PREM 19/178

SECRET

Part 4

201

MT

Confidential filing

Domestic Monetary Policy

ECONOMIC POLICY

Part 1: May 1979

Part 4: May 1980

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
6.5.80							
15.5.80							
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12-9-80							
19.9.80							
24-9-80							
26-9-80							
22.9.80							
ends							

PREM 19/178

PART 4 ends:-

PM to Brunner 22.9.80

PART 5 begins:-

Evening Standard extract 23.9.80

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
CC(80) 23rd Conclusions, Item 4 (Extract)	11/06/80
CC(80) 33rd Conclusions, Item 3	18/09/80

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed *CWayland* Date *18 March 2010*

PREM Records Team

HS

10 DOWNING STREET

THE PRIME MINISTER

22 September 1980

Dear Professor Brunner,

Thank you very much for your letter of 10 September and for the papers which you sent under separate cover.

It was indeed a great pleasure to discuss our monetary problems with you in Switzerland, and I am delighted to hear that you will be coming over to the seminar which is being organised by the Treasury and the Bank of England on 30 September. I would like to have the opportunity of hearing your views after the seminar and my Private Secretary, Tim Lankester, will contact you when you get to London to arrange a time when we might meet.

Yours sincerely,

MT

Professor Karl Brunner

CF. One for you as PM is seeing Dr. Brunner.

GR – BF this note and letter on 29/9/80.

PRIME MINISTER

Attached is a letter from Karl Brunner repeating some of the criticisms of the Bank which, I understand, he made to you in Switzerland. Also attached are a number of papers which he has sent: I do not think you will want to spend much time on these because they are almost entirely devoted to the United States situation.

There is to be a seminar for United Kingdom bankers and financial specialists to discuss the Monetary Base Green Paper on 29 September. Following your suggestion, Peter Middleton has also arranged a seminar the following day (i.e. 30 September) for a small group of foreign experts. He has included Karl Brunner and his associate Allan Meltzer and about four others including Poehl from the Bundesbank. Would you like to see Karl Brunner on his own for, say, half-an-hour after the seminar on that day; or would you prefer to see all the members along with Peter Middleton (who will be in the chair)? If the latter, you could have a private word with Brunner after the meeting to discuss his proposal towards the end of his letter that he should organise visits by an informal group of foreign experts from time to time. I think you could welcome this; but it would be for Brunner to organise his own funding. – Doubt if that would be possible.

I attach a draft letter that you might care to send.

19 September 1980

10 DOWNING STREET

Clive

I have passed on the PM's decision on this to the Treasury.

P.

BF next monday 23/9 Econ Pol.

B/F 29/9/80 R

Chancellor of the Exchequer 23/9

cc Financial Secretary
Sir Douglas Wass
Mr Ryrie
Mr Monck
Mr Britton
Mr Williams
Mr Culpin
Mr Grice
Mr Lankester - No 10
Mr Goodhart - B/Eng

MBC: SEMINAR WITH FOREIGNERS

We have made some progress in arranging a discussion with a small group of foreigners. Thanks to some skilful organisation by Mr Goodhart, we should be able to spend most of Tuesday 30 September talking to a group consisting of:

Professor Brunner Professor Meltzer	close colleagues and leading experts on monetary base control
Dr Schlesinger	Bundesbank
Dr Schiltknecht	Swiss National Bank
Dr Monte	Bank of Italy

We also hope to add one American - James Pierce - who has had practical experience of running monetary base control at the Fed. This makes a pretty distinguished group and covers all the main countries operating a monetary base type control.

2. The Bank have offered to host the occasion which all other things apart has the great advantage of keeping down the cost - central bankers do not normally charge each other. However, to bring these experts over will involve some expense. We will have to pay Brunner's flight and hotel room and also Professor Pierce's if he can be enticed over. The cost of first class air travel and hotel accommodation would be £1,000 - £1,500 per person. The Treasury has obviously not budgeted for this expenditure but, assuming that you are content, it would be possible to set up a new budget to cope with it and accommodate it within our overall cash limit by allocating underspends by other budgets.

3. The Bank and Treasury will share the chairmanship. Our intention is to concentrate on the effects of applying monetary base type controls to UK institutions and circumstances.

4. If the Financial Secretary is free, the Bank would be very happy if he could join the group for lunch. Mr Lankester to whom I am copying this will wish to consult the Prime Minister about whether and when she would like to see them.

PEM

P E MIDDLETON
19 September 1980

Econ Pol. 1

cc Mr. Lankester
Mr. Gow

PRIME MINISTER

Treasury Select Committee

We gather from the Treasury that Mr. du Cann's Select Committee are to meet privately on Wednesday 24 September to consider whether to hold a special hearing in the week after the Party Conference to discuss the Government's monetary policy and the recent growth in the money supply. This plan is obviously not calculated to be helpful to the Government. Nigel Lawson wondered whether you would think it worthwhile having a word with Edward du Cann on the telephone this weekend, in an attempt to dissuade him from going ahead. Tim and I have doubts about this suggestion, not least because we have no reason to believe that Mr. du Cann would acquiesce. It would be most inadvisable

If the Committee do go ahead Treasury Ministers are minded to attempt to field officials before the Select Committee rather than attend themselves. I do not know whether they will be able to get away with this, and I do not even know whether it is a wise course. The theory is that evidence from officials will be more guarded and will receive much less publicity than an appearance by Ministers, but it might not work out that way.

No Do you feel inclined to have a word with Mr. du Cann about all this, or to let the Committee do their worst, given that we have a little time to prepare for any meeting they may hold?

MS

19 September 1980

Prime Minister.

You will recall that we heard earlier this week that Edward du Cann was not going to seek to summon Treasury Ministers.

15 ...

Mike — arranged MAP 16/IX.
i.e. meeting on Oct 13 plus 1 → Chancellor and Governor.

Econ Pol

PRIME MINISTER

R
15/9

Meeting on Monetary Policy

You said you wanted to have a further meeting on monetary policy - and in particular on the monetary base proposals - before the Party Conference. The Chancellor does not get back from Washington until Thursday, 2 October. We have set aside virtually all of the Friday, and also the whole of Monday and Tuesday for your conference speech. If we are to have a meeting on monetary policy before the Conference, we should probably take say 1½ hours on the Monday to give the Chancellor the weekend to go over the papers. But you may prefer to leave the whole of Monday and Tuesday for the speech - in which case we would postpone the meeting until the following week. I doubt whether you would actually announce anything on monetary policy in your speech, and the Treasury say they will be able to do a better job if they can have that extra week - given the complexity and importance of this issue.

Agreed MT

Which would you like to go for?

So much for their idea of 'urgency'

R

12 September, 1980

P.S. We have fixed a meeting on inflow controls for next Thursday before Cabinet.

010

CONFIDENTIAL

Prime Minister

2

September figure for CGBR (£0.7 bn) as forecast would be the lowest this year. But the cumulative figure for the first 6 months will still be £1 bn up on last year's. (I have instructed MOD to let us have the profile of their spending).

12 12/9

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

We shall have to prepare for No vember. The cumulative figure will be very high. MT.

11th September 1980

T.P. Lankester, Esq.,
No.10, Downing Street

Dear Tim,

THE CGBR IN THE PERIOD IMMEDIATELY AHEAD

The Treasury note attached to my letter of 5 September to Clive Whitmore promised, inter alia, a speedy preliminary report on the forward estimate of the central government borrowing requirement in September.

I now attach a note on the September figures, which is based on the latest work of our Accounts Division. I might add that the pattern of the CGBR in the calendar months October and November is likely to be similar to that of the last year (shown in table 1 attached to the enclosed note), namely low in October and high in November.

The publication sequence is that the calendar month figures - not seasonally adjusted - are published by Treasury press notice on the 7th working day of the following month (i.e. 9 September in respect of August). The banking month figures (normally relating to periods ending on the third Wednesday of each month) are published with a longer delay, and initially in seasonally adjusted form; they are included in the Bank of England press notice on the money supply which is published (normally) on the 5th Thursday following the end of the banking month (i.e. 18 September in respect of the banking month ending on 20 August).

Yours

John

A.J. WIGGINS

CONFIDENTIAL

11 SEP 19 0

THE OUTLOOK FOR THE CENTRAL GOVERNMENT BORROWING REQUIREMENT (CGBR) IN SEPTEMBER

a) Calendar month

The CGBR is expected to be under £1 billion in September: the working figure is £650 million, with a margin of error of perhaps 200 either way. Some £1087 million of Petroleum Revenue Tax was received on 1 September. Table 1 below summarises the development of the CGBR so far this year, and compares it with last year's profile. Table 2 shows some details for September alongside developments to date and the Budget forecasts for the whole year.

2. Receipts into the Consolidated and National Loans Funds in September are forecast at £5.8 billion (excluding repayments of past lending). The main elements are Inland Revenue receipts of £3.2 billion, including £1.1 billion PRT, and Customs and Excise receipts of £1.7 billion.

3. Receipts of VAT and PRT are less unevenly distributed between the two halves of 1980-81 than they were in 1979-80. This affects the percentage comparisons shown in Table 2, raising that for the half year, relative to that for the whole year.

4. Expenditure from the Consolidated and National Loans Funds (including net lending) is forecast to be about £6.6 billion in September. Issues to finance departments' expenditure (ie supply services in Table 2) are forecast at £5.3 billion: monthly figures have been in the range £5-5½ billion so far this year. Little or no reining back of cash payments by Ministry of Defence is expected so soon. Excluding defence, supply services so far have been broadly in line with the Budget forecast.

b) Banking September

5. Banking September ends on 17 September. In the first 11 days

(21-31 August) the CGBR was £590 million. With the PRT receipt on 1 September the outturn for the banking month is forecast to be £650 million.

c) Year to date, and comparison with 1979-80

6. Table 1 shows that at end-August the CGBR this year totalled some £7 billion compared with £4.9 billion to end-August 1979. The increase of £2.1 billion is forecast to be roughly halved to £1 billion during September, since the CGBR in September last year was £1.7 billion. The Budget forecast for the year as a whole was an increase of approximately £1 billion on the outturn for 1979-80.

HM TREASURY
9 September 1980

TABLE 1

Central Government Borrowing Requirement

£ billion

			Cumulative		
	1979-80	1980-81	1979-80	1980-81	Difference
April	1.3	0.9	1.3	0.9	-0.4
May	1.5	2.3	2.8	3.2	+0.4
June	1.0	1.3	3.8	4.5	+0.7
July	-	0.8	3.8	5.3	+1.5
August	1.1	1.6	4.9	6.9	+2.0
September	1.7	(0.7)	6.6	(7.6)	(+1.0)
October	0.1		6.7		
November	1.8		8.5		
December	1.6		10.1		
January	-2.5		7.6		
February	0.4		8.0		
March	0.2		8.2	9.3*	

* Budget forecast

TABLE 2

CENTRAL GOVERNMENT BORROWING REQUIREMENT

£ million and %

	(1) April - August	(2) September forecast	(3) Year to end September	(4) % change of col.3 on year earlier	Budget Forecast for whole year	
Receipts				%		% change
Consolidated Fund						
Inland Revenue	11460	3200	14660	18	32860	17
Customs and Excise	8864	1730	10594	43	24000	33
Other	3135	600	3735	38	8555	5
National Loans Fund						
Interest etc receipts	1353	300	1653	-16	5050	19
Total Receipts	24812	5830	30642	25	70465	20
Expenditure						
Consolidated Fund						
Supply services	26081	5300	31381	24	64765	20
Other	1333	250	1583	13	3460	12
National Loans Fund						
Service of the national debt	3904	800	4704	24	10000	19
Net lending	1441	280	1721	2	2905	27
Total expenditure	32759	6630	39389	22	81130	20
Other Funds and Accounts	+990	+150	+1131		+1352	
CGBR	-6957	-650	-7616		-9313	

R16/9

CENTER FOR RESEARCH IN GOVERNMENT POLICY & BUSINESS

GRADUATE SCHOOL OF MANAGEMENT
UNIVERSITY OF ROCHESTER, ROCHESTER, NEW YORK 14627

KARL BRUNNER, *DIRECTOR*, (716) 275-3396
RONALD W. HANSEN, *ASSOCIATE DIRECTOR*, (716) 275-3218

September 10, 1980

The Right Honorable Mrs. Thatcher,
Prime Minister
10 Downing Street
London
England

Dear Prime Minister:

After returning to my mountain village after the visit with you on Lake Zug I thought further about the issues raised in our discussion on August 20. It occurred to me to formulate my ideas and also examine ways of mobilizing some help among competent professionals.

With respect to the Bank of England's monetary policy the following two conditions are crucial for any reliable and effective anti-inflationary policy.

The Bank needs to develop an implementation procedure adjusted for the purpose of controlling monetary growth. Such implementation is not a mystery and can be instituted in England as in other countries. The Swiss National Bank has successfully attended to this requirement. The Shadow Open Market Committee in the USA discussed this issue since its inception in 1973. A general procedure was developed and has been checked over the past three years in order to assure that it could be usefully applied. We seriously contend that the procedure which involves a refinement of the Swiss technique could be used as a design for control over monetary growth. It is certainly not perfect, but it should yield over one year a monetary growth within a target band of two percentage points. This procedure could also be applied by the Bank of England. The inherited procedures customarily cultivated by the Bank are not designed for purposes of monetary control.

The institutional arrangements of the British monetary system need be reexamined and adjusted for the purposes of an effective monetary control. These arrangements actually obstruct at the moment an effective monetary control. I mention specifically the reserve arrangements for commercial banks and the operation of the Bank's discount window. The first item, introduced with the new law in the early 1970's seriously undermines any attempt at effective monetary control. And a propos the second item: the

Bank should abandon its lender of first resort attitude and concentrate on controlling the monetary base.

These recommendations would hardly be greeted with any enthusiasm at the Treasury or the Bank of England. The supply of excuses has been in my experience the best developed activity of many Central Banks. I noticed that you did hear an objection emphasizing that "the Swiss National Bank" failed in its attempt to control monetary growth. As I had many discussions with the staff and President Leutwiler I can assure you that this is simply not true. They deliberately abandoned for about six months the control procedure developed and replaced it with a procedure addressed to the pegging of the DM. They knew perfectly well what they were doing and that they risked an inflationary surge - which indeed they got in 1979/80. But they returned, just as deliberately, to the control procedure in the spring of 1979.

I had an opportunity to ask this summer an official of the Bank of England about their attitudes and procedure. I inquired in particular why the Green Book essentially attempted to sell the traditional procedures and customs under the pretense of a monetary control policy. The answer I obtained emphasized that the announcement of a monetary control policy was really sufficient and any adjustments of external institutions or internal procedures would have "confused" the financial markets. This is in my judgment just a camouflage justifying an essentially rhetorical attention to monetary control. It is noteworthy in this context that the Green Book on Monetary Control thoroughly failed to address the central issues and crucial requirements for an effective monetary control. I find this particularly distressing as some members of the Bank's staff, at the request of the Governor, engaged in regular discussions with the Swiss National Bank bearing on these issues.

Whatever observations I may have on the behavior of Central Banks suggest that we cannot expect a change in attitudes or procedures developed by an entrenched bureaucracy without substantial outside pressure. I find it difficult to believe that the Bank of England will on its own initiative attend to the two recommendations made above. Let me suggest therefore the useful function of an academic group attending to these problems. They could examine both internal and external aspects in detail and articulate these issues possibly in public. There are three excellent English professionals in the USA and in Canada: Allan Walters, Michael Parkin and David Laidler. I talked recently with Brian Griffiths concerning this matter. Perhaps Brian could act as informal organizer arranging visits in regular intervals by this group in England. These visits should be used for intense professional attention to the issues noted above and possibly other issues in fiscal policy. I am sure that some (non-English) colleagues of these gentlemen mentioned could also be relied upon to offer technical advice on the basis of their accumulated work. As a matter of fact, my friend and long time collaborator

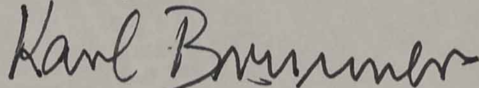
The Right Honorable Mrs. Thatcher
Prime Minister
September 10, 1980
Page 3.

Allan H. Meltzer (Professor at Carnegie-Mellon University) will visit London by the end of September or early October in order to attend a Conference organized by Brian Griffith. We have worked closely on these issues over 20 years and he would certainly be most willing to discuss with you issues affecting monetary and fiscal policy.

You will receive by separate mail some material from the Shadow Open Market Committee, two opening statements from last year's Congressional Hearings on monetary policy and two pieces attending to my increasing interest in political and social aspects of our world.

You should realize that there are many academics in this country who understand and appreciate what you want to do. If I can be of service in any particular way, please let me know.

Sincerely,



Karl Brunner
Fred H. Gowen Professor of Economics

KB:jwm

R 16

TL

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KARL BRUNNER, *DIRECTOR*, (716) 275-3396
RONALD W. HANSEN, *ASSOCIATE DIRECTOR*, (716) 275-3218

September 10, 1980

This material is mailed in accordance with a discussion held with the Prime Minister on August 20, 1980. Please submit the material to the Prime Minister.

(Material in wallet attached to file.)

Karl Brunner

Karl Brunner
Fred H. Gowen Professor of Economics

Enclosures

1. The Perception of Man and Justice and the Conception of Political Institutions

2. Reflections on the Political Economy of Government: The Persistent Growth of Government

3. Reflections on the State of International Monetary Policy

4. The Choice and Implementation of Monetary Policy, Statement Dec. 4, 1980

5. Statement Prepared for Hearing on Conduct of Monetary Policy U.S. House of Representatives, February 22, 1979

6. Shadow Open Market Committee Policy Statement and Position Papers, September 16-17, 1979

7. Shadow Open Market Committee Policy Statement and Position Papers, February 3-4, 1980

Chancellor of the Exchequer

cc Financial Secretary
Sir Douglas Wass
Mr Ryrie
Sir Kenneth Couzens
Mr Middleton
Mr Monck
Mr Britton
Mr Unwin
Mrs Gilmore
Mr Mower

BRIEFING FOR TODAY'S ANNOUNCEMENTS

I attach a brief on today's monetary announcements. There is a separate brief on the CGBR.

G INGHAM
9 September 1980

Encs

SECRET AND PERSONAL UNTIL 2.30PM ON 9 SEPTEMBER

BANKING AUGUST

The attached statement will be issued at 2.30pm on 9 September at the same time as the figures for the banks' eligible liabilities (ELs) on August make-up day (20 August), and the London Clearing Banks' press release are published (copies attached), and the CGBR for calendar August.

Main Points

1. £M3 rose by 3% on the basis of preliminary evidence.

2. There was an increase in all banks' eligible liabilities of £1682 million, i.e. 2.7%. The clearers accounted for about 17% of the total increase.

