8/2

Meeting with the Governor

1. The Chancellor said it would be useful to discuss the issues raised in the Governor's letter of 1 February - in particular the objectives of policy for the period ahead. It would be helpful to consider what the response should be, should the exchange rate weaken and interest rates begin to rise, while the Chancellor was abroad.

2. The Governor said that since their last meeting market conditions had been uneasy but were showing signs of stabilising. The exchange rate had fluctuated narrowly around 81 in effective terms and interbank rates were not putting pressure on base rates. This improvement had been achieved despite two adverse developments - greater immediacy of a fall in oil prices and higher US rates. The next lot of money figures to be published would be favourable. Nevertheless, there was always the chance that pressure could emerge unexpectedly.

3. The Governor was concerned that the Government's presentation of policy could create the impression that no further rise in interest rates would be permitted in any circumstances. It would be dangerous to face a weakening of confidence with one instrument of policy in baulk. This would create the expectation that the exchange rate would be allowed to fall without limit. An attempt to hold interest rates down by flooding the money markets would be seen as an abandonment of firm monetary policy.

4. The Chancellor said the objective was to maintain the right posture for monetary policy as a whole not to maintain given levels for either the exchange rate or interest rates. He was trying to condition expectations so that the markets would themselves conclude that a further rise in interest rates was not appropriate. The best way to do

this was not to talk about interest rates and the exchange rate directly but to stress that the underlying financial position was sound.

5. The Chancellor accepted that a rise in interest rates could not be ruled out and that care would be needed to avoid giving this impression. Nevertheless, a further rise in interest rates would be damaging to business confidence and should be avoided if at all possible.

6. The Chancellor said there was a better chance of success if expectations could be conditioned while markets were stable than after they had come under pressure. He was anxious to find early opportunities as time might be short. In particular he was keen to get across the message that an exchange rate fall produced by a fall in the oil price would not have a major inflationary impact on the UK. Our petro-status should not be exaggerated. Mr Middleton said a paper would reach the Chancellor shortly on this.

7. The meeting then considered how to respond to different circumstances. The Governor said it was difficult to define this in advance as the response would vary with what were identified at the time as being the causes. The Chancellor agreed, but felt that further work could be done on various scenarios. Mr Middleton agreed to take this on. The Economic Secretary noted that a number of participants at the seminar had argued that if the authorities had given a clear signal eg by opening the discount window at the desired level of interest rates, the rise in rates could have been avoided. If the authorities remained silent, the market would assume that the rise in market rates would ultimately be validated. Sir Douglas Wass felt that the Bank's first response where a weakening exchange was threatening to raise market rates should be to try and hold rates in order to give time for thought. The Governor said that this was more or less what they were doing at present. Such an approach had succeeded on occasions in the past, but he warned that if it were carried too far it could become counter productive. The difficulty was to determine at what point this would occur. Mr Middleton said that use of the discount window might succeed in holding down only the very short rates if the authorities did not manage to change expectations.

8. The Chancellor asked whether, in retrospect we had had more influence on the exchange rate in the period when intervention was heavy. He doubted this. The Governor said it was natural to think that because the rate had not been held the intervention had not been worthwhile but at the time it appeared to have a reasonable chance of success. For a while it looked as though the position was going to be held after the first fall in the exchange rate and if external developments had been different, it might have been. The Chancellor observed, however, that a key factor in dislodging the new equilibrium had been the publication of the reserves. For the future, there was agreement that the reserves should be used sparingly. There was certainly no question of trying to defend $1.50.

9. Concluding the meeting the Chancellor said that there was agreement that it was unwise to rule out a rise in interest rates in all circumstances. Efforts should be made while markets were stable to stress that the fundamentals did not currently call for a rise but without giving the impression that rates would be capped. It was agreed that rules could not be laid down in advance on how to respond to a weakening exchange rate but further work on refining the scenarios should be carried out. It was important to get across the message about combined impact of a fall in the exchange rate and a fall in oil prices.

AT

A TURNBULL
4 February 1983

Circulation

Those present
Chief Secretary
Mr Lavelle
Mr Monck
Mr Peretz