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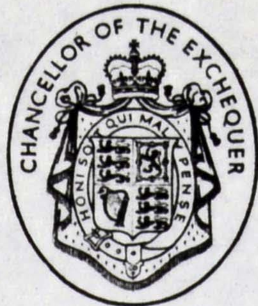


Rt-l
7/8

NOTE OF A MEETING HELD IN THE CHANCELLOR'S ROOM NO 11 DOWNING STREET AT 4.30PM ON 2 AUGUST 1984

Present: Chancellor
Economic Secretary
Sir P Middleton
Mr Cassell
Mr Kelly

Governor
Deputy Governor
Mr Loehnis
Mr Coleby

MONETARY POLICY AND INTEREST RATES

The Chancellor began the meeting by saying he was concerned, following the Governor's letter of 23 July, that there appeared to be differences of emphasis between the Bank and Treasury over the operation of monetary policy. The aim of policy was to stay within the target ranges for the monetary aggregates. While it was right to take account of movements in the exchange rate where there was reason to think that the monetary aggregates were giving a false reading, this was not the case at present. The provisional money figures to be published on 7 August confirmed the domestic monetary position was sound. Pressures on the exchange rate reflected the temporary effects of the miners' strike, expectations about oil prices, and events in the US - none of which pointed directly to a rise in inflationary pressures in the UK.

2. The aim therefore, should be to look for an early fall in interest rates. The Chancellor accepted that rates were unlikely to come back immediately by the full 2¾ per cent by which they had risen in recent weeks. But he hoped that a fall of 1 per cent would be possible after publication of the August 7 money figures.

3. If his analysis was accepted he saw two questions that needed to be discussed. The first was how in practice the authorities

should best operate so as to encourage interest rates to fall.

4. The second related to the markets' perception of the authorities' policy on the exchange rate. In recent weeks it had seemed that when pressures arose that might be expected to lead to a fall in sterling, in practice the market responded not by marking the £ down, but by marking interest rates up. The markets' assumption appeared to be that the authorities were likely to respond to a fall in sterling by themselves seeking to raise interest rates. The question was, how to educate the market out of this misconception about Government policy.

5. The Governor agreed that to some extent the analysis in his letter of 23 July had become out of date. In particular funding had gone quite well since then.

6. As he saw it, the problem was not so much a misconception by the market, but a - correct - belief that if sterling came under continued pressure, sooner or later interest rates would rise, because at some point as it fell sterling would reach a level where the authorities became concerned about inflationary consequences. The markets' belief in this respect was strengthened, in his view, by the Government's declared policy of confining intervention in the foreign exchange markets to smoothing activity only. A decision to intervene on a larger scale, on occasion, could act to undermine the markets' certainty that the authorities would react to an exchange rate movement by interest rate changes.

7. The Chancellor commented that the Government did not have an exchange rate policy, but that it was "not indifferent" to exchange rate movements. That was an important distinction. There was, for example, certainly no reason to wish to support the exchange rate if it was falling because of a fall in the oil price: to a large extent the effects of the two movements (on inflation and on the PSBR) were self-cancelling. In any event, so far as intervention was concerned, all the experience had been that large

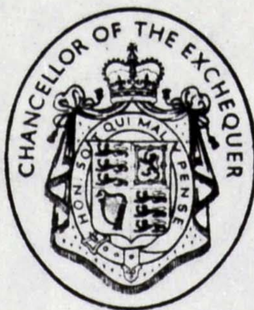
scale intervention by itself had little lasting effect on the exchange rate, unless interest rates were also allowed to move.

8. The Deputy Governor said he did not believe there was any substantial difference of view between the Treasury and the Bank about policy. It was more a tactical question. The Bank's concern about the proposal to seek to give market interest rates a lead downwards was that, in the wrong circumstances, this could undermine the credibility of policy: it might look to the market as if the authorities had moved from a monetary policy to a policy of targetting interest rates.

9. The Chancellor accepted this was a risk, but commented that in his view the greater risk for the present was the market's misperception of Government policy, so that if, for example, the exchange rate were depressed by oil factors the market might look at that, and not respond to the money supply figures. In these circumstances, he believed the authorities should give a lead, as a way of confirming that the policy was to look at the money figures. The monetary aggregates would be well within the target ranges, so that they would not immediately be put at risk were the Bank, for example, to give some extra assistance to the money market.

10. The Governor accepted the 1981 arrangements included provision for the authorities to give a lead to interest rates when it was appropriate to do so. The question was whether now was such a moment.

11. Mr Coleby said that in his view there was a good chance that the August 7 money figures would re-start the process of moving interest rates down, "decoupling" UK from US rates. This would be helped were the market to see that funding was going well. In those circumstances it would be open to the authorities to use the normal techniques to acquiesce, in an enthusiastic manner, in a market-led fall in interest rates.



12. The gilts market might well, however, respond to the money figures rather quicker than the money markets. Were it approved, the proposed £1 billion partly paid short tap for tender on the day after the figures were published would be seen as a useful indicator of the authorities' confidence.

13. Sir Peter Middleton agreed that, if circumstances made it possible, it would be better enthusiastically to follow the market than to be seen to be leading it.

14. Mr Loehnis mentioned, as a separate matter, the Bank's concern about the extent to which the foreign exchange reserves were being depleted; and the risks that it might prove impossible to proceed with some elements of the 1984 foreign currency borrowing programme. Sir Peter Middleton suggested, and it was agreed, that it would be necessary, separately, to consider both this, and the extent to which the reserves were being depleted by off-market purchases of foreign currency for the Bank's customers.

15. After further discussion it was agreed that:

i) Following publication of the provisional money figures on Tuesday 7 August, it should be the firm intention to operate so as to get the market to lead interest rates down. The Bank should act to follow a downward movement both enthusiastically and promptly.

ii) The presentation of the figures themselves should emphasise that over the target period both M0 and £M3 were now firmly within their target ranges, and avoid placing any stress on one month's figures.

iii) At the same time it should be emphasised that the Government's policy remained based on the monetary aggregates, not the exchange rate, and that the authorities therefore had to have regard to the level of interest

rates that in their (cautious) judgement was needed to produce monetary growth within the target ranges (ie neither below the bottom or above the top). The <u>Chancellor</u> commended the description of policy in his speech to the House of Commons on 31 July.

D L C PERETZ
Principal Private Secretary

<u>Distribution</u>

Those present
Mr Littler (or)
Mr Unwin
Mr Lankester (or)
Mr Lavelle (or)
Mrs Lomax (or)
Mr Culpin