3. Interest bearing eligible liabilities (IBELs) rose by £1686 million, i.e. 3.8%.

4. All banks' reserve asset ratio remained at 13.2%; the clearers' rose from 12.8% to 12.9%.

5. M1 is estimated to have grown by about ¼% in August; over the six months from February it has grown at 8% at an annual rate.

6. The provisional estimate for the CGBR for calendar August was : £1566 million. The provisional estimate for banking August - not for disclosure - is £1861 million.

Bank of England Briefing

The Bank of England's attributable briefing will say that preliminary indications suggest a rise in £M3 of 3%. There is reason to believe that this figure has been distorted partly by changes following the removal of the corset and partly by an unusally large central government borrowing requirement.

SECRET AND PERSONAL UNTIL 2.30PM ON 9 SEPTEMBER

Q. What is the underlying rate of growth in £M3?

A. There are a number of difficulties involved in an assessment of the underlying rate of growth. Not all the necessary information is yet available and further work needs to be done. Our best estimate at present, however, is that the underlying rate of growth in £M3 in recent months has been 1-2%.

Q. Is the Greenwells' estimate that £M3 has so far grown at an annual rate of 15-16% correct?

A. This sort of figure on present information seems to be in the right range.

Q. How does this affect the £M3 target of 7-11% annual rate?

A. The situation following the removal of the corset in June is still being assessed but the Government are determined to maintain their monetary policies as set out in the Budget and the Medium Term Financial Strategy. The present target will be rolled forward in the Autumn when these recent and any further developments will be fully taken into account in the decisions that are announced. [If pressed : no decision has yet been taken on the timing of the announcement].

Q. Do the latest figures mean that £M3 growth will have to be negative or very low in the second half of the target period?

A. Public sector borrowing is likely to be much reduced in the second half of the financial year and bank lending is expected to moderate considerably as inflation abates and companies borrowing needs are reduced as costs are cut and stocks run down. Monetary growth is therefore expected to fall back in the months ahead. We are still assessing the effects of the removal of the corset. The Chancellor referred to the increase in £M3 following the removal of the corset in his Budget speech. He said:

> "The scale of this exceptional increase cannot be precisely measured or predicted, and we shall need to assess its effect both as it occurs and when the target is rolled forward in the Autumn".

Q. <u>How much more reintermediation is there still to come?</u>

A. The outstanding stock of commercial bills is now £1350 million. Not all these will come back into £M3; some will be judged by the non-bank sector as appropriate to hold in normal circumstances. But there are other forms of reintermediation - probably involving local authority debt as well as eurosterling and foreign currency deposits - which will take longer, and about which we do not yet have all the necessary information.

Q. <u>How much roundtripping has there been?</u>

A. This has caused some distortion. Press estimates of £500 million, however are too high.

Q. <u>Are we moving to M1 as a target?</u>

No. But we watch closely the movement of all monetary aggregates.

NATIONAL SAVINGS PACKAGE

The New Index-Linked Certificate

The present Retirement Issue National Savings Certificate, the "Granny Bond", will be withdrawn from sale and replaced by a new issue to be known as the 2nd Index-Linked Issue. Details of the new issue are being finalised but broadly it will be index-linked with a five year life.

On release it will be available to men over 60 years of age, as well as both men and women over retirement age. It will be subject to a personal holdings limit of £3,000.

When will the new issue be available?

Probably mid-November at which time the "Granny Bond" will be withdrawn from sale.

How many extra staff will be required?

At the maximum the Department for National Savings will require something like 500 extra staff but this will decrease after the initial high inflow to a permanent staff increase of about 100. Essentially the number of extra staff will fluctuate according to the work involved.

What about existing holdings of "Granny Bonds"?

People of retirement age can retain their existing holdings of "Granny Bonds" in addition to the new issue, within the "Granny Bond" maximum of £1,200 and £3,000 limit of the new issue. Thus it is possible for retired people to hold £4,200 of indexed certificates.

How much will the new issue realise?

Say £1.5 billion new money.

<u>The extra staff and switching</u>

This is an acceptable cost bearing in mind the amount expected to be raised.

<u>How much will the new issue realise in a full year?</u>

About £1¾ billion new money.

<u>Do you anticipate making the new issue available down the age scale?</u>

Yes, depending on funding needs and administrative feasibility.

<u>On release the new issue will hit other National Savings instruments?</u>

The effect on other National Savings instruments has to be taken into account, of course, in our calculations. So far as savers holding other National Savings instruments are concerned they will not be affected except to the extent that those over sixty might choose to invest in the new issue.

<u>The New Save As You Earn Limit</u>

<u>How much is expected to be realised from the increase in the limit on monthly contributions from £20 to £50?</u>

Perhaps some £50m in a year.

<u>When will the increase take effect?</u>

Work on the new 2nd Index Linked Issue and the new SAYE share option scheme will be given priority.

Monetary Effects

It is the Government's intention to step up efforts to tap personal sector savings. This is desirable not only in the short term but also for achieving over the medium term a better balance in the funding programme. Over the last year and a half the contribution of National Savings to financing the PSBR has fallen back to well below the levels achieved in the previous two and a half years, and the Government intends to ensure that from now on National Savings once again makes a sizeable contribution. It will considerably ease the pressure on the gilts market; lengthen interest rates and could bring to life the long term capital market.

To Mr. Monck
From Mr George

cc Mr Middleton
Mr Ingham

A Bank of England spokesman said that preliminary information suggested that £M3 (seasonally adjusted) may have grown by about 3% during the month. M1 is provisionally estimated to have grown by about ½%. These figures may of course need to be revised in the light of subsequent information.

The spokesman commented that, as in July, the figure for £M3 was again substantially distorted by post-corset adjustments, including a further fall of around £350 million in the volume of bank acceptances held outside the banking system. In addition there was an unusually large CGBR in banking August.

The market news is that the 1991 tap is sold out. Short prices up $\frac{1}{4}$ and long up $\frac{1}{2}$.

[illegible] 9 Sept.

Banking statistics

Eligible liabilities, reserve assets, reserve ratios and special deposits *(Quarterly Bulletin* Table 4)

1 Banks

£ millions

	Total	*of which interest-bearing*	British banks: London clearing banks	British banks: Scottish clearing banks	British banks: Northern Ireland banks	British banks: Accepting houses (a)	British banks: Other	Overseas banks: American (b)	Overseas banks: Japanese	Overseas banks: Other (a) (b)	Consortium banks
Eligible liabilities											
1979 Aug. 15	49,863	*32,488*	28,669	3,044	1,007	2,135	6,813	4,456	359	3,093	287
Nov. 21	52,262	*34,530*	29,794	3,235	1,077	2,239	7,217	4,619	359	3,403	319
Dec. 12	51,647	*33,608*	28,971	3,215	1,078	2,274	7,231	4,722	357	3,448	352
1980 Jan. 16	52,937	*35,429*	30,378	3,211	1,089	2,270	7,208	4,611	368	3,480	322
Feb. 20	52,875	*35,887*	30,055	3,267	1,124	2,279	7,079	4,753	359	3,623	335
Mar. 19	52,779	*35,620*	29,754	3,243	1,170	2,279	7,137	4,721	371	3,756	349
Apr. 16	54,297	*36,504*	30,903	3,334	1,154	2,341	7,270	4,805	417	3,718	356
May 21	55,216	*37,568*	31,022	3,338	1,176	2,410	7,585	5,077	380	3,825	404
June 18	56,455	*38,940*	31,913	3,433	1,174	2,465	7,706	5,001	392	3,955	415
July 16	61,458	*44,302*	33,761	3,683	1,159	2,862	8,987	5,660	533	4,350	463
Aug. 20 (e)	63,140	*45,988*	34,048	3,847	1,141	2,784	9,384	6,316	528	4,606	487
Reserve assets											
1979 Aug. 15	6,609		3,648	408	138	303	927	613	51	468	54
Nov. 21	6,888		3,835	435	151	306	947	607	53	496	57
Dec. 12	6,861		3,719	422	152	315	997	628	55	519	54
1980 Jan. 16	6,983		3,861	428	154	320	970	628	56	512	54
Feb. 20	6,965		3,860	422	158	319	943	626	51	529	57
Mar. 19	6,908		3,784	427	164	314	936	623	53	550	56
Apr. 16	7,141		3,956	433	167	319	974	649	57	530	57
May 21	7,232		3,963	436	165	330	995	661	54	565	63
June 18	7,344		4,028	440	170	342	1,012	661	55	574	63
July 16	8,124		4,323	482	168	403	1,209	760	75	631	73
Aug. 20 (e)	8,316		4,381	500	166	393	1,250	823	74	654	75
Ratio (per cent)											
1979 Aug. 15	13.3		12.7	13.4	13.7	14.2	13.6	13.8	14.2	15.1	18.9
Nov. 21	13.2		12.9	13.4	14.0	13.7	13.1	13.2	14.8	14.6	17.8
Dec. 12	13.3		12.8	13.1	14.1	13.8	13.8	13.3	15.4	15.1	15.5
1980 Jan. 16	13.2		12.7	13.3	14.1	14.1	13.5	13.6	15.3	14.7	16.8
Feb. 20	13.2		12.8	12.9	14.1	14.0	13.3	13.2	14.2	14.6	16.9
Mar. 19	13.1		12.7	13.2	14.1	13.8	13.1	13.2	14.3	14.6	16.0
Apr. 16	13.2		12.8	13.0	14.4	13.6	13.4	13.5	13.7	14.3	15.9
May 21	13.1		12.8	13.1	14.0	13.7	13.1	13.0	14.2	14.8	15.5
June 18	13.0		12.6	12.8	14.5	13.9	13.1	13.2	14.1	14.5	15.2
July 16	13.2		12.8	13.1	14.5	14.1	13.4	13.4	14.0	14.5	15.8
Aug. 20 (e)	13.2		12.9	13.0	14.6	14.1	13.3	13.0	14.1	14.2	15.4

Constitution of total reserve assets

	Total	Balances with Bank of England	Money at call: Discount market	Money at call: Other	UK and Northern Ireland Treasury bills	Other bills: Local authority	Other bills: Commercial	British government stocks up to 1 year	British government stocks over 1 year and up to 18 months
1979 Aug. 15	6,609	480	3,383	238	933	144	899	532	325
Nov. 21	6,888	584	3,782	228	897	148	957	292	363
Dec. 12	6,861	449	3,399	230	1,118	152	947	565	210
1980 Jan. 16	6,983	611	3,592	271	801	171	956	582	160
Feb. 20	6,965	574	3,553	247	905	174	979	532	138
Mar. 19	6,908	370	3,707	232	861	241	988	509	131
Apr. 16	7,141	416	3,602	266	1,065	300	1,008	483	78
May 21	7,232	456	3,641	276	1,083	358	1,021	397	100
June 18	7,344	475	3,413	333	1,200	436	1,034	453	208
July 16	8,124	357	4,289	299	1,199	390	1,126	464	166
Aug. 20 (e)	8,316	672	4,157	269	1,110	382	1,153	575	243

2 Finance houses

£ millions

	Eligible liabilities (c)	Reserve assets	Ratio (per cent)
1979 Aug. 15	404	42.0	10.4
Nov. 21	456	46.2	10.1
Dec. 12	460	47.8	10.4
1980 Jan. 16	462	48.9	10.6
Feb. 20	496	50.4	10.1
Mar. 19	502	52.0	10.4
Apr. 16	499	51.2	10.3
May 21	517	53.3	10.3
June 18	537	54.9	10.2
July 16	493	52.2	10.6
Aug. 20	466	48.4	10.4

3 Special and Supplementary deposits

£ millions: *number of institutions in italics*

	Special deposits: Rates of call (per cent)	Special deposits: Banks	Special deposits: Finance houses	Supplementary deposits: Total		Supplementary deposits: 1st tranche		Supplementary deposits: 2nd tranche		Supplementary deposits: 3rd tranche	
1979 Aug. 15	1½	504	6	10	*14*	6	*14*	3	*5*	2	*3*
Nov. 21	2	794	8	3	*8*	-	*8*	-	*4*	3	*3*
Dec. 12	2	794	8	3	*8*	-	*8*	-	*4*	3	*3*
Dec. 17 (d)	2	822	9	19	*20*	10	*20*	8	*7*	2	*2*
1980 Jan. 16	-	-	-	28	*14*	9	*14*	9	*5*	10	*2*
Feb. 20	-	-	-	104	*22*	15	*22*	31	*15*	58	*7*
Mar. 19	-	-	-	132	*23*	12	*23*	31	*16*	89	*7*
Apr. 16	-	-	-	216	*27*	14	*27*	31	*21*	171	*8*
May 21	-	-	-	219	*28*	13	*28*	31	*18*	174	*8*
June 18	-	-	-	242	*30*	19	*30*	37	*18*	187	*7*
July 16	-	-	-	456	*47*	27	*47*	63	*28*	366	*11*
Aug. 20	-	-	-	-	-	-	-	-	-	-	-

(a) One contributor was transferred from 'British banks: Accepting houses' to 'Overseas banks: other' in July 1980.

(b) One contributor was transferred from 'Overseas banks: American' to 'Overseas banks: other' in March 1980.

(c) Virtually all interest-bearing.

(d) Adjustments to special and supplementary deposits arising from mid-November figures are made after the mid-December reporting date.

(e) The exclusion of three contributors at the end of July reduced eligible liabilities of 'British banks: other' and of total banks by £60 million (of which £64 million were in the interest-bearing category), and reserve assets by £9 million; the reserve ratios of each remaining unchanged.

PRESS INFORMATION from Banking Information Service

10 Lombard Street, London EC3V 9AR
Telephone 01-626 8486

MONTHLY STATEMENT OF THE CLEARING BANKS

AUGUST 1980

Sterling borrowing from the London Clearing bank groups by the U.K. private sector rose by £123 million in the five weeks to August 20. Borrowing by the U.K. public sector rose by £34 million.

An appreciable seasonal fall was to be expected in private sector borrowing, and after allowing for this and an identifiable amount of "re-intermediation" which has continued to affect the course of bank lending since the abolition of "corset" controls, it would seem that the underlying trend in advances was not very different from recent months.

Sterling deposits by the U.K. private sector rose by £438 million, mostly in time deposits. When allowance is made for the seasonal adjustment the underlying movement is nearly double this amount.

There was a small net withdrawal of funds by the banks from the inter-bank market (£92 million including certificates of deposit). In addition, loans to the discount market fell by £113 million; and Treasury bill holdings declined by £63 million. By contrast, loans to local authorities rose by £38 million. Holdings of British Government stocks rose by £422 million net; nearly one-half of this took place under the sale and repurchase arrangements offered by the Bank of England. Finally special deposits were eliminated with a repayment to the banks of £437 million under the supplementary scheme.

Sterling advances by the Scottish Clearing bank groups to the U.K. private sector rose by £74 million. Sterling deposits by the U.K. private sector fell by £109 million.

Eligible liabilities of the five London parent banks rose by £274 million; the reserve ratio went up from 12.8 to 12.9. Eligible liabilities of the three Scottish parent banks rose by £164 million and the reserve ratio fell from 13.1 to 13.0.

* * * * * * *

The quarterly analysis of advances for the London Clearing bank groups shows an increase of £2,900 million in sterling advances to U.K. residents. Only about one-sixth of this was attributable to seasonal factors. The largest increases were in the manufacturing sector and in miscellaneous services (which includes leasing); in these two categories there was the bulk of the re-intermediation that has so far occurred. Other increases were in the personal, farming and retail sectors.

Sterling advances to U.K. residents by the Scottish Clearing bank groups rose by £384 million over the quarter. The major increases were in the manufacturing, agricultural, miscellaneous services and personal sectors.

9th September 1980

CONFIDENTIAL UNTIL 2.30 P.M. ON TUESDAY, 9TH SEPTEMBER, 1980

BALANCES OF THE LONDON CLEARING BANKS AS AT 20TH AUGUST, 1980

Tables 1 and 2 cover the business of offices of the London Clearing Banks and their subsidiaries (excluding Scottish and Northern Ireland banks) in Great Britain, the Channel Islands and the Isle of Man which are listed by the Bank of England as falling within the banking sector. Table 3 covers the parent banks only. The items are defined as in Table 3 of the Bank of England's Quarterly Bulletin.

TABLE 1. AGGREGATE BALANCES

£ millions

		Total Outstanding		Change on Month		Change on Year	
LIABILITIES							
STERLING DEPOSITS:							
	U.K. banking sector	5,403		+ 252		- 1,942	
	U.K. private sector	37,812		+ 438		+ 6,348	
	U.K. public sector	700		+ 108		+ 284	
	Overseas residents	4,269		- 74		+ 1,083	
	Certificates of deposit	2,240	50,424	-	+ 724	+ 137	+ 5,909
	of which: Sight		*17,975*		*- 4*		*- 853*
	Time (inc. CD's)		*32,448*		*+ 728*		*+ 6,762*
FOREIGN CURRENCY DEPOSITS:							
	U.K. banking sector	7,273		+ 352		+ 2,509	
	Other U.K. residents	1,372		+ 21		+ 360	
	Overseas residents	18,279		+ 784		+ 4,980	
	Certificates of deposit	1,666	28,590	+ 93	+1,250	+ 548	+ 8,397
TOTAL DEPOSITS			79,014		+1,974		+14,307
OTHER LIABILITIES [(a)]			12,166		- 83		+ 1,588
	TOTAL LIABILITIES		91,180		+1,891		+15,895
ASSETS							
STERLING							
Cash and balances with Bank of England			1,568		+ 295		+ 234
Market loans:	Discount market	2,383		- 113		+ 112	
	U.K. banks	7,922		+ 279		- 1,645	
	Certificates of deposit	1,486		- 119		+ 432	
	Local authorities	1,110		+ 38		+ 139	
	Other	519	13,419	- 58	+ 26	+ 151	- 812
Bills:	Treasury bills	590		- 63		+ 29	
	Other bills	1,260	1,850	+ 12	- 51	+ 386	+ 416
Special deposits with Bank of England			-		- 437		- 285
Investments:	British Government stocks	1,359		+ 422		- 659	
	Other	1,890	3,249	+ 8	+ 430	+ 244	- 415
Advances:	U.K. private sector	30,193		+ 123		+ 6,640	
	U.K. public sector	457		+ 34		+ 149	
	Overseas residents	3,179	33,829	+ 166	+ 323	- 61	+ 6,728
Other sterling assets *(a)*			7,241		- 17		+ 893
FOREIGN CURRENCIES							
Market loans:	U.K. banks and discount market	6,659		+ 204		+ 2,492	
	Certificates of deposit	203		+ 86		+ 9	
	Other	12,433	19,295	+ 799	+1,088	+ 3,842	+ 6,343
Bills			23		-		- 4
Advances:	U.K. private sector	2,212		+ 29		+ 181	
	U.K. public sector	853		+ 1		+ 3	
	Overseas residents	6,087	9,152	+ 189	+ 219	+ 2,403	+ 2,587
Other foreign currency assets *(a)*			1,552		+ 13		+ 211
	TOTAL ASSETS		91,180		+1,891		+15,895
ACCEPTANCES			*880*		*- 66*		*+ 128*

(a) includes items in suspense and in transit

Owing to rounding of figures, the sum of the separate items will sometimes differ from the total shown.

FOR TABLES 2 & 3 SEE OVER

£ millions

TABLE 2. INDIVIDUAL GROUPS OF BANKS' BALANCES	TOTAL		BARCLAYS		LLOYDS		MIDLAND		NATIONAL WESTMINSTER		WILLIAMS & GLYN'S	
	Out-standing	Change on Month	Out-standing	Change on Month	Out-standing	Change on Month	Out-standing	Change on Month	Out-standing	Change on Month	Out-standing	Change on Month
LIABILITIES												
Total deposits	79,014	+1,974	22,200	+ 417	14,192	+ 467	16,208	+ 278	24,230	+ 770	2,184	+ 42
ASSETS												
Cash and balances with Bank of England	1,568	+ 295	440	+ 38	389	+ 170	280	+ 19	415	+ 69	44	- 1
Market loans:												
UK banks and discount market	16,963	+ 370	4,727	+ 62	2,444	+ 71	2,698	+ 13	6,628	+ 238	466	- 16
Other	15,751	+ 745	4,653	+ 197	4,000	+ 239	2,430	+ 57	4,311	+ 211	356	+ 41
Bills	1,873	- 51	405	- 52	242	+ 20	543	- 24	655	+ 19	29	- 14
British Government stocks	1,359	+ 422	356	+ 176	146	+ 28	477	+ 148	316	+ 58	64	+ 12
Advances	42,981	+ 542	12,310	+ 104	7,396	+ 259	9,763	+ 66	12,218	+ 94	1,293	+ 19
TABLE 3. CREDIT CONTROL INFORMATION (Parent Banks only)												
Eligible liabilities	33,868	+ 274	10,310	+ 95	5,452	- 163	7,960	+ 148	8,985	+ 172	1,160	+ 21
Reserve assets	4,357	+ 56	1,313	+ 2	717	- 29	1,035	+ 43	1,145	+ 43	147	- 3
Reserve ratio (%)	12.9	+ 0.1	12.7	- 0.1	13.2	- 0.1	13.0	+ 0.3	12.7	+ 0.2	12.6	- 0.6

Committee of London Clearing Bankers' Statistical Unit
10 Lombard Street
London EC3V 9AP

CONFIDENTIAL UNTIL 2.30 P.M. ON TUESDAY, 9TH SEPTEMBER, 1980

ANALYSIS OF ADVANCES TO U.K. RESIDENTS BY THE LONDON CLEARING BANKS' GROUPS

AS AT 20TH AUGUST, 1980

This table covers advances by offices of the London Clearing Banks and their subsidiaries (excluding Scottish and Northern Ireland banks) in Great Britain, the Channel Islands and the Isle of Man which are listed by the Bank of England as falling within the banking sector.

Loans under the special scheme for shipbuilding, other than those refinanced with the Bank of England, are included within item 6 "Shipbuilding"; but lending under the special export schemes is not included, since this is classified as advances to overseas residents.

£ million

	Total Outstanding (1)	Change on Quarter (2)	Change on Year (3)
MANUFACTURING			
1. Food, drink and tobacco	1,552	+ 341	+ 542
2. Chemicals and allied industries	1,121	+ 3	+ 187
3. Metal manufacture	531	+ 100	+ 103
4. Electrical engineering	832	+ 147	+ 298
5. Other engineering and metal goods	2,275	+ 301	+ 636
6. Shipbuilding (including special scheme lending)	452	+ 5	+ 35
7. Vehicles	524	+ 171	+ 278
8. Textiles, leather and clothing	816	+ 93	+ 66
9. Other manufacturing	1,835	+ 264	+ 414
Total 1-9	9,939	+ 1,426	+ 2,560
of which in sterling	*8,747*	*+ 1,291*	*+ 2,220*
OTHER PRODUCTION			
10. Agriculture, forestry and fishing	2,240	+ 213	+ 468
11. Mining and quarrying	366	+ 44	+ 17
12. Construction	1,687	+ 60	+ 310
Total 10-12	4,293	+ 317	+ 794
of which in sterling	*4,162*	*+ 301*	*+ 803*
FINANCIAL			
13. Hire purchase finance companies	401	+ 33	+ 107
14. Property companies	1,093	+ 9	+ 43
15. Insurance enterprises (including pension funds)	194	+ 4	- 59
16. Other financial	1,174	+ 38	- 59
Total 13-16	2,862	+ 84	+ 32
of which in sterling	*2,345*	*+ 75*	*+ 284*
SERVICES			
17. Transport and communications	996	+ 12	+ 146
18. Public utilities and national government	904	+ 52	-
19. Local government services	171	+ 10	+ 82
20. Retail distribution	1,869	+ 143	+ 461
21. Other distribution	1,612	+ 95	+ 317
22. Professional, scientific and miscellaneous	4,408	+ 471	+ 1,320
Total 17-22	9,959	+ 783	+ 2,327
of which in sterling	*8,743*	*+ 792*	*+ 2,222*
PERSONS			
23. House purchase	1,944	+ 132	+ 392
24. Other personal	4,717	+ 310	+ 869
Total 23-24	6,661	+ 442	+ 1,261
of which in sterling	*6,654*	*+ 441*	*+ 1,261*
TOTAL ADVANCES TO U.K. RESIDENTS	33,715	+ 3,052	+ 6,973
of which in sterling	*30,650*	*+ 2,900*	*+ 6,789*
in foreign currencies	*3,065*	*+ 152*	*+ 184*

C.L.C.B. STATISTICAL UNIT

9 September 1980

1. The growth of £M3 in banking August is estimated, on the basis of preliminary evidence, at 3 per cent. As in July, there is evidence that the recorded figure has been substantially increased by the reversal of the effects of the distortions which have arisen since the corset was introduced in June 1978.

2. M1 is estimated to have increased by about ¼ per cent in August; over the 6 months from February it has grown at 8 per cent at an annual rate.

3. The reintermediation of commercial bills amounted to about £1 billion in July and a further £350 million in August. In addition, there have been other forms of reintermediation involving local authority debt, as well as euro-sterling and foreign currency deposits. These effects cannot be quantified precisely but it is estimated that the underlying growth rate of £M3 both in July and in August was 1 to 2 per cent.

4. The rate of growth of the money supply is however expected to fall back significantly. Bank lending is expected to moderate considerably in the second half of the financial year as inflation abates; companies' borrowing needs will be reduced as stocks run down. Public sector borrowing is also expected to be substantially lower in the second half of the year, chiefly because of the uneven pattern of receipts and expenditure throughout the year.

5. Petroleum revenue tax is now payable in September and March; over £1 billion was received on 1 September. Receipts from special sales of assets are expected in the latter half of the financial year. Refunds arising from the 30 May agreement on the UK contribution to the European Community's budget will also occur towards the end of the financial year.

6. In addition, defence expenditure has been unusually high so far and is now being reined back.

7. The high PSBR so far is similar to last year's pattern, when the PSBR was high in the first three quarters of the financial year and was substantially negative in the final quarter. The next assessment of the PSBR for the year will be published at the usual time in the autumn Industry Act forecast.

8. The Government is determined to pursue the monetary policy set out in the Budget Speech and the Medium Term Financial Strategy.

9. Over the last year and a half the contribution of National Savings to financing the PSBR has fallen back to well below the levels achieved in the previous two and a half years. The Chancellor of the Exchequer has decided that National Savings should once again make an appropriate contribution. This will ease the pressure on the gilt-edged market and hence on long term interest rates.

10. As a first step, a new index-linked certificate will be issued. It will initially be available to everyone aged 60 and over, subject to a limit on individual holdings of £3,000. It is expected that sales of this new certificate will raise an additional £1½ billion through National Savings during the remainder of this financial year.

11. The Chancellor of the Exchequer has also decided to raise the limit on monthly payments under the National Savings SAYE scheme (3rd issue) from £20 to £50 as soon as possible to bring it into line with the limit on the new SAYE share option scheme to be launched in October.

Press Office
HM Treasury
Parliament Street
LONDON SW1P 3AG
01-233-3415

PRESS OFFICE BRIEFING ON CGBR

The CGBR is again unusually high this month. At £6,966m it now stands at 83 per cent of the Budget forecast for the year of £9,313m.

Although the figure looks bad, we should continue to be robust in saying that it is still "roughly in line" with Government predictions. The traditional "front-end loading" is exacerbated by changed timing of PRT receipts. The first tranche of PRT (about £1.26bn) has now been received, but will not appear in the books until next month. The remainder of the expected £2.5bn will arrive in March.

Consolidated Fund

Customs and Inland Revenue receipts are holding up well against the affect of the recession. Still broadly in line with projections at £4.129, or 21% up on last year, against a Budget forecast of £65,415, or 20% up on last year's outturn.

Supply Services are running ahead at 25% higher than last August, against a Budget forecast of 20% for the year as a whole. If pressed on Defence spending, we should stick to Hansford's briefing (attached). We can stress:

1) Too early to judge affect of CST's cut-back last month, but Government determined to hold Defence spending to the new limit.

2) The moratorium on new contracts is already in operation and has three months to run.

3) Careful monitoring will continue - and it's the end-year figure that counts.

Miscellaneous payments (Table 1 line 7) shows a large August figure (£331 million). A major factor in this is the repayment by NEB of public dividend capital as a consequence of the transfer of control

of Rolls Royce from NED to DOI and will have been balanced by DOI supply services expenditure.

NLF There may be some comment on the large increase in loans to the Nationalised Industries. There seem to be two factors here.

1) The announced price increases are largely timed to come into force in the autumn and should contribute to improved outturn in the later months of the financial year.

2) The need to finance coal stocks falling on NCB and the electricity industries.

National Insurance Fund

This is a typically erratic item. The big increase compared with 1979 is boosted by a number of special factors.

1) 1979 was atypically low due to actuarial adjustments.

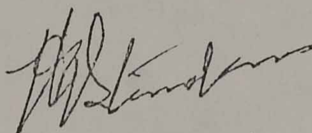
2) The pattern of timing of receipts and benefits tends towards to surplus in this stage of the year, which is unlikely to be maintained throughout the year.

S F J GODFREY
9 September 1980

CONFIDENTIAL UNTIL 2.30PM 9 SEPTEMBER 1980

NATIONAL SAVINGS PACKAGE

Attached is a brief on the National Savings package that is announced today for the assistance of press officers.

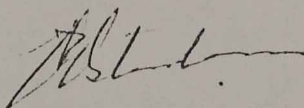


H A STANDEN

9 September 1980

IDT

The attached is subject to FST's scrutiny.



NATIONAL SAVINGS PACKAGE

The New Index-Linked Certificate

The present Retirement Issue National Savings Certificate, the "Granny Bond", will be withdrawn from sale and replaced by a new issue to be known as the 2nd Index-Linked Issue. Details of the new issue are being finalised but broadly it will be index-linked with a five year life.

On release it will be available to men over 60 years of age, as well as both men and women over retirement age. It will be subject to a personal holdings limit of £3,000.

When will the new issue be available?

Probably mid-November at which time the "Granny Bond" will be withdrawn from sale.

How many extra staff will be required?

At the maximum the Department for National Savings will require something like 500 extra staff but this will decrease after the initial high inflow to a permanent staff increase of about 100. Essentially the number of extra staff will fluctuate according to the work involved.

What about existing holdings of "Granny Bonds"?

People of retirement age can retain their existing holdings of "Granny Bonds" in addition to the new issue, within the "Granny Bond" maximum of £1,200 and £3,000 limit of the new issue. Thus it is possible for retired people to hold £4,200 of indexed certificates.

How much will the new issue realise?

Say £1.5 billion new money.

The extra staff and switching

This is an acceptable cost bearing in mind the amount expected to be raised.

How much will the new issue realise in a full year?

About £1¼ billion new money.

Do you anticipate making the new issue available down the age scale?

Yes, depending on funding needs and administrative feasibility.

On release [illegible] the new issue will hit other National Savings instruments?

The effect on other National Savings instruments has to be taken into account, of course, in our calculations. So far as savers holding other National Savings instruments are concerned they will not be affected except to the extent that those over sixty might choose to invest in the new issue.

The New Save As You Earn Limit

How much is expected to be realised from the increase in the limit on monthly contributions from £20 to £50?

Perhaps some £50m in a year.

When will the increase take effect?

Work on the new 2nd Index Linked Issue and the new SAYE share option scheme will be given priority.

Monetary Effects

It is the Government's intention to step up efforts to tap personal sector savings. This is desirable not only in the short term but also for achieving over the medium term a better balance in the funding programme. Over the last year and a half the contribution of National Savings to financing the PSBR has fallen back to well below the levels achieved in the previous two and a half years, and the Government intends to ensure that from now on National Savings once again makes a sizeable contribution. It will considerably ease the pressure on the gilts market; lengthen interest rates and could bring to life the long term capital market.

SECRET

SUBJECT

FILE (

12

DSG

cc: Governors Office
John Hoskyns
bc: Sir R. Armstrong

10 DOWNING STREET

From the Private Secretary

9 September 1980

Dear John,

As you know, the Prime Minister held a meeting yesterday afternoon to discuss the latest banking figures. The following were present:

The Chancellor of the Exchequer
The Financial Secretary,
Sir Douglas Wass,
Mr. Burns,
Mr. Middleton,
Mr. Fforde,
Mr. George, and
Sir Robert Armstrong.

Much of the meeting was taken up with going over the draft statement which you had sent over, and no doubt the final version will take into account the Prime Minister's comments. In particular, she suggested some reordering of paragraph 4 and the excision of the sentence describing the 1980/81 target, and that there should be a reference to the discussions to be completed within the next few weeks on the Green Paper on Monetary Base Control (MBC).

There was also some discussion of monetary developments and prospects and the options open to the authorities. The Prime Minister said that she understood that the underlying rate of monetary growth was now reckoned to be 15 per cent or higher. This was extremely disturbing - given that the 7-11 per cent target was the centre-piece of the Government's economic strategy. It seemed to her that the Bank had been pursuing an interest rate policy rather than a policy to control the money supply. With hindsight it might have been better if the Bank had not undertaken the continuing money market relief measures, even though this would have meant still higher interest rates in the short-term. As long as the clearers could rely on the Bank to relieve any pressure on their liquidity, they would surely be all too willing to maintain a high level of lending to the private sector. If the clearers' liquidity had been under pressure, they would have reduced their lending and by now interest rates might well be lower. On the other hand, she doubted whether the current high level of interest rates was having any restraining effect on bank lending. On the contrary, it was arguable that - with the quarterly crediting of interest payments to company overdrafts -

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lower interest rates would result in lower borrowing. Furthermore, high interest rates had pushed up the exchange rate, and this was adding greatly to the difficulties of the corporate sector.

The Prime Minister went on to say that in her view the present methods of selling debt and of monetary control had compounded our difficulties. The objections to major changes in the funding arrangements had been rehearsed often. She welcomed the decision to issue a new index-linked certificate, but she was still not convinced that the present arrangements were the best available. On monetary control, she was disappointed that it had taken so long to reach a conclusion on the proposals to change over to a monetary base system. Finally, she wondered whether more could not have been done to put pressure on the clearing bank chairmen to get them to reduce their lending.

The Chancellor said that he too was extremely worried about the latest two months' figures. But it was easy to be wise after the event. Not only the Treasury and the Bank, but also most outside commentators had under-estimated the underlying rate of monetary growth. The siutation was highly uncertain; but quite apart from the effect of reintermediation, there were some special factors - as paragraph 4 of the draft statement pointed out - which had boosted the figures. The much lower level of public borrowing expected in the remainder of the financial year and the likely reduction in corporate borrowing as costs continued to moderate and as the recession took further hold should bring down the rate of monetary growth in the coming months. Until the underlying situation became clearer, and until the likely consequences of the various policy options had been properly considered, he thought it would be unwise to take any immediate action in response to the figures. At the same time, Ministers would need to make clear that the Government was determined to pursue the medium term financial strategy, notwithstanding two months' bad figures.

In discussion, it was pointed out that if the Bank had not provided relief to the money market, interest rates would certainly have risen including in all probability the mortgage rate. But this had effectively been ruled out. As to the effect of interest rates on borrowing, the <u>net</u> effect of high rates was almost certainly to restrain the level of lending - for the crediting of quarterly interest payments to overdrafts was likely to be offset by the demand elasticity factor. This was reflected in the large amount of destocking that was currently going on. High interest rates were helping to bring down the rate of inflation both through their effect on lending and on the exchange rate. As regards methods of monetary control, it was important that the discussions on the Green Paper with interested parties should be completed before final decisions were taken. The issue was extremely complex, and it was not yet clear how the clearers would respond to a monetary base system or that, for example, we would not end up with distortions similar to those that had emerged under the corset. Two seminars on MBC were planned for the next few weeks - one for domestic and a second for overseas participants. Finally, as regards putting pressure on the banks, the Governor had seen the chairmen just before the July figures had been announced and had underlined the Bank's directional guidance. The chief executives

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[illegible] been seen since then. But any attempt to put pressure on them, formal or informal, to restrain the total volume lending would all too soon lead to distortions once more and in particular to borrowing outside the banking system.

In conclusion, the Prime Minister said that it was crucial to get the money supply back under control and to this end a great deal of work was clearly needed. She would want to hold a further meeting in the first week of October.

I am sending a copy of this letter to Tim Allen (Governor of the Bank of England's Office).

Yours ever,

Tim Lankester

John Wiggins, Esq.,
H.M. Treasury.

PRIME MINISTER

Banking Figures

Attached is the draft Press Statement.

You will want to focus particularly on paragraph 4, and ask the Treasury whether they still really believe that - even taking out reintermediation - we can achieve the 7-11 per cent target for this year. That is what paragraph 4 seems to imply.

There is obviously a dilemma here. If we imply that we are not going to meet the target, the markets will expect either a readjustment of the target or new policy measures (higher interest rates, a fiscal package?).

My hunch is that we are now unlikely to meet the 7-11 per cent target; but at the same time I do not think we are in a position to go for either of the alternatives mentioned above this month. More time is needed to assess the options. Hence, the Treasury will have to do their best to fudge. It may well be that that is precisely what they are trying to do in paragraph 4; but I think it would be wise to tone it down a bit with a phrase such as - "It will be another month also before it is possible to assess how the underlying growth of the money supply is developing in relation to the 7-11 per cent target".

I do not know whether you discussed with the Chancellor the decision to extend index-linked certificates (see paragraph 8 of the draft). You might like to ask whether there is scope for raising more than £1½ billion this year, and what are the arguments against introducing the new certificate more quickly.

You might also ask the Chancellor how he intends to handle the media. These latest figures certainly pose not just an economic problem but a political one too. You said in your Censure Debate speech - "We adhere firmly to our monetary strategy". The impression is getting around that not only are we not adhering to the strategy, but we do not even know ~~whether~~ where we are.

/You have

You have seen the Treasury's "plan of action" (Flag A). You may want to go over some of the points in this.

The Governor and the Deputy Governor and Mr. Goodhart are all away. Mr. Fforde and Mr. George will attend for the Bank.

8 September 1980

ph File

DRAFT STATEMENT

1. The growth of £M3 in banking August is estimated, on the basis of preliminary evidence, at 3 per cent. As in July, there is evidence that the recorded figure has been substantially increased by the reversal of distortions which have arise over the period since the corset was introduced in June 1978.

2. M1 is estimated to have increased by less than ½ per cent in August; over the 6 months from February it has grown at only 8 per cent at an annual rate.

3. The reintermediation of commercial bills amounted to about £1 billion in July and a further £350 million in August. In addition, there have been other forms of reintermediation probably involving local authority debt, as well as euro-sterling and foreign currency deposits. These effects cannot be quantified precisely but it is etimated that the underlying growth rate of £M3 both in July and in August was 1 to 2 per cent.

4. ~~The Government remains determined to pursue its monetary policies as set out in the Budget Speech and the medium term financial strategy. The target is for growth in £M3 of 7 to 11 per cent annual rate from February 1980 to April 1981. The underlying growth in recent months has exceeded this rate.~~

[Handwritten: will continue; put at end]

[Handwritten: There are grounds for believing that monetary growth will fall back in the months ahead.]

The profile of public sector borrowing in the early months of the financial year and the difficulty of cutting back the growth of bank lending in the early stages of a recession, have contributed to this. But public sector borrowing is likely to be much reduced in the second half of the financial year. Bank lending is expected to moderate considerably as inflation abates; companies' borrowing needs will be reduced as costs

are cut and stocks run down. Monetary growth in the months ahead is therefore expected to fall back.

The Path of the PSBR

5. The PSBR in the April-June quarter was £4¾ billion. Central government borrowing in July and August totalled over £2¼ billion. This high borrowing so far is similar to last year's pattern. Last year the PSBR was high in the first three quarters of the financial year and large repayments were made in the final quarter. Some important factors affect the profile of borrowing this year. Petroleum revenue tax is payable in September and March~~; receipts of~~ over £1 billion were received on 1 September ~~and will reduce the Government's need to borrow this month~~. Defence expenditure has been unusually high so far and is now being reined back. Receipts from special sales of assets are expected in the latter half of the financial year. Refunds arising from the 30 May agreement on the UK contribution to the European Community's budget will also occur towards the end of the financial year.

6. The effect of these factors is for the PSBR again to be concentrated in the early part of the financial year. Borrowing will be less in the second half of the year, especially in the final quarter. The next assessment of the PSBR for the year will be published later in the autumn, in the twice-yearly Industry Act forecast.

National Savings

7. In the past few years the Government has relied heavily

on the gilt-edged market to meet is funding needs. It is intended to shift this emphasis more directly towards personal savings so that National Savings once again make an appropriate contribution.

8. ~~The Government intends to make index-linked certificates more generally available, but this will be a gradual process.~~ [handwritten above "intends": is going] It has been announced, ~~as a first step~~, that a new index-linked certificate will be issued; it will be available to everyone aged 60 and over, subject to a limit on individual holdings of £3,000. It is expected that sales of this new certificate will raise an additional £1½ billion through National Savings during the remainder of this financial year.

9. ~~It~~ The Government also intends, as soon as possible, to raise the limit on monthly payments under the National Savings SAYE scheme (3rd issue) from £20 to £50 as soon as possible to bring it into line with the limit on the new SAYE share option scheme to be launched in October.

8.9.80

PM would add [illegible] MBC - but the discussion [illegible] be brought to a conclusion within 6 weeks.

MR. LANKESTER

Your first priority will be money supply.

Banking figures to be announced tomorrow are pretty horrible. The Prime Minister is angry about this, which confirms in her view what the Swiss bankers told her when she was on holiday - that her strategy is right but that her instruments are wrong, and particularly that the Bank of England is not interested in running her policy.

We had a stormy meeting last Wednesday. There is to be another episode at 3.30 this afternoon. You should see recent papers on this file to get the flavour.

(M.A.P.)

8 September 1980

COVERING SECRET

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

8th September 1980

T.P. Lankester Esq.
10 Downing Street

Dear Tim,

As foreshadowed in my letter of 5th September to Clive Whitmore, I attach a draft of the material to be drawn on in commenting on tomorrow's eligible liability figures.

Yours
John

A.J. WIGGINS
Private Secretary

10.

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8.9.80

Extract from Observer Business
Sunday 7 September 1980

WILLIAM KEEGAN'S VIEW

Operation Fudge-Up

ALL RIGHT. Stand by your beds. Prepare for Operation Fudge-Up.

The money supply, under our brilliant monetarist policy, is meant to be growing at between 7 and 11 per cent a year. But M3, the broad definition of money supply, grew by 5 per cent in the month to mid-July alone; and it will become known on Tuesday that it grew a further 3½ per cent in the month to mid-August.

We have managed to achieve a seemingly impossible feat: monetary growth far in excess of what our monetarist ministers said was necessary to bring inflation down, yet a squeeze which is half killing British industry.

The stance of policy is too tight—with high interest rates attracting 'hot money' from abroad and driving the exchange rate up; yet we have had a whole year's targeted growth for money supply in virtually two months. On top of which the Bank of England is intervening, under Government instructions, in the money markets with what are smoothly described as smoothing operations — *in order to prevent interest rates from rising further.*

Monetarism has failed, and the Government is now in a vicious circle, a box, or any other metaphorical trap you care to name.

The logic of the policy is that interest rates should be hoisted sharply, in order to slow down monetary growth. Yet, if this were done, the upward pressure on the exchange rate would be even worse. It was after the last money supply figures, because the figure suggested interest rates would have to stay high (the pound now rises on good *and* bad news); and monetary growth would not necessarily slow down much, because there are signs that companies are so squeezed that they often add interest payments to their overdraft.

For all her plucky rhetoric, Mrs Thatcher will be going naked into the Conservative Party conference chamber next month if she cannot offer something tangible on the interest rate front. Hence Operation Fudge-Up.

Stomping in the lemonade

Operation Fudge-Up is based on the following premise: traditionally, the two big financial market constraints on economic policy are the threat of a run on the pound, and and/or or a 'strike' by insurance company and pension fund managers, when they refuse to buy Government stock unless the interest rate is raised.

However, people don't run *on* the pound these days—they run *up* it; the City has been amazingly resilient, in the face of wayward money supply and public sector borrowing figures; and, anyway, wouldn't it be a way out of the vicious circle if the Government was a little less reliant on gilt sales in the next few months, so that fund managers can cough up for companies wishing to 'fund' their overdrafts by raising longer term capital?

This way, the argument runs, we may not be selling so many gilts, but bank advances will be falling away, thereby slowing monetary growth. And, to make up some of the lost gilt sales, we could launch a major national savings campaign.

Hence to Operation Fudge-Up itself. Since there is no panic in the City, we shall unashamedly take full advantage: get all the bad news out of the way (isn't 3½ per cent monetary growth in August an improvement on 5 per cent in July?); rebase the monetary targets in October, so that the last few months figures are forgotten; claim, with the aid of an obfuscatory epithet much-loved of officials, that the 'underlying' rate of monetary growth is now under control; and hope for the best.

Although this amounts to a complete and utter U-turn on monetary targets, this will not matter to the public at large, which can't tell the difference between M3 and a battleship. But the public can tell the difference between a battleship and a 2 per cent cut in MLR. And the Prime Minister will not have any credibility left with her industrial support lobby unless MLR falls very soon.

For 'operational' purposes we can expect an announcement along these lines, certainly by the time Parliament reassembles on 27 October; and almost certainly by the second week in October, for the Tory conference.

Clive has a copy.

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

5 September 1980 r 1440

C. Whitmore, Esq.,
Private Secretary,
10, Downing Street

Dear Clive,

Mike Pattison's letter to me of 3 September reported the Prime Minister's discussion about monetary developments with the Chancellor and Governor, and asked for a further note about the handling of the banking figures to be announced on 9 September.

Accordingly we shall be sending over to you on Monday morning, 8 September the note on the August eligible liability figures and their presentation in relation to the Government's monetary strategy. Meanwhile the Prime Minister may like to have a note summarising the different pieces of work now being undertaken by the Treasury and the Bank on a number of topics which were discussed at her meeting on 3 September, together with an indication of the timing in each case.

I am sending a copy of this letter to Roger Mayes at the Bank of England.

Yours ever

John Wiggins

A.J. WIGGINS

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

5 September 1980

Prime Minister.

I have provisionally arranged a meeting for 1530 on Monday 8 September.

[illegible]
5/ix

C. Whitmore, Esq.,
Private Secretary,
10, Downing Street

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Yours ever

John Wiggins

A.J. WIGGINS

A

1. Statement

A draft statement to accompany the EL figures and the August CGBR figures on Tuesday 9 September. To contain:

a. an analysis of the effects of the corset.

b. prospect for lower monetary growth for the rest of the target period. Sticking to Medium Term Financial Strategy.

c. profile of the PSBR.

d. announcement of National Savings package: main item is increase in limits on and entitlement to indexed linked certificates. Also intention to raise indexed SAYE limit to £50 as soon as possible.

Timing: draft to Treasury Ministers by the weekend
to the Prime Minister by lunchtime Monday 8 September.

2. CGBR

Arrange to let the Prime Minister have the 3 month forward estimate of the Central Government Borrowing Requirement each month, with a breakdown between the revenue, expenditure and Public Corporations' and Local Authorities' borrowing elements.

Timing: preliminary report on September very quickly.
- first full 3 monthly forecast next month with the revised forecast for the PSBR - quarter by quarter.

3. PSBR

Prepare new forecast of PSBR for Prime Minister. To be done as part of next forecast. Mr Burns will ensure that detailed attention is given to the quarterly path.

Timing: forecast ready early October

Note to the Prime Minister as soon after that as possible.

4. The Target and the Medium Term Strategy

Target has to be rolled forward from mid-October. Some adjustments will have to be made to allow for reintermediation, post corset as forshadowed in Budget Speech. Announcement does not need to be made in mid October. But need to have clear idea of where we are going by, at the latest, before the Mansion House speech on 16 October.

Before party conference the previous week

Timing: preliminary work being undertaken by Treasury and Bank now to set out options, consistent with medium term strategy.

- numbers to be finalised in early October after September money supply figures and next forecast available.

5. Monetary Control

Present state of play: Question of whether to move to monetary base is being carried forward towards a conclusion:

a. written comments on Green Paper have been received from main institutions and a lot of discussion already taken place.

b. seminar arranged with analysts of all opinions (academic, City, institutions) at Church House on 29 September to discuss Green Paper.

c. 4 supplementary papers:

i. measurement of capital - non controversial Bank document. To be issued tomorrow in final form.

ii. foreign exchange positions: draft under discussion with the banking system.

iii. Prudential Liquidity Document out and an intense debate taking place with the banking system. The ultimate objective is that a liquidity "norm" should replace the reserve asset ratio.

These concern the prudential control of the banks under the Banking Act. There is also:

iv. the paper about a new form of cash ratio which was promised in the Monetary Control Green Paper. This Paper is essentially about the way in which the Bank raises its revenue by taxing the banking system and about the way in which it influences short-term interest rates. This paper thus covers both banking regulation and

monetary policy/and should be ready for issue before the end of this month.

It is essential to ensure that none of these proposals would prejudge decisions about moving towards more effective methods of monetary control. Prudential questions can be settled after we consider our attitude to changes in monetary control.

Timing: - potentially big institutional changes involved so we should seek to ensure that if any change were to be made this should be done so far as possible in a staged way.

- By mid October should assess the position about monetary base and other alternatives to present arrangements, and possible timescales.

- Assessment would include identification of half way stages which would give more flexibility to interest rates.

6. Reserve Assets and Special Assistance to the Banks

!! A related issue to be sorted out. Papers with the Financial Secretary who will take forward the extensive and continuing work already done on this.

7. Other Funding Ideas

National Savings decided, but other methods of funding might take pressure off conventional gilts and long rates of interest. Extensive analysis so far done suggests that indexed gilts restricted to institutions are a hopeful possibility. The Financial Secretary will be carrying forward this work.

8. Market Intelligence

!! Governor urgently looking into this and assessing how the banking system is likely to develop, post corset.

COVERING SECRET

MR WHITMORE

MR LANKESTER (O.R.)

The Prime Minister is much preoccupied with what she sees as a failure of monetary policy. Michael Alexander is aware of the general direction of her anger.

Relations with the Chancellor are not good at present, and with the Governor are appalling - at least in the PM's eye. Clive will probably find this dominant in the Prime Minister's mind this weekend. That is why I have agreed with the Treasury that it will be helpful to have a further short piece of paper for her over the weekend, in the hope that this helps her to have a more useful meeting with the Chancellor on Monday afternoon. (No time is yet set, but her afternoon is more or less clear, and you may want to settle a time before she gets back.)

MAP

3 September 1980

SUBJECT

9

Summary Record of a Meeting held at 10 Downing Street at 1800 hours on 3 September 1980

Present:

Prime Minister

Chancellor of the Exchequer

Governor of the Bank of England

Financial Secretary to the Treasury

Mr. T. Burns)
Mr. P. Middleton) HM Treasury
Miss P. Brown)

Mr. C. Goodhart, Bank of England

Mr. David Wolfson

Mr. Michael Pattison

The Prime Minister said that she had talked to a number of bankers in Switzerland during her holiday. They were unimpressed with our monetary control. She had been told that British money supply was out of control, that her strategy was right, but that it was not being properly operated. She returned home to learn of the disastrous banking figures due to be announced on 9 September. It seemed to her that the Bank of England was functioning as a lender of first resort, not last resort. The clearing banks did not seem to be deeply attached to the Government strategy. Indeed, they were shovelling money out. The stability of MLR had made it too easy for the banks to lend freely. The international banking community realised that British money supply was out of control, and this would become more obvious with the announcement of the following week's figures. The Government must begin to take steps to get back in control before the announcement. Public expenditure also seemed to be out of control, and she was dissatisfied with the available estimates of the shape of the PSBR. She was not seeking explanations, but prescriptions for action. Money supply had been running at 15-16% growth since February, without taking account of re-intermediation. Bank lending had been at £0.8 - 0.9 bn per month, and the CGBR was £2 bn for banking August. She was determined to see both money supply and public expenditure back under control. She expected to be told that this would involve increased interest rates. She was

/prepared

prepared for this, but did not accept that interest rates would stay up once raised.

The Chancellor said that the broad shape of the public expenditure figures had been known in the Treasury. The last detailed Treasury estimate had produced a figure of just over £9 bn for the year, and that figure might still hold. Since April, forecasts had been more or less met. There were major revenue variations: the next big return of VAT was due in October. There did seem to be a total shortfall to date of £0.5 bn from Customs and Excise (including VAT). The economic downturn might have caused this. But this was to some extent offset by increased PAYE receipts as incomes increased. PRT should produce £2.5 bn - the first £1 bn of which had been received this week. The remainder would come through in March. BNOC advance sales produced revenue late last year and would produce a further £600 m next March. The sale of assets was planned to produce £500 - 600 m late in the year. There could be some shortfall. At present, £500 m was anticipated from our EC Budget refund. An additional distortion was caused by heavy public corporation borrowing in this part of the year which would be recovered later from higher charges.

The October PSBR forecast was under preparation. Of the prospective overshoot about £200 m was directly attributed to the recession. The picture was not a cause for major alarm, with the exception of defence - where the spending profile still showed an overspend of £400 m over the revised cash limit.

In further discussion, the Prime Minister expressed her concern that borrowing forecasts always seemed to undershoot, not overshoot. The forecasting system and spending profiles would need to be much improved. If cash limits were successful at present, it was only because the limits themselves were too generous. The real issue was whether the Chancellor was in any position to say that the money supply was under control and that targets would be met. She wanted to see a detailed month by month spending profile. The Financial Secretary explained that monetary control was not exercised on a month by month basis. The quarterly return was the best available information.

/The Chancellor

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The Chancellor said that his main worries were the levels of borrowing and spending by local authorities, and the EFLs of the nationalised industries. The Financial Secretary had been looking at the way in which Government effectively guaranteed local authority borrowing. This was an issue which needed tackling.

The Prime Minister said that she was far from convinced that the truth of the position was yet known. She wanted to see a clear statement of where matters now stood which needed to be updated month by month. Mr. Burns explained that the latest forecasting run would be completed at the end of September. The Prime Minister said that, whilst the Chancellor had pointed to policy issues under consideration for the future, some psychological levers would be needed for the following week's banking figures announcement. The Chancellor said that he recognised the need to give some shape to figures for the rest of the year and to maintain confidence in response to the figures on Tuesday. Some refining of control mechanisms was necessary. He saw no case for any fiscal changes, but was fully aware of the need to bear down hard on expenditure. The Governor said that £2 bn in gilts was due for redemption by the end of the year, so that £10.5 bn, with any necessary over-finance, had to be found in the market in the course of the year.

In later discussion, the Governor presented his prepared analysis of the economic situation. There was a marked inconsistency between what was happening in the real economy and the performance of the financial variables - PSBR and M3. M3 was developing as should be expected with a monetary squeeze, but real incomes remaining obstinately high. The Prime Minister said that this was not true of the public sector. The Governor stressed that he was particularly concerned with the private sector. The strength of the pound was the greatest diversion from the Chancellor's budgetary forecasts. The oil price rise played a considerable part in this, but the rises had now worked through and the rate was still strengthening. So the strong pound must be a reaction to monetary policy. The first sign of lax monetary policy was a weakening in a currency. But if money supply figures were bad, this offered prospects of high interest rates, and therefore sustained the strength of a currency. The

/enormous

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enormous strengthening of the pound was much more than anyone had expected. It was exercising a far more deflationary effect on the private sector than had been anticipated in setting the targets. The recession in output and employment was well under way, although it had taken longer than expected to take effect. From this point, there was a danger of a much greater acceleration than forecast. Even if PSBR and M3 were out of control, there were no indications in the real private sector economy to suggest a failure of policy, but the exchange rate was a major consequence of the Government's major monetary policy stance. Inflation prospects were now encouraging. RPI had peaked well below 23%. Over the last 3 months it was running at 11.3%. There was a similar sharp fall in wholesale price whilst the latest CBI survey forecast the smallest range of price increases for 12 years. Nor were there signs of lax money supply in asset prices - neither house nor land prices were running riot. The issue was what had gone wrong on the public sector side. The skew in the funding figures was much worse than expected. Gilts were about right, but other Government debt had yielded only £250 m, not the projected £1150 m. The £2 bn excess on PSBR gave a total of nearly £3 bn. With most of the planned £8.5 bn already used up, the Treasury had to persuade people that this would swing back to the £8½ - 9 bn range.

The Prime Minister intervened to argue that the real problem was the volume of money being pumped out by the banks. Some of it was being pressed on companies who were not even seeking extended facilities. The Governor responded that he was trying to show how the components of M3 differ from the forecast. He felt that the Prime Minister did not properly understand where the figures had gone over the top. The bank lending was only £800 m up for the period. The real dilemma was how bank lending could come down in the future. The corporate rate sector deficit was up perhaps £11 bn this year. In previous years the figure had been £6.7 bn and £5.6 bn. Companies were finding their liquid assets down, and were unwilling to raise capital (only £900 m so far this year). With this huge corporate sector deficit, the personal sector had bloomed. The funds had put their money in gilts, while others had put money in banks and building societies. The greatest proportion of bank lending was going to the corporate sector and to unincorporated businesses. He characterised it as a domestic OPEC situation. Money had to be recycled from the personal to the corporate sector.

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The Prime Minister interjected that the banks were being allowed to print money for the corporate sector instead of collecting from the personal sector. The banks were not nearly selective enough. There was effectively no venture credit for small but sound businesses. She doubted whether the banks really understood what was happening. The Governor said that the major task was to get the balance right by a major attack on the personal savings sector. The Prime Minister said she felt that the centre-piece of Government strategy was being undermined by her own supporters. Mr. Goodhart said that the capital market was not functioning, and this had created a corporate squeeze. The choice was simple. Either the banks lent to industry or many more businesses would go bust. The Prime Minister said this confirmed comments from her Swiss friends that the Bank was simply unwilling to implement Government strategy.

The Chancellor said that the Bank was not simply brushing aside the targets. All institutions of Government are trying to fulfil the M3 target. Working back from the effects of reintermediation it seemed that M3 had been growing at 15 to 16 per cent all along. When he had assured the Select Committee that money supply was coming under control, he had had no idea of the scale of reintermediation, nor of the underlying picture. In retrospect the authorities might have been too eager to help the system on liquidity, because interest rates were thought to be too high. But if lending was restrained, it would reinforce the imbalance against the private sector. The Governor commented that if the Prime Minister were able to stop lending to the private sector, companies would seek to raise money overseas despite the exchange rate risk.

In the light of this discussion, the Prime Minister said that she would wish to see urgently a plan covering four points: how to get back to the 7 to 11 per cent monetary growth target, or how to revise the target; whether to return to a base interest rate set by the market; whether to use the reserve asset ratio to control lending in addition to its role as a measure of prudence; and how to carry to a conclusion the discussion on monetary base. The Chancellor explained that he was working on these topics, and would be ready to put proposals to her in the middle of October.

The Prime Minister felt strongly that she should herself see the clearing banks. The Chancellor counselled equally strongly against

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doing so. The Prime Minister deferred the matter until she returned from her Scottish trip.

The Chancellor emphasised that these complex issues would have to be taken step by step but there were three pressing questions in relation to the 9 September figures. First, was a substantial rise in interest rates right? In view of the state of the real economy he had doubts about this. Either interest rates were having less effect on borrowing than expected, or larger variations in the rate were necessary to achieve the desired effect. Secondly, the question whether anything could be achieved through funding policy to get interest rates down. One useful but small element would be an extension of the "Granny Bonds" principle through the population. He now had ready a plan to do this in two stages. It would require a dispensation on staff numbers by the Department of National Savings but the scheme could be implemented from mid-November. He might hope to raise about £1 bn. An announcement on 9 September might be appropriate. The Prime Minister was content in principle. The third issue was the one of pure presentation on 9 September. The Chancellor was working on this, and would have proposals ready for the Prime Minister on her return from Scotland. He confirmed that he would be available for television and the media in general on 9 September.

3 September 1980

SECRET

SECRET AND PERSONAL

10 DOWNING STREET

From the Private Secretary

3 September 1980

File cc CAW TPL B. of E.

cc Master Set

BF 5.9.80

Dear John

As you know, the Chancellor and the Governor of the Bank of England had a meeting with the Prime Minister today to discuss progress in the money supply. The Financial Secretary to the Treasury, Mr. Burns, Mr. Middleton, Miss Brown from the Treasury, and Mr. Goodhart from the Bank were also present.

The discussion centred on the issues raised by the banking figures due to be announced on Tuesday. The Prime Minister expressed her serious concern that the money supply would be seen to be out of control. The Government would need to consider urgently how to act in the face of this situation. In the Prime Minister's view, it would be necessary to draw up a plan next month covering four elements: the question of how to get back on target for a 7 to 11 per cent growth in money supply, or alternatively what revised target to adopt; whether to go back to allowing interest rates to follow the market; whether to use the reverse asset ratio for controlling purposes as well as a measure of prudence; and how to carry to a conclusion the Green Paper discussion on monetary base.

The Chancellor said that he would be ready to come forward with proposals on these matters by the middle of October.

The Prime Minister was uneasy about forecasting of PSBR and CGBR. She asked to see the best available profile of the future performance of PSBR. The Chancellor explained that the best immediately available profile would be provided by the CGBR three monthly forecast, and he would arrange for the latest update to be provided.

The Prime Minister asked about the handling of the banking figures announcement on 9 September. The Chancellor said that he had been giving very careful thought to this, and would let the

/Prime Minister

Prime Minister have a note by the time she returned to London on Monday 8 September. There were two other issues which he needed to raise with her in this context. One was policy on interest rates, which would now need to be considered in the context of the work commissioned for mid-October. The second was the question of expanding, in stages, the "Granny Bond" principle to the population as a whole as part of an effort to mop up liquidity in the personal sector. He had a scheme ready for announcement, possibly on Tuesday. The Prime Minister agreed that this was a necessary step.

The Prime Minister will be returning to London around 1 p.m. on Monday, and it would be helpful if you could ensure that the necessary material reaches us before she gets back. If, on reflection, you feel it would be useful to let the Prime Minister see any further material on these matters over the weekend, we should be able to arrange to get it to her at Balmoral provided that we have it in good time on Friday afternoon. Perhaps you could liaise with Clive Whitmore about this.

I am sending a copy of this letter to John Beverly at the Bank of England.

Yours ever

Mike Pattison

A.J. Wiggins, Esq.,
HM Treasury.

GB

MONETARY CONTROL

1. Facts: money supply increasing at underlying 16% since February - excluding reintermediation. Has been over 15% since July 1978 on same basis:

a. bank lending averaging about £1 bn a month - about 30% a year.

b. PSBR £5 bn in 1st quarter. CGBR £2 bn in August.

c. Reintermediation post corset much more than thought - now expected to be 6-10%.

Problems with Present System

1. Can we do anything more to control the profile of the PSBR.

2. Can we do anything to restrain bank lending.

- the banks simply respond to drawing down overdrafts
- the 12½% reserve asset ratio does not bite because the Bank always relieve banks. If we sell gilts to neutralise high bank lending, we have to lend back to the banks - to prevent reserve asset pressure. Is there any alternative to this as long as interest rates are set at the discretion of the authorities.
- is the increase in lending after the corset simply reintermediation - or is the banking system out of control and trying to expand in all directions. What is happening?
- can we do anything by funding policy to take the pressure off bank lending by getting long rates of interest down. Sell fewer gilts and more National Savings: problems for building societies.

More Fundamentally

- How can we get back to a system in which interest rates fluctuate and the market has more of a say?

2 possibilities a. monetary base
                 b. use present reserve asset system

Both of these at present would mean higher short term interest rates - including base rates + mortgage rates. Yet the economy is now in a sharp recession.

- An essential transitional stage is the Bank's discussions with the banking system on bank liquidity for prudential purposes (in a bit of a tangle) and cash ratios (not even issued yet).

- How are the present monetary base discussions to be brought to a conclusion in such a way as to ensure that at a very minimum we do not impede a move in this direction.

2.9.80

Domestic Monetary Policy.

Econ Pol

MONEY MARKET RELIEF MEASURES

The Bank made the attached press release at 10 a.m. today. It simply announces the rolling forward of part of one of the facilities - aimed at relieving money market pressures - which soon falls due to be unwound. Without this further relief there would be a risk that short term interest rates would be driven up as banks bid for funds to relieve the pressure on their liquidity.

Measures of this kind are now commonplace. We would not normally expect any adverse market reaction but, following Tuesday's money supply figures it might appear that the authorities were in fact easing their monetary policy.

Line to Take

1) These are technical operations designed to avoid upward pressure on short term interest rates beyond that necessary to maintain monetary control.

2) The money market pressure arises from a shortage of liquidity, in turn a consequence in part of substantial gilt sales and, in the future, calls due on sales of part paid gilts. The measures are not aimed at preventing a rise in interest rates generated by market concern about the monetary prospect.

3) It would hardly be appropriate to change the stance of policy in response to the July money supply figures, when these so heavily obscure the underlying change. Today's announcement is the neutral policy; not to have announced the partial continuation of the facility would in fact have been a change of policy given the likely impact on short term rates.

4) The authorities judge that the current level of interest rates is appropriate to ensure that the underlying rate of money supply growth will be consistent with the target for the year to next April. Reintermediation - one of the major distortions in banking July's figures does not of itself modify what is likely to happen to the underlying rate of growth.

PRESS RELEASE to the five news agencies for release at 10 am on Thursday 7 August

The temporary facilities for the sale and repurchase of gilt-edged securities made available by the Bank of England to the banking system on 27 June, and taken up on 4 July, expire on Monday 11 August. The continuing pressures on the short-term money market, arising in part from the substantial calls that are payable on recent official sales of partly-paid Government debt, make it inopportune for the whole amount of the special transactions to be unwound, and the Bank of England has accordingly decided to offer further facilities to the banking system for take up on 11 August.

The facilities are again to be offered to those institutions that are subject to the reserve asset ratio requirement, and they will be for 1% of each institution's eligible liabilities at the mid-July reporting date. A facility relating to over 2-year Government-guaranteed export credit or shipbuilding paper is offered as a supplement to a sale or repurchase operation in gilt-edged securities (as it was in the facilities taken up on 11 July). There will again be a minimum size for the total transaction for each institution of £½ mn. If the facilities were fully used, the aggregate amount made available would be some £500 mn. Transactions under the facilities will be unwound on Monday 8 September, and interest on the funds made available will be charged at Minimum Lending Rate.

Covering SECRET

Econ Pol 1 pt

Prime Minister
Even allowing for the reintermediation, this is very worrying.

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

1 August 1980

TL
1/8

T.P. Lankester, Esq.,
No.10, Downing Street

Dear Tim,

MONETARY SITUATION

When the Chancellor spoke to the Prime Minister yesterday morning, he promised her a note on the current monetary situation for her weekend box. This is attached.

Yours

John

A.J. WIGGINS

I am a little worried about the last sentence of the draft release to News Agencies. MP.

Treasury have changed it - made it less bland. TL.

SECRET

7

JULY MONEY SUPPLY FIGURES

The preliminary analysis of the monthly returns for banking July show that £M3 grew by £2.9 billion (5.0%). An indication of this figure will be given by the Bank to news agencies, in the normal way, at the same time as the publication of the Eligible Liability figures at 2.30pm on Tuesday, 5 August. The full figures, together with the analysis of counterparts, will be published on Thursday, 14 August.

2. The Annex to this note sets out the main counterparts of this growth, as currently estimated, and compares them with the average of the last four months, as well as setting out the cumulative position in the first five months of the current target period. The figure of the growth of the money supply could change slightly - by perhaps up to ¼% - before the final figure is published on Thursday week: the figures for counterparts could change by more as the analysis of the returns is completed.

3. As the following paragraphs on particular elementsbring out, the very high figure for banking July is due to some combination of:-

i. reintermediation, that is bringing back onto banks' balance sheets business which was diverted during the operation of the SSD scheme, without actually affecting underlying monetary conditions: the most clearly identifiable example of this is the bill leak which has unwound to the extent of £1 billion during banking July;

ii. the adjustment by banks of their balance sheet structure following the end of the SSD scheme: the proportion of banks' balance sheets lent to the private sector has been growing, and that lent to the public sector falling, for some time. The banks significantly increased their holdings of Treasury bills, gilts and local authority debt during the month;

iii. a blip in monetary growth: for example, there now appears to be a well established 3 monthly cycle in the level of

bank lending to the private sector, and July was another high month in that sequence.

It is impossible to say precisely how much each of these elements contributes to the total, or indeed whether the underlying rate of monetary growth is also running above the top of the target range. We may learn some more about the extent of reintermediation from the discussions which the Bank is currently having with individual clearing banks about their figures, and from further analysis of the returns generally. Any conclusion about the underlying trend must similarly really wait for the banking August figures. However, as explained in the paragraph below on the development of other aggregates, there are some grounds for disquiet.

Main Developments in the Counterparts

4. The Central Government Borrowing Requirement was exceptionally low in banking July at £0.4 billion (the calendar month figure to be published on 11 August was only a little higher at £0.8 billion). There will however be a further high figure for the CGBR in banking August, partly because of the effect of the income tax refunds affecting the payments from employers to the Inland Revenue during the month.

5. The take-up of central government debt, particularly gilts, outside the banking system was much lower than had been expected, given the very high gross gilts sales by the Issue Department. The banks appear to have increased their holdings by £0.6 billion, a much larger amount than had been expected: this is an important element in the restructuring of banks' balance sheets referred to above. The overseas take-up of gilts (£0.3 billion) was relatively modest. The non-bank sector's holdings of other public sector debt was reduced during the month, largely because of the extent to which the banks were bidding for Treasury bills, probably partly as a result of the pressure on reserve assets ratios.

6. Banks lent £0.6 billion to the rest of the public sector during the month, overwhelmingly to local authorities. We have not yet any basis for

telling how far this was a form of "reintermediation", in which the banks were bidding short term local authority debt away from non-bank holders, and how far it was the result of a high local authority borrowing requirement during the month. We may have a better idea of this when we have the results of the local authority borrowing survey for 31 July.

7. Sterling bank lending to the private sector was at a record level of £2.4 billion. However, the bill leak was reduced by £1 billion, so the adjusted figure is only £1.4 billion. This is very much in line with the peak levels of banking January and banking April. Unless there is a significant further element of reintermediation which we have not identified, therefore, this figure indicates that the level of bank lending is continuing at about its recent level, rather than declining. The increase in clearing bank lending (not seasonally adjusted) was £2.2 billion. Of this £1.3 billion was to manufacturing industry - a phenomenal increase of 21% of the stock oustanding in one month. The other major sector for which advances increased was the service sector though their increase was only some 6%. The increase in personal lending of just over £0.1 billion was more than accounted for by interest debited to accounts.

8. Sterling lending to overseas was also high (£0.7 billion): it would appear that this too included some element of reintermediation.

9. Taken together, these elements made DCE £3.7 billion, very little less than the total for the four previous months taken together.

The Other Aggregates

10. All the other monetary aggregates appear to have risen sharply in the month also. M1 rose by nearly £1 billion or 3.6%: this follows a run of months over which it had, on average, hardly moved at all. More significantly, measures of private sector liquidity which are less distorted by reintermediation also rose strongly. The narrower measure, PSL1, which is £M3 together with non-bank holdings of bills and of short

term public sector paper, is estimated to have risen by 2.2%. This had been rising more rapidly in recent months than £M3, because of disintermediation, so since February its annual rate of growth has been just over 20%. The wider measure of private sector liquidity, PSL2, which also includes deposits with building societies, rose by nearly 2% in the month bringing the rate of growth since mid-February to about 17% per annum. It is the fact that these other measures, less affected by disintermediation and now reintermediation, are all growing fairly rapidly which gives cause for concern that not all the growth in £M3 this month was due to special factors, so underlying monetary growth may be exceeding the target range.

The PSBR

11. The PSBR in the first 3 months of the financial year is now estimated to have been £5 billion - subject to an error at this stage of plus or minus £250 million. This is significantly more than half the Budget estimate of £8½ billion for the year. There are some grounds for thinking that this year the PSBR will be even more front-end loaded than last year, when one third of the final borrowing requirement was borrowed in the first 3 months - one element in this is the retiming of PRT which has removed £0.7 billion of receipts from those months, while because of the rising trend, receipts in the rest of the year are expected to be over £1 billion above what they were last year. A similar point arises on the forward oil sales, where BNOC is now delivering oil against the advance payments made in March. That said, the forecasters now consider that their central estimate for the PSBR this year has risen by rather more than £1 billion since the Budget. The largest elements in the change are additional supply expenditure of £0.4 billion, and a reduction in the estimate of excise duty revenue of like amount.

Conclusion

12. A large element of the exceptional increase in the money supply in banking July was almost certainly due to reintermediation, and other

adjustments to the structure of banks' balance sheets following the end of the SSD scheme. This will almost certainly be accepted by the markets. The point will also be made that while it is difficult to interpret the data, and so to identify the underlying rate of monetary growth, it would be premature to conclude that the underlying rate was outside the target range. The market may well be willing to suspend judgement on that, so that any adjustment in market interest rates and the exchange rate will not get out of control in a way which forces the authorities' hand. But there must be a very real chance that the August figures would confirm the grounds cited above for concern that the underlying growth is too high.

RECENT BEHAVIOUR OF £M3 AND ITS COUNTERPARTS

£ billion, seasonally adjusted

	Average banking March-June (4 months)	banking July	Cumulative banking March-July (5 months)
Central Govt. Borrowing Requirement	+0.71	+0.42	+3.27
Purchase of Central Govt. debt by non-bank private sector (increase:-)	-0.59	-0.41	-2.78
of which: gilts	(-0.55)	(-0.55)	(-2.76)
other	(-0.04)	(+0.14)	(-0.02)
Net other public sector	+0.05	+0.58	+0.79
Sterling bank lending to:			
private sector	+0.70	+2.43	+5.22
overseas	+0.10	+0.66	+1.08
Domestic Credit Expansion	+0.98	+3.68	+7.58
External and foreign currency finance adjustment	-0.28	-0.42	-1.56
Net non-deposit liabilities, etc.	-0.14	-0.34	-0.89
£M3	+0.55	+2.92	+5.13
% increase	1.0	5.0	21.0*
Memo item			
Sterling bank lending to the private sector plus "bill leak"	+0.86	+1.43	+4.88
PSL1 (% increase)	1.4	2.2	20.7*
PSL2 " "	1.2	1.8	16.8*

*at annual rate

SECRET

DRAFT RELEASE TO NEWS AGENCIES - 2.30 pm, TUESDAY, 5 AUGUST

A Bank of England spokesman said that preliminary information suggested that £M3 (seasonally adjusted) may have grown by about 5% during the month. This figure may of course need to be revised in the light of subsequent information.

The spokesman commented that the July figures were massively exaggerated by the unwinding of distortions within the financial system that had built up over the period of operation of the Supplementary Special Deposits Scheme (the "corset"). As one example of this, provisional information indicates a fall in the volume of bank acceptances held outside the banking system equivalent to about one third of the recorded increase in £M3. Other forms of post-corset adjustment cannot be measured as precisely. But there appears to have been a correspondingly large increase in the banking system's claims on the public sector which had been run down through the corset period; and there may also have been some switching of foreign currency or offshore sterling transactions back into domestic sterling associated with the ending of the corset.

While it is difficult to interpret the data, and thus accurately to identify the underlying rate of monetary growth, the authorities have no reason to conclude that the July figures represent a sudden upturn. ?

THE MONETARY CONTROL SEMINAR

Introduction

1 There is no fixed timetable for the day's proceedings; we would, however, hope to cover most of the subjects raised in paras 2-9 below (ie to discuss various aspects of the debate on monetary base control (MBC) in theory and in practice) in the morning sessions.

The time horizon for monetary control

2 The first issue is the period over which control is sought. Is there general agreement with the view expressed in the Green Paper that month-by-month control is not essential and that it is doubtful in any case whether any form of control could act with such precision?

3 We would then like to discuss the way in which MBC works and to clarify the implications of MBC for the behaviour of banks. In particular would MBC affect the volume of funds that banks were willing to provide at any given price? In this context, the Group might consider the views put forward by Dr Mervyn Lewis in the attached paper (to be published shortly in The Banker). Is the distinction he draws between retail and wholesale banking a valid one? Would the banks respond to control of the base in the way he suggests?

4 This naturally leads into questions about the implications of MBC for interest rates. We would welcome views on the implications of achieving a given monetary target by MBC rather than the present methods. Would interest rates on average be higher or lower; and would the volatility of interest rates be increased or reduced?

Mandatory forms of MBC

5 The discussion might then move on to mandatory forms of MBC. Having set a mandatory minimum then (except in a system of lead accounting) it is argued in the Green Paper that the authorities

would have to ensure that sufficient base was in fact available at the time when the requirement was to be met. Is this agreed? If so, the main issues then concern the methods by which it would be made available and the interest rate at which assistance was given. What would be the role of the authorities' judgment and what the role of the market in setting interest rates under such a system?

6 A mandatory system has been criticised as inequitable, implying a discriminatory tax on banking. It has also been suggested that disintermediation could occur in response to mandatory MBC as it did in response to the corset. Do these arguments point towards a non-mandatory form of MBC, at least as the better option to consider for the long term, if some form of MBC is favoured?

Non-mandatory MBC

7 A non-mandatory MBC would probably involve more fundamental changes in the structure of financial markets. We would welcome discussion of the nature and the extent of these changes.

8 A non-mandatory control works only if the demand for base has a predictable relationship to the money supply over an operationally relevant time period. But varying degrees of liquidity would also be offered by Treasury bills, etc, even if these assets were no longer rediscountable at the Bank of England. Would the existence and variability of the stock of such assets complicate any relationship between the base and money? If so, does it carry implications for debt management policy under a non-mandatory regime, either because of the implications for banks' likely demand for base or because we should take account of the size of the stock of near-money assets created by central government and other borrowers in assessing monetary conditions?

9 Most forms of MBC would involve to some degree a modification of the lender of last resort facility. It has been suggested that some form of 'half-way house' could be devised, which might limit rather than abolish lender of last resort facilities (and so preserve many of the characteristics of the present system) while still moving towards the principle of non-mandatory MBC - that cash

is a distinctive asset which banks will feel the need to hold in some predictable relationship to their deposits. Is such a half-way house possible on either a theoretical or practical basis? What would be the implications for the structure of financial markets and for the main borrowers and lenders?

Broader issues

10 We would like then to broaden the scope of the discussions and to consider briefly some of the general issues in the debate over rules versus discretion in the conduct of monetary policy.

11 In this context, we might consider the system of automatic interest rate adjustments outlined in Chapter 5 of the Green Paper.

12 There will also be an opportunity for members of the Group to raise other issues relevant to the debate over monetary control. We do not expect clear conclusions to emerge but we do hope for some indication of the range of views on the direction in which monetary control methods should develop.

IS MONETARY BASE CONTROL JUST INTEREST RATE CONTROL IN DISGUISE?

Is monetary base control merely "a means for the markets to generate the interest rates necessary to bring the rate of growth of the money supply back towards the desired path" (Green Paper - our emphasis), or is it something more? If the former, most of the participants to the flagging monetary control debate could eventually reach some form of accommodation, in which interest rates are left more to market forces. Many of the critics of present monetary policies really wanted no more than this in the first place.

The idea that control of the money supply via the monetary base is different from interest rate control was stated forcibly by Milton Friedman to the House of Commons Select Committee (as reported in The Observer, July 6):

"Direct control of the monetary base is an alternative to .... interest rates as a means of controlling monetary growth. Of course, direct control of the monetary base will affect interest rates, but that is a very different thing from controlling monetary growth through interest rates."

If monetary base control is different, we must ask how it works and provide a frame of reference for evaluating its costs and benefits vis-a-vis interest rate control. Our concern is with the behaviour of the banking system, for this is where the money supply problem currently exists.

Base money (alias high-powered money or simply cash) is important to the banking system because it is the ultimate means of payment. Convertibility into cash is one of the characteristics expected of deposits which are treated as 'money', while transferability in the settlement of debts and to make payments is a distinguishing feature of banking services. In an overdraft system, transfers can also be made from accounts in debit, so that liquidity services are provided on both sides of the balance sheet. Banks can be

visualised as purchasing primary securities, pooling them to eliminate risks and combining them with capital, labour, materials and high-powered money to create 'liquidity'. High-powered money has the role as an input into banks' production function.

How much high-powered money is required by the banks depends on the nature of the production process and on institutional arrangements. Banks providing liquidity services face uncertain demand for cash from deposits and from loans where there are undrawn facilities or open credit lines. They are able to employ the law of large numbers to keep cash at low levels, but cannot eliminate the need for cash completely. As a bank lends or invests, the loss of cash puts it in a position where any subsequent deposit withdrawals or loan demands may necessitate sales of securities at a loss or interbank borrowings at unknown rates. These possible costs must be balanced against the benefits of increased income. In this way, the availability of cash limits banks' acquisition of non-cash assets.

Control of the money supply is exercised by restricting the quantity of the factor of production, base money, to the banking industry. Since the monetary authorities have a monopoly over the production of this factor input, they can make it available in less than perfectly elastic supply: in the limit, the supply could be made perfectly inelastic. Banks are then in the same position as firms in any industry for which the inputs required for production are available only at sharply increasing cost. For an individual bank, the restriction of the supply of base money imposes an external cost as banks in the system expand deposits and bid for reserves. (Each bank's supply response is a mixture of a movement along a short-run cost curve and a shift of that cost curve as rising factor prices impose an external pecuniary diseconomy.) An individual bank can react in a variety of ways: by bidding for inter-bank funds, raising deposit (and loan) rates, improving services, cutting back on new facilities, cancelling or reducing existing facilities, selling CDs, disposing of bills or bonds. The route actually chosen will be the one most profitable to the bank.

One immediate difference from the interest rate mechanism presently operated is the involvement of the banks. Following the removal of the corset, the banks are now almost passive spectators in the process of monetary control. In response to an increase in MLR, their 'job' is to raise base rates in line (which they have done), but that is about all. The Bank of England, as it were, appeals directly over their head to the public's demand for credit. In the meantime, the banks can continue to push out facilities with relative impunity. If borrowers are not daunted by the higher interest rates, the banks could conceive their job to include bidding for deposits and reserves to sustain any expansion of advances. Monetary base control, by contrast, impinges directly upon banks' decision-making and provides a pecuniary incentive for them to participate in the process of adjusting their balance sheets to the dictates of monetary policy.

A second difference concerns the adjustment mechanism, which, under monetary base control, would be chosen by the banks on profit-maximising grounds. At present, the form of the adjustment (eg interest rates operating upon credit demand) is chosen by the authorities. If that fails, the authorities must either raise rates further, or wait for credit demands to subside. Until the latter eventuates, banks are suppli with cash to prevent them running out of reserves. Left to themselves, banks could well choose to respond to a reserve shortage in the same way - by raising deposit and loan rates. Should interest rates fail to restrain the demand for money or credit, this could not be the end of the matter. A reserve deficiency would still exist and banks would be forced to try something else. Some assurance would exist that the adjustments would proceed until monetary growth came into line. The idea that there is some new breed of banker who will always eschew asset management for liability management is patently false. If interbank rates are bid up high enough, it would pay some banks to sell bills and bonds to the private sector in order to obtain funds for lending out in the interbank market. Liability management is allowed to succeed because the Bank provides the reserves needed to validate deposit expansion.

Perhaps the most important difference is in terms of the implications for behaviour next time round. Once banks are forced to make up reserve shortages by borrowing interbank at 'penalty cost' or by

selling securities at a loss, they are likely to exercise much greater care in future when granting facilities and open credit lines. Unused facilities are a valuable source of liquidity to customers, and banks might, in different circumstances, be expected to vary the 'price' for this service. There would also be an incentive for banks to refrain from lending and build up reserves when reserve shortages are anticipated. Accordingly, surges in monetary growth may be less likely to occur.

In this description, monetary base control is qualitatively different from interest rate control. At the aggregate level it operates by imposing a quantitative retriction upon banks' intermediation. This is translated directly into individual banks' profit calculus. Both the initial response and subsequent adjustments are determined by market forces, and the rewards and punishments these forces give to banks would seem very considerable benefits indeed. Unfortunately, it is not as easy to be clear about the possible costs.

For restraint upon cash to be an effective control device, it is not enough that its supply be inelastic, as is witnessed by the idea of using negotiable licences to control banks' deposit expansion. As with base money, the supply of negotiable licences would be monopolised by the authorities. As banks expand beyond allowable limits, variations in the market price would raise costs against individual banks. Yet is is generally agreed that such a scheme would encourage banking to be done outside the controlled area - particularly in offshore markets. Would the same consequences follow from monetary base control? If banks' holdings of base money were involuntary, as under a reserve requirement, this might well be the case. But we have argued that banks' demand is a voluntary one based on a production function for liquidity services, not an arbitrary restriction upon an institution designated to be a 'bank'. Institutions in the Eurosterling market (not that such a market can really be said to exist, thanks to the Bank of England) which provided substitute liquidity services, would require inputs of high-powered money, just as is the case in domestic markets. What competitive advantages would they have over domestic banks to be able to attract the deposits and reserves needed for liquidity production? Much the same question must be asked of the idea that non-banking intermediaries in domestic markets would provide substitute liquidity services.

But are liquidity services the distinguishing characteristic of money? If they are, then perhaps one-third of £M3 should be excluded from the definition. This is a conservative estimate of the amount that represents wholesale funds of the non-bank private sector, much of which is held in banks which specialise in wholesale banking. This type of banking differs substantially from retail banking, which is the model outlined earlier. Retail banks exist by producing liquidity services; they endow claims with attributes of capital certainty, convertibility and transferability. The economic basis of wholesale banking is to lower transactions costs in markets for corporate borrowing and lending and to intermediate within the term structure of interest rates. In contrast with retail banking, in which virtually all deposits are in sterling and withdrawable on demand (or at very short notice), wholesale deposits are for various maturities and in a variety of currencies. Unlike retail deposits, where each bank may have millions of small accounts, to which the law of large numbers can be applied, each bank in wholesale business may have only a few hundred large accounts and is not large enough, relative to the total market for wholesale funds, to apply the same principles.

Because the economic basis of wholesale banking is different and the balance sheet structure differs, a different 'production process' applies. A substantial degree of matching of currency and maturity is the rule, even when, with non-bank business, substantial maturity transformation occurs. (Maturity transformation in sterling wholesale banking is only slightly less than that which now occurs in Euro-currency business.) A critical role is played by the interbank market in 'reconciling' the public's preferences with those of the banks. Funds are channelled from ultimate lenders to ultimate borrowers through several banks. What begin as short-term deposits finish up as rollover loans of several years' duration. Each bank is mismatched, but not to any great extent, and no one bank is left with a large share of the transformation. This is in marked contrast to retail operations, in which the transformation is undertaken fully by the bank accepting the deposits. It follows that the Bank's proposals about prudential liquidity, with the higher requirements in interbank funds, strikes at the heart of wholesale banking, and indicates a failure to understand this type of intermediation.

Our immediate concern, however, is that, for wholesale banking activities, there is no demand for base money. In this sense, much of the British banking system has already progressed to a cashless society. Even the concept of a reserve ratio has little meaning, for the demand for marketable securities (bills, CDs) to cover an open position depends on the mismatching, maturity by maturity, not upon any scale measure of the total balance sheet.

Restraint upon the supply of base money will curtail retail banking and those substitutes for retail banking which involve the production of liquidity services using inputs of high-powered money (or, in a pyramid of credit, claims against retail banks). If, as we have argued, wholesale banking involves different services and different production processes, it is unlikely to be constrained directly by monetary base control. The vital question, then, is, should it?

Analogies are helpful, but which is the correct one? At one extreme, we could, as Friedman does, liken the production of money to that of motor cars, with high-powered money like steel. Steel is a vital and irreplaceable input to the production of motor cars, at least in the short run. By restricting the supply of steel, control could be exercised over the production of motor cars, even though there are different brands and different models. Alternatively, we could envisage money to be like containers. There are several different types of container (steel cans, glass, aluminium, plastic) and many different production processes involving quite different inputs. Each type of container, and its associated input, has its distinctive merits, but all can be substituted at a price. Is the same true of different forms of banking and finance more generally?

Thus the monetary control debate is really a debate about the first principles of monetary economics. Is the aim of monetary policy to control something special called money, or is it to control all borrowings and lendings and all forms of financing in the economy? In the latter case, the Bank's interest rate policies are clearly appropriate. But if money does have a special place, it is unnecessary and inefficient for the Bank to control all borrowings and lendings

when a more direct means of controlling the relevant money supply is available. Monetary base control will involve interest rate variations as a by-product or as a means to an end, but it may not prove necessary to deflate all borrowings and lendings and alter all credit conditions in the economy on the way. Altering all financing demands in order to change one particular form of financing is a blunt instrument.

There is something to be said for both views. Proponents of monetary base control have, somewhat slavishly, applied a theory developed in the United States, with its preponderance of retail banking, to the quite different environment of the British banking system. On the other hand, it is surely the case that those bank and non-bank claims which are backed (directly or indirectly) by base money are more liquid than much of wholesale money, which differs little in character from commercial paper. By ignoring the importance of base money to liquidity production, the Bank has overemphasised wholesale banking and failed to distinguish money from credit.

24 July 1980
M K Lewis

Econ Pol

MR BRIGGS

CONTROL OF THE MONEY SUPPLY UNDER MR HEALEY

You suggested that the Prime Minister may wish to reiterate the comments which the Chancellor made on Mr Healey's record of controlling the money supply, during last week's Industry debate. I attach a draft speaking note which was provided for the Chancellor on that occasion and which the PM could use. The paragraph was provided to refute Mr Healey's earlier assertion that money supply growth in the last year of his Chancellorship was lower than in the first year of the present Government. I presume you will attach a copy of the relevant extract from last week's Hansard.

Dinis Lennon

T LENNON
15 July 1980

LIST OF PARTICIPANTS (EXCLUDING BANK OF ENGLAND AND HM TREASURY)

PM

Participant	Institution
Professor R Alford	LSE
Professor Artis	Manchester University
J Atkins	Citibank
Professor A Bain	University of Strathclyde
Professor W Buiter	Bristol University
A Courakis	Oxford University
D Currie	London University
T Congdon	Leeds University
G E Gilchrist	Union Discount
D Gowland	York University
Professor B Griffiths	City University
M Hall	Loughborough University
C Johnson	Lloyds Bank
D Kern	National Westminster Bank
T Laugharne	Grieveson, Grant
S Lewis	Phillips & Drew
Professor C Foster	Coopers & Lybrand Assoc Ltd
Professor M Miller	University of Warwick
Professor P Minford	Liverpool University
Professor V Morgan	Reading University
I Morison	Inter-Bank Research Organisation
Professor W Newlyn	Leeds University
G Pepper	Greenwells
R J Petherbridge	Union Discount
G C Powell	Jersey, States Office
B Riley	Guernsey, States Office
Professor H B Rose	Barclays Bank
Professor T Rybzynski	Lazard Bros
D Savage	NIESR
Professor J R Sargent	Midland Bank
A Smithers	Warburgs
M Stewart	University College London
Professor B Tew	Nottingham University
P Turner	James Capel
B Williamson	Gerrard & National Discount
H Wills	LSE
G Wood	City University
P Wood	Barclays International Bank
G. B[illegible]	Morgan Grenfell

DRAFT SPEAKING NOTE

The problem with the last Government was that the Rt. Hon. Gentleman completely lost control of the money supply in the last two years of his administration. Then the money supply was running at an annual rate approaching 14% compared with a more modest 7½% for the preceding two years. It was this legacy of an accelerating money supply that the Rt. Hon. Gentleman left us. Even so, in our first year we have managed to bring down the rate of increase from that we inherited. This improving trend has continued; and over the last 6 months £M3 growth at an annual rate has been within the 7-11% target range.

Sir G. Howe: The right hon. Gentleman, much more recently, in a debate in January last year, told the House:

"The Government are determined to maintain the monetary policy to which they have pledged themselves and the fiscal policy implied by the monetary policies."—[*Official Report*, 25 January 1979; Vol. 961, col. 755.]

The trouble is that he was not so prepared, but we are. I hope that we may continue to count on his support. Unlike some of his hon. Friends, the right hon. Gentleman——

Mr. Healey: I must point out to the right hon. and learned Gentleman, as I have done in every debate since the election, that a monetary target of 8 per cent. to 12 per cent. with inflation running at under 10 per cent. is perfectly consistent with the growth of British industry, and was so. A monetary policy which sets a target which is well under half the rate of inflation created by the Government is one with which industry and Government cannot live.

Sir G. Howe: We shall examine in a moment the responsibility for the present rate of inflation. The right hon. Gentleman will not find himself easily acquitted.

The link between monetary policy and inflation is crucial. The right hon. Gentleman understands that. At any given time, one may identify one or more temporary factors affecting inflation. Recently, as I have remarked, there was the rise in world commodity prices, not unconnected with the doubling of world oil prices. In the United Kingdom, wholesale input prices, dominated by imports, including oil, increased by nearly a quarter over last year. By contrast, they were falling in the last year of the previous Administration. There are the price increases that follow from the necessary reduction in subsidies and financial support for the nationalised industries. In the period before the election, increases in rates and nationalised industry prices had not matched the impact of cost increases. That unsound price structure had to be corrected. There are the short run consequences in the change of the burden of taxation from direct to indirect taxation.

I remind the House that the effect on the year-on-year inflation rate of the changes made in my first Budget will pass out of the retail price index when the index is published in August.

The last but not the least of the short-term influences on the rate of inflation has been the backlash from the previous Government's pay policy. The disintegration of that policy led to immediate and accelerating pay increases far greater than the country could afford and bequeathed an inheritance of large and disruptive catch-up awards in the public sector stretching well over a year ahead. The clutch of staged comparability awards is estimated to have cost almost £3,000 million in a full year. Of that total almost a half falls on the local authorities' pay bill, with inevitable consequences for the rates.

Those are the short-term factors that have been at work, but, as the right hon. Gentleman reminded the House, the real and underlying causes of inflation usually lie in the past. The past year is no exception. The rise in prices over the the last 12 months reflects primarily the acceleration of monetary growth and fiscal expansion during the last two years of the right hon. Gentleman's stewardship at the Treasury. Whereas sterling M3 rose at an annual rate of 7 per cent. between mid-1975 and mid-1977, it increased at more than twice that rate between mid-1977 and mid-1979. That acceleration was associated with a major change in the budgetary stance with increased public spending and tax cuts that he embarked upon in autumn 1977.

Mr. Jack Straw (Blackburn) *rose*——

Sir G. Howe: I shall give way in a second.

In our first year, we have managed to curb the money supply increase that we inherited. Over the last six months, sterling M3 growth, at an annual rate, has been within the 7 to 11 per cent. target range. We have not shrunk from the painful and other fiscal measures that were necessary. I stress that the high rate of inflation with which we are currently grappling was largely caused by the right hon. Gentleman's failure to exercise sufficient control of monetary and fiscal policy.

Mr. Straw: If it is correct that the rate of money supply in the previous two years caused the present level of inflation,

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Top copy on Econ Pol July 1980 PM's luncheon at Chequers on Sunday 13 July 1980 for a group of academic economists.

NOTE OF A DISCUSSION AT CHEQUERS: SUNDAY 13 JULY

Present: The Prime Minister
Chancellor of the Exchequer
Chief Secretary
Sir Douglas Wass
Mr. Terry Burns
Professor Matthews
Professor Griffiths
Professor Hague
Professor Minford
Professor Ball
Mr. Christopher Foster

Mr. T.P. Lankester

Professor Minford said that, since last November, the Government had got a grip on the fiscal and monetary environment. The Medium-Term Financial Strategy (MTFS) was the cornerstone of the Government's economic strategy, and it was crucial that people should understand this and be influenced by the targets that had been set. There were signs that the credibility of the strategy was beginning to take hold. But the battle was still to be won. It was essential that the Government should "see it through", and give no sign that it was going to relax. The current method of monetary control was not ideal, but the authorities had to live with it for the time being. Their objective should be to stay well within the monetary target range - and probably at the lower end of it. Only by a progressive reduction in the PSBR and by sticking to the monetary targets would the inflationary psychology be cracked and would there be any prospect of recovery of the real economy.

Professor Matthews said that it was important that the Government should not over-estimate its powers of bringing about recovery. The 1940s, 1950s and 1960s had been years of success; the 1970s had been years of significantly worse performance, and it was far from clear exactly why there had been this deterioration. If Government claimed too much for its ability to change things, there was a real risk of disappointment. He agreed in general terms with the Government's

/strategy.

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strategy. But he was nonetheless concerned that the strategy might fail - with the result that, after much pain, a Leftist government might be returned with a commitment to destroy the market economy as we knew it. In order to reduce the short-term cost of the strategy, he strongly favoured a lower exchange rate. He believed this could be achieved by "talking it down". There was no point in companies getting rid of restrictive practices and improving efficiency if they were still going to collapse or run down because of an excessively high exchange rate. It was all very well to say that companies and employees had to adjust to the 40 per cent loss of competitiveness since 1976 by greater efficiency and more realistic pay bargaining; but the extent of the adjustment that was required was simply too great. On the other hand, he accepted that there was the danger that any announcement designed to get the exchange rate down could all too easily be interpreted as implying that the Government was moving away from the strategy. Professor Matthews also said that it was important not to take too insular a view of Britain's problems. At present, we were disinflating more than other countries. He hoped that in due course we would be able to move more into line with them.

Commenting on the exchange rate point, Professor Minford said that the only sure way of getting the real exchange rate down was for people to price themselves into jobs. If it were possible to get the nominal exchange rate down without shifting away from the medium-term financial strategy (and in his view this was very doubtful), it would only aggravate the problem of inflation. Mr. Burns said that the 40 per cent loss of competitiveness since 1976 exaggerated the extent to which companies had to adjust; for in 1976 the exchange rate had been substantially under-valued. Professor Ball said that the Government could not have an inflation target and an exchange rate target at the same time: the two were mutually incompatible. Unless the authorities felt that the exchange

/rate market

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rate market was working inefficiently, there was no way they could get the rate down without tampering with the inflation target..

Professor Ball went on to say that, while he supported the MTFS wholeheartedly, he was worried about the absence of a proper industrial policy. With the MTFS securely in place, the Government had reached an important point of transition; and should now be giving more attention to the supply side of the economy. He was concerned that the necessary structural adjustments would not take place through market forces alone, and that a great deal more needed to be done - for example, in the provision of training, energy investment, regional assistance, industrial infrastructure, and the implementation of a more radical housing policy. What the Government had done, and was likely to be able to do, in the field of taxation, would not be sufficient on its own. On the question of training, the problem was largely an institutional one. It had been a great mistake to convert the colleges of advanced technology into universities, and the polytechnics were giving far too much emphasis to the social sciences at the expense of industrial technology. Professor Matthews added that restrictions on entry to apprenticeships was another major problem which needed tackling. Shortage of skilled labour had been a constraint on UK development since the turn of the century, and the apprenticeship system was responsible for a great deal of this.

Mr. Foster said that spending more money on training would not necessarily help. It would be far better to concentrate on trying to improve the working of the market - by tackling the apprenticeship entry problem, improving mobility, and relying on the re-emergence of differentials following the demise of incomes policy. Professor Minford made the same point in relation to regional policy: spending more money on the regions would not work. On Merseyside, the

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Government was actually preventing the market from working properly through its policies on subsidies and transfers.

Professor Griffiths said that he strongly supported the strategy but he hoped the social cost would not be too high. There was a need for certain gestures at least to show that the Government cared about unemployment. He agreed that the strategy was more likely to succeed if the Government could attack restrictive practices generally, but it was also crucial to hold down public spending and borrowing so as not to starve the private sector of resources. Like Professor Ball, he thought that there was an urgent need to look at supply side measures.

As to what the Government might do in the way of gestures, Professor Matthews suggested that they could cut the National Insurance Surcharge. This was particularly inappropriate at the present time since it was a tax on employment. Professor Minford disagreed. The NIS could only be cut at a cost to the PSBR and therefore to interest rates. He went on to say that the trade unions were responsible for causing unemployment, and it would be as well for the Government to attack them for doing so. The Government had to make people understand that they could only get their jobs back by competing - and this meant reducing real labour costs.

Mr. Foster said that he thought that a great deal could be accomplished through more radical housing policies. The Housing Bill was, in his view, disappointing. The Government ought to move towards de-restricting rent control altogether. This would surely be very popular. At present the disadvantages of moving, and the advantages of staying at home if one was unemployed, militated against mobility. Professor Matthews said that far too many resources were going into housing in the UK. This required an end to the subsidisation of housing generally - both council houses and owner occupiers. As regards the latter, it would be far better to re-introduce Schedule A than to get rid of the tax relief on mortgage

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/interest.

interest. The Prime Minister said that neither of these were a starter.

There was then some discussion of the question of what was the appropriate level for the PSBR. Mr. Burns said that, if the recession was deeper than forecast, the PSBR would increase of its own accord. The Government would then have to face the question of whether to cut spending and/or increase taxes to bring the PSBR back. Professor Minford said that it was quite clear that, if the recession turned out to be approximately the same as forecast, and the PSBR was running higher than forecast, then corrective action should be taken. If, on the other hand, the recession was worse than expected, then in principle it might be acceptable to allow for a higher PSBR. But there was a risk that the markets would misunderstand and that interest rates and inflationary expectations would suffer. It would take considerable persuasion to convince the markets that the Government was not going off course. Mr. Foster said that a clear distinction had to be drawn between the case for a higher PSBR described by Professor Minford and the old fashioned argument that we should "spend our way out of recession". The latter was clearly unacceptable. Sir Douglas Wass pointed out that for a given monetary target there was a trade-off between interest rates and the PSBR. A decision not to allow the PSBR to rise would benefit interest rates and thus should help to bring the exchange rate down. In this context, the experience of 1977 was interesting: the Cambridge forecast of unemployment following the IMF package had been completely disproved, and the rapid fall in interest rates was no doubt responsible for this.

Professor Minford raised the issue of Monetary Base Control (MBC). The present system of control was creaky, and the authorities ought to move over to a new system which would allow interest rates to move more flexibly. Mr. Foster,

/who incidentally

who incidentally said that he thought there was a real risk that money supply growth would not moderate over the coming six months and that a rise in interest rates would be necessary, criticised the Green Paper on MBC. Professor Griffiths said that he strongly favoured a move to MBC. MBC was about controlling what could be controlled - namely, the banks' deposits with the Bank of England. The authorities should be prepared to take the interest rate consequences of such a system. The main causes of up-turns in the money supply over the years had been governments' unwillingness to let interest rates rise to appropriate levels. MBC would de-politicise the problem of monetary control. The Bank of England disliked MBC because they wanted to retain control over interest rates. In his view, MBC would not mean large swings in interest rates, but rather, small and continuous fluctuations. The Chancellor said that a move to MBC would involve a major upheaval. There was much disputing the merits and de-merits of such a move, and many of the arguments put forward in favour had been expressed in support of the changeover to Competition and Credit Control. When the Government was trying to achieve so much else, it was a mistake to embark on adventures. He did not necessarily rule out a change to MBC, but the burden of proof had to rest with its proponents. // Mr. Foster then raised the issue of public sector monopolies. In the case of the seven or eight monopolies which were not subject to foreign competition, there was a limit to what could be achieved by references to the Monopolies Commission. With these monopolies, there could well be a case for some kind of regulatory framework. He cited the example of telecommunications, where higher costs could always be passed on in prices under the present arrangements. One possibility would be to set up an independent commission which would supervise monopolies on a continuing basis. The Chancellor said that, in contrast to the USA, the Government stood behind the public utilities; and therefore the result of price regulation could

/all too

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all too easily be an increase in Government spending. Sir Douglas Wass said that it was important for the Government to develop better tests of performance, and to insist that management achieved them. This was probably a better approach than setting up a regulatory commission.

CC Econ Pol Pt 2 Public sector Pay Policy.

Finally, there was some discussion of public sector pay. Mr. Foster said that, if private sector employers saw the public sector standing up to pay demands, they were much more likely to do so themselves. In his view there was a strong case for a public sector pay freeze to help speed the transition to lower inflation. Professor Minford said a freeze would be a disaster. He went on to suggest that cash limits next year should be set within the money supply target range and the Government should try to settle the pay of its employees within this range, too. If the Government expected the private sector to settle within the monetary target range in order to prevent jobs from being lost, it should adopt the same approach with public service employees. The Chief Secretary said that the Government would need to set tough cash limits, but they must also be realistic. Professor Matthews said that there were inherent difficulties in improving the productivity of the public services. There was greater accountability in the public service than in the private sector; public servants had to be more even-handed; and they had to guard against charges of corruption. Each of these factors militated against better productivity. Mr. Foster said that somehow greater financial discipline must be instilled at local government level. The best way would be to reduce the proportion of Government grant to local authority expenditure, and replace it with a widely spread tax at local level. This would make the local authorities more accountable to their electorates. Even with the present arrangements, there was evidence from the recent local authority elections that those authorities which had increased rates the most had performed relatively poorly.

/Professor Minford

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Professor Minford suggested that, to help set public service rates of pay at appropriate levels, the Government should do more to monitor the supply and demand of particular categories of employees: the Clegg Commission had failed to do this in their reports.

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SUBJECT

Econ Pol

B/c D. Wright

10 DOWNING STREET

From the Private Secretary

3 July 1980

Dear Tom,

As you know, the Chancellor and the Governor called on the Prime Minister at 0900 hours this morning and they decided that MLR should be reduced today by 1%. This is simply to record the basis of their decision.

The Governor said that, since the meeting with the Prime Minister on Monday, new information had emerged on the banking figures for June which was less favourable than he had then indicated. Instead of M3 increasing 0.5%, it now seemed likely that it would have increased by 0.7%. Bank lending was estimated at £410 million rather than £270 million, though the bill leak was somewhat lower than had earlier been estimated. Given these figures, M3 since February would show an increase of 11.2% at an annual rate, which was just outside the target range. This made him more doubtful about the wisdom of reducing MLR at all. Indeed, the money supply figures on their own would scarcely justify a reduction and the new Bank forecasts due the following week could well reinforce his doubts. Bank lending did appear to be moving down as the recession deepened. But the case for a reduction now, rather than waiting for some further improvement in the money supply figures, was that the pressure on the corporate sector caused by high interest rates and the high exchange rate had become too great and needed to be moderated. (If there was to be an early move, it ought to be today: a reduction next week might appear to be in response to the Cabinet discussion on strategy.) A further factor in favour of a reduction was that Barclay's were considering the possibility of reducing their Base Rate. If this happened, and all the more so if the other clearers followed, the authorities would look very stubborn if MLR were held at 17%. Provided he could be sure that Government expenditure was not going to get out of control, it might still be worth taking the risk of reducing MLR by 1%. If it were decided to move, it was essential that the presentation should be got right: the Government must rebut any criticism that it was backing away from the strategy and emphasise that MLR was being reduced by a modest amount because it believed that monetary growth was coming back within the target range.

The Prime Minister and the Chancellor said that on balance they believed it was right to go for the 1% reduction proposed, in spite of the risks involved.

There was a short discussion of a draft press statement - which was subsequently amended in discussion between yourself, myself and the Bank, with the Chancellor's approval.

I am sending a copy of this letter to John Beverly (Bank of England).

Yours ever

Tim Lankester

A.J. Wiggins, Esq.,
H.M. Treasury.

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Econ Pol.

SECRET until 12.30pm on 3.7.80.
then CONFIDENTIAL

MR J PAGE

cc Chancellor
Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Sir K Couzens
Mr Burns
Mr Ryrie
Mr Barratt
Mr Middleton
Mr Bridgeman
Mr Britton
Mr Unwin
Mr Lavelle
Mrs Lomax
Mrs Gilmore
Mr Riley
Mr P G Davies
Mr Bottrill
Mr Shields
Mr Ridley
Mr Cropper
Mr Cardona

Mr Ingham, No. 10
Mr Prescott, PMG's Office

MLR

The Bank are announcing at 12.30pm today (Thursday) a reduction of MLR of 1% (to 16%). I attach a copy of their press release; the crucial point is to present the change as entirely consistent with the Government's monetary policy. It simply represents a slight adjustment in one of the instruments of monetary control in response to changing economic circumstances. More detailed briefing follows.

Positive

1. The change is warranted by the current and prospective trend of monetary developments. Thus:

(i) There are signs that monetary growth moderated during banking June. (The Bank will not give a precise figure at this stage, but if asked you can indicate that we are confident that £M3 growth in the 6 months to mid June was, at an annual rate, within the 7-11% target range [You can agree that this implies that the figure was under 1% but do not leave the impression that it was ½% or under.])

(ii) With increasing evidence of a downturn in the economy, there are signs that the underlying demand for credit may be beginning to ease. Although the timing of the CGBR has been such that it has been high in the first months of this year, this has been financed by large gilt sales; the long tap was exhausted yesterday and a flow of part payments extending to banking September has been secured. (In detail: part payments totalling over £0.8 billion are due on 13½% Exchequer 1994 and 13% Treasury 2000 in banking August, with a further £0.2 billion on 13% Treasury 2000 in banking September; part payments will also be due in August on 12¼% Exchequer 1985A, but their amount will depend on future sales of this tap.)

(iii) In view of these factors, a slight adjustment in MLR is appropriate for the achievement of the monetary target.

2. Thus the change is entirely consistent with the emphasis Ministers have put on meeting the 7-11% target. They have made clear that interest rates would fall as soon as monetary developments warranted it.

3. The change is not a response to pressure from the CBI or some Cabinet members; nor is it an attempt to secure a lower exchange rate.

4. Caution requires that the change should only be modest. Further falls will follow, but their timing will depend on future monetary developments and prospects.

Defensive

1. Risks for Monetary Control. MLR would not be reduced if we thought this was inconsistent with meeting the target. But clearly we will monitor the position. With the onset of the recession, and the associated easier demand for credit, not to have lowered MLR would have implied we risked undershooting the target.

2. Impact on the Exchange Rate. Interest rates are only one influence on exchange rate; given there is no change in underlying stance of policy we would expect only a modest effect. But the foreign exchange market is notoriously unpredictable.

3. Effect on Industry. The benefit to industry's cash flow will be slight. But it is a step in the right direction. Ministers are well aware of the impact of high interest rates on companies, and they have put considerable emphasis on the need to cut public spending and borrowing to make it possible to meet the money supply target with lower interest rates. Today's cut is a start.

4. Implications for Building Societies. The reduction will ease - but only partially - building societies present uncompetit-ive position. The implications for the mortgage rate is a matter for the societies, but this change - of itself - is unlikely to mean a reduction in the mortgage rate. However it will reduce the chances of the societies deciding that an increase in rates was required.

5. Impact on Inflation. In the long run, the rate of inflation will be determined by the rate of monetary growth. The short run impact will depend on how the exchange rate reacts.

6. Timing. Given we now have an indication of banking June figures, there seemed no reason to delay a change. [The timing was not linked to today's Cabinet meeting.]

7. CGBR. The CGBR was high in April/May, but it usually is in the first quarter of the year. Tax receipts were particularly affected by the absence of PRT receipts following the decision taken in November to speed up payment. Voted expenditure was over 30% higher than a year earlier in April/May. But movements in the CGBR are always erratic, and we have no reason to think that cash limits for the year will not hold and supply expenditure will not come in line with the forecast. (You can hint that supply issues in June were somewhat lower - the figures will be published on 9 June - hence the word"rather" in the notes to editors.)

3 July 1980 M L Williams M L WILLIAMS

SECRET

PRIME MINISTER

MLR

The Chancellor and the Governor have not yet reached a final view on whether to reduce MLR tomorrow. Accordingly, they want to discuss it with you at 0900 tomorrow morning - the Chancellor hopes he will be able to have ten minutes with you beforehand.

The Governor seems to be vacillating for two reasons. First, the money supply figures now seem likely to be slightly less good than he indicated to you on Monday - 0.7 per cent increase rather than 0.5 per cent. (This is based on further information which has come in from the smaller banks.) Secondly, the money markets have been a bit off - with short-term rates rising. But they have come back today - the long tap is sold out and inter-bank rate is below 17 per cent again. In addition, I suspect that the Governor may be having second thoughts in view of the slight contradiction - which you of course noticed - between his serious concerns about overspending and his view that it is safe to move interests rates down now.

I am told that the Chancellor still thinks it is safe - and worth while - to go for a 1 per cent cut. Even though the money supply figures since February will still be running at an annual rate slightly above the target range, the figure for June does suggest that we are getting back towards the target range; gilt sales are going ahead well; and there is the confidence factor for manufacturing industry. Furthermore, if we do not move tomorrow, it will probably be impossible to move until next month. But there are risks, and it is a difficult decision. If we do decide to go down, it will require very careful presentation.

T.L.

2 July 1980

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CHANCELLOR

c.c. Financial Secretary
Sir D. Wass
Mr. Ryrie
Mr. Middleton

Mr. Fforde

MLR

The Governor and yourself may find it useful to have available for your talk with the Prime Minister the attached copies of an alternative draft of the note to editors, reflecting comments made at your meeting this evening. I have agreed it with Mr. Fforde.

J.M.B.

(J.M. Bridgeman)

2 July 1980

HAS SO FAR APPEARED HIGH

Note to Editors

Alternative Texts

(a) Revised Text

There are signs that monetary growth moderated during banking June, and also that the underlying demand for credit from the private sector may be beginning to ease, with increasing evidence of downturn in the economy. While the CGBR has ~~remained somewhat~~ so far been high in comparison to the forecast for the year as a whole, this has been financed by large debt sales: recent gilt sales have secured substantial funding for the next few months. It is now the judgement of the authorities that the present monetary target of a 7-11 per cent annual rate of increase of £M3 in the fourteen months to mid-April 1981 can be achieved with modestly lower short-term interest rates.

[illegible]

(b) Earlier Text

Early statistical returns indicate that monetary growth has moderated during banking June, in part as a result of continuing large debt sales. While the CGBR has remained high in comparison to the forecast for the year as a whole, there are signs that the underlying demand for credit from the private sector may be beginning to ease, with increasing signs of downturn in the economy. In the Bank's judgement, the present monetary target of a 7-11 per cent annual rate of increase in the fourteen months to mid-April 1981 can be achieved with modestly lower short-term interest rates.

Chancellor

The Governor wants "has so far been high".

I have told him that this is OK with you.

But John Hoskyns/Bridgeman want "[illegible]" included. I have told them to argue their case

NOTES TO EDITORS

There are signs that monetary growth moderated during banking June, and also that the underlying demand for credit from the private sector may be beginning to ease, with increasing evidence of downturn in the economy. While the CGBR has so far been rather high in comparison to the forecast for the year as a whole, this has been financed by large debt sales: recent gilt sales have secured substantial funding for the next few months. In the judgement of the authorities this lower MLR is now appropriate to the achievement of the present monetary target of a 7-11 per cent annual rate of increase of £M3 in the fourteen months to mid-April 1981.

MR MIDDLETON

cc Mr Burns
Mr Bridgeman
Mr Britton
Mr Cassell
Mr Unwin
Mr Riley
Mrs Stamler
Mr Powell

Mr S P Collins (Bank)

SELECT COMMITTEE: MINFORD

I attach a note by Stephen Collins of the Bank on Patrick Minford's appearance yesterday before the Select Committee, together with some press clippings. The note brings out clearly the general approach adopted by the Committee and their main lines of attack. Minford defended his position solidly and as usual showed few signs of hesitating to go onto the counter-attack. He was clearly facing a hostile and sceptical group and on at least two occasions chose to accuse them of acting irresponsibly in making suggestions that the Government might (or should) at some stage change their stated policies.

2. As Collins' note points out, du Cann and other members harked back frequently to their last report and the need to get more detailed forecasts from HMT on elements of the PSBR projections. At times they seemed to be concentrating more on the implications of policy for the PSBR than for the management of the economy.

3. The Committee gave the impression of having been well briefed on an individual basis and the procedure of giving each of the first three interlocutors (Higgins, Bray and Baker) an uninterrupted 15 minutes provided a good basis for detailed questionning. However, any attempt they may have made to co-ordinate their questions in advance was not wholly successful. It seemed to me they wasted too much time on asking repeatedly about matters on which Patrick couldn't be expected to be an expert - the response of Trade Unions, the setting of "cash limits" for Nationalised Industries - and too little on the issues of evidence and costs. Nevertheless, having sat through a good many Congressional hearings over the last couple of years,

but not previously having seen a Commons Committee in action, I found the session refreshingly free of attempts to play to the gallery and much more prepared than its American counterparts to tackle intellectual problems.

4. The Committee concentrated more on the questions of how current policy should be carried out and what its costs were likely to be than on what alternatives might be available. There were several questions on what PSBR objectives were needed to support the monetary target (including references to the City University paper), but none on whether the right figures had been chosen for the £M3 target. A query put several times by Terence Higgins was how a tight monetary policy differed from "old-fashioned deflation". The exchange rate was proferred a couple of times as an additional objective, but only Jeremy Bray went into the theoretical potential for successful stabilisation policy, quoting Lucas and Sargent against Minford. There were no questions on the stability of the demand for money, or on evidence of the link between monetary growth and inflation or on details of the transmission mechanism itself.

5. A few less obvious questions did creep into the examination. Baker queried the short-term outlook in detail, variable by variable. Higgins asked about the effectiveness and PSBR-cost of the ECGD's activities. Bray suggested that monetary policy simply shifted instability from the money supply to the exchange rate and thus put the burden onto exporters and importers. Sheldon claimed that the best way the Government could show it meant action on credit and inflation was to impose direct controls. That would also transfer the cost from possibly advantageous public investment (otherwise cut because of the PSBR constraint) to less vital consumers' expenditure. Finally, Bray was allowed to query whether the 1979 budget switch between direct tax and VAT really had no impact on inflation.

Jon Shields

JON SHIELDS
1 July 1980

1. 7.80

NOTE FOR RECORD   Copies to Mr Fforde Mr Goodhart Mr Foot
Mr Dow Mr Holland Mr Midgley
Mr Loehnis Mr Walker GPS
Mr Flemming Mr Dicks-Mireaux DGPS
Mr George Mr Quinn

SELECT COMMITTEE: ORAL EVIDENCE

1 The Select Committee examined Patrick Minford for about ninety minutes yesterday afternoon, this being the first session of oral evidence in their monetary policy enquiry. The proceedings were recorded by the BBC*. Journalistic attendance was reasonable, although the Committee room was by no means full. Advisers present were Budd, Hendry and Miller; they were consulted hardly at all. Minford's replies reflected the extreme views set down in his written submission. The purpose of this note is to give some impression of the issues which appeared particularly to interest MPs, and which might prove relevant to forthcoming appearances by Bank witnesses; accordingly, more attention is paid to the questions than to Minford's replies.

2 MPs' questions covered in an unstructured manner a good part of the questionnaire, and also referred on more than one occasion to an article published by Minford in "The Banker", July 1979. There was a tendency to hark back to the Committee's second report (on the Budget and public expenditure White Paper) - see paragraph 10 below. The majority of questions were asked by Higgins, Bray and Baker, although all members present were given a say (there was not a full house, however - Shepherd, Wainwright and Woolmer were absent). One was left in little doubt that the Committee did not share Minford's optimism about the outcome of present policies.

3 The main issue concerning <u>Terence Higgins</u> was to try to discover how the present monetary policy differed in its impact on wage negotiations from old-fashioned deflation as used in the days of "stop-go". Is it not the case that inflation will be slowed by falling aggregate demand, caused by adherence to restrictive monetary

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* Apparently to be broadcast in part in a Sunday evening programme which specialises in the proceedings of Select Committees /"Inside Parliament"?/.

targets? Minford denied that falls in demand and output were an inevitable and necessary part of present policy, and suggested that they would be absent if all concerned believed the Government's policy announcements and acted accordingly. A second issue raised by Higgins was, rather surprisingly, that of export credit subsidies: are they not an illogical feature of policy - effectively adding a premium to the price of foreign exchange - in an era of floating exchange rates? Minford agreed, but, in response to a further question, doubted whether their removal would materially affect the ability to achieve monetary and PSBR targets.

4 Jeremy Bray predictably made some remarks about Minford's economic model and the application of optimal control techniques. It was eventually agreed to conduct further dialogue on these subjects in written correspondence. He also, however, raised a few points of more general interest. In contrast to reports of his behaviour at the Chancellor's appearance last week, he asked his questions quietly and sensibly, although gently chiding the Treasury at one point for the lack of empirical content in their response to the questionnaire. Bray doubted whether it was necessary to know exactly where high-employment, non-accelerating-inflation equilibrium was in order to conduct stabilisation policy; so long as one knows the direction in which one wishes to move, that should be sufficient. Minford strongly disagreed for the reason, *inter alia*, that any relaxation of policy for anti-cyclical stabilisation would impede the formation of correct expectations about Government policy by the private sector. Bray's second point was that it is naive to assert that for a policy to be credible it must be simple; for if it is too simple - which he interpreted as meaning rigid - it would in fact appear fragile and susceptible to a U-turn. His final point was that adherence to a monetary target shifts instability into the exchange rate, and that this can itself entail severe costs to the private sector, which are not necessarily fewer than those which fluctuating monetary growth would impose.

5 Kenneth Baker questioned Minford closely about the forecasts contained in his submission. Baker said that Minford's forecast was the most optimistic seen by the Committee, and that therefore

the validity of his case depended on the accuracy of that forecast - a non sequitur emphatically disputed by Minford. Despite this dubious logic, Baker scored some telling points against the optimism of Minford's forecast. His main concerns were clearly with the short-term outlook for the economy, rather than with theoretical niceties. He wanted to know Minford's forecasts for unemployment, inflation and manufacturing output next year; what can be done to help Merseyside (the location of Minford's university - Liverpool), and whether Minford's proposed policies of lower unemployment benefit and lower real wages would be socially acceptable to Merseysiders; and whether Minford honestly believed that wage negotiations in the public sector should be left totally free from Government interference.

6 Robert Sheldon only asked one question: what happens if the unions disbelieve the signals contained in the Government's monetary strategy? Minford's response was equally simple: they would be making a great mistake.

7 Tim Eggar asked a number of different questions. The most significant was derived from the assertion in Friedman's evidence that the PSBR *per se* is not necessarily of great significance for the development of the money supply; Eggar supplemented this by reference to the paper by Middleton et al., submitted by the Treasury (and referred to in our evidence), which shows that the relation between the PSBR and the money supply varies according to the composition of the former. Minford argued, by contrast, that the PSBR is of critical importance, being the major source of new financial assets in the economy.

8 Anthony Beaumont-Dark claimed in a single intervention that we do not have a free exchange rate because of Bank intervention - and, by implication, that this was a bad thing. Minford agreed.

9 Michael English made one or two points worth noting amid some confused and confusing questions. He seemed to think that we do not monitor enough monetary aggregates (unlike the Fed), and that we are inhibited from so doing because, for example, building society statistics are collected for a different period from banking figures. He also argued that it was perfectly possible to

depress the exchange rate without unduly increasing the money supply simply by imposing a Swiss-type negative interest rate on monetary inflows. Again drawing on the American parallel, he asked whether the direct controls recently imposed in the USA were responsible for the rapid fall in interest rates. He was clearly of the view that they should be considered as a strong counter-inflationary weapon wholly in tune with Minford's desire to see clear policies introduced to that end. Minford agreed that they hit hard against inflation, but said that they introduced undesirable distortions.

10 The Committee's critical recent report on the Budget and expenditure White Paper was clearly to the forefront of several members' minds. Edward du Cann's interventions were almost wholly directed to reminding Minford of the doubts expressed in the report about in particular the expenditure projections underlying the PSBR targets - especially as regards nationalised industries and the housing programme. English complained that the Chancellor had admitted to the Committee that the Treasury did not even know the details underlying these projections. Minford responded robustly that that was a perfectly tenable position, quite consistent with the ultimate achievement of the PSBR targets. Also taking up earlier themes, Eggar asked whether Minford thought the Government is making enough information available to assist in the formation of expectations. Minford seemed quite content with what was forthcoming from the Treasury.

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11 It will be apparent that limited time prevented any issues from being explored in great depth, and it is not possible to draw any clear lessons for the Bank's forthcoming appearance. But certain observations may be worth making. Some MPs clearly have hobby-horses on which questions can be expected in the future. Bray's are well known, but it would not seem difficult to steer technical econometric questions into subsequent written exchanges - certainly, du Cann seemed eager to encourage this. Du Cann himself appears to be excessively concerned to reiterate points made in the Committee's last report. Baker is likely, on this showing, to explore our views about economic prospects this year and next. English appears intent on pressing his view that more direct methods

of monetary control are desirable. But if one thing emerges above all, it is that MPs will feel themselves free to range over a very wide area indeed, and question-spotting might well prove to be a very hit-and-miss affair.

Economics Division
1 July 1980

S P Collins (4874) HO-4

SPC

Daily Papers 1st July 1980

GUARDIAN

Economist gives evidence

By Christopher Huhne

Professor Patrick Minford of Liverpool University, one of Britain's leading monetarist economists, yesterday called for cuts in unemployment pay and the removal of the "monopoly powers" of trade unions in order to reduce unemployment.

The professor, who was giving evidence to the House of Commons Treasury and Civil Service Committee, said that there was nothing in the setting of monetary targets which ensured high unemployment. If workers adjusted their expectations of inflation and their wage demands to monetary targets, the transitional cost of the policy in lost output and unemployment would be negligible.

The professor said that people who suggested that the Government would do a U-turn did Britain a great dis-service, because it would make the loss of output and worsening unemployment more severe.

The Treasury committee recently produced a report which cast doubts on many of the assumptions behind the Government's strategy, and which was particularly sceptical of the projected £2 billion turnround in nationalised industry's finance. But Professor Minford maintained that these were merely "details."

In questioning by Mr Kenneth Baker MP, the professor admitted, however, that his view of the economy, which assumes that workers will adjust quickly in cutting real wages, had become more pessimistic since his last forecast in March.

Where he had predicted zero growth, he now expects a three-quarter per cent decline in total GDP, though a larger fall in manufacturing output. Inflation would still be about 16½ per cent at the end of the year, but unemployment would rise to 1.75 million, and to 1.9 million at the end of 1981.

Professor Minford denied, though, that the changes in any way undermined the validity of his policy prescriptions. Every economic forecast had become more gloomy due to the deterioration in the world economy, particularly in the United States.

Despite this deterioration, Professor Minford rejected any Government policy to stabilise the level of demand. This was not, he said, because it was not feasible, but because any Government error could compound the situation, and expectations would be adversely affected.

TIMES

Warning against early interest rate cuts

By John Whitmore

A warning to the Government that it should not lower interest rates prematurely came yesterday from Professor Patrick Minford, a leading monetarist economist, in evidence to the House of Commons Treasury and Civil Service committee.

Professor Minford, of Liverpool University, told the committee that lower interest rates would not be appropriate until there was firmer evidence that the money supply was under control. He suggested that the Government should aim at the lower end of its 7-11 per cent target for the annual growth rate in sterling M3.

He said a premature cut in interest rates might lead to a fresh upsurge in credit demand and make it much more difficult to control the monetary aggregates. He felt the present policy mix on public sector borrowing, monetary targets and interest rates was probably about right, although he would have preferred to have seen a public sector borrowing target some £1,500m lower in the present financial year.

He regretted the Government had not taken a firmer grip on the PSBR and monetary growth during its first six months in office.

Until wage negotiators accepted the implications of the Government's monetary policy, excessive wage awards would inevitably mean a loss of jobs. As long as the Government maintained its present monetary aims, speculation of a U-turn was irresponsible and could lead wage bargainers into making mistakes.

A tight monetary policy need not in itself lead to a loss of jobs, provided people understood the limitations imposed by that policy. He differentiated between the loss of jobs arising from monetary policy itself and from the world recession, which was deepening more quickly than expected.

He emphasized, however, that the present level of unemployment in the United Kingdom was largely the result of an excessive level of real wages. He suggested that trade union power should be weakened and that levels of unemployment benefit were too high.

Professor Minford advocated progressive reduction of public sector borrowing. A policy of using the PSBR as a stabilizer in recession could lead to confusion and cause uncertainty among wage bargainers about "sensible" expectations.

The committee will continue to hear evidence on monetary policy during the next few weeks, including evidence from Sir Geoffrey Howe, the Chancellor of the Exchequer and Mr Gordon Richardson, the Governor of the Bank of England.

Monetary policy defended

By Peter Riddell, Economics Correspondent

BEWILDERMENT and incomprehension resulted yesterday when Parliamentary sceptics about the workability of the Government's reliance on monetary policy came face to face with a true believer whose firmness of faith might occasionally raise doubts even among Treasury Ministers.

Professor Patrick Minford of Liverpool University gave evidence to the all-party Treasury and Civil Service Committee of the Commons at the start of the series of public hearings which it is holding on the conduct of monetary policy between now and the end of July.

Profesor Minford provided an eloquent defence of the need to publish medium-term monetary targets in order to influence the attitudes of pay bargainers and others operating in the economy.

He said that the key task was for these people to accept the credibility of the targets. Then it should be possible to reduce inflation without unnecessary loss of output or jobs.

Professor Minford said that mistakes such as higher unemployment would occur if participants in the economy such as pay bargainers did not have full information about the Government's intentions.

That was why it was necessary for opinion formers such as MPs on the committee to convince the public that there would be no U-turn in economic policy.

Prof. Minford's comments were received with evident scepticism by some members of the committee including various Tory MPs.

In particular, Mr. Kenneth Baker, a minister in the Heath Administration, strongly questioned Prof. Minford's theories on the basis of his forecasting record. Mr. Baker questioned whether the Professor had been too optimistic earlier this year about the prospects for the economy.

Prof. Minford said that expectations about output had been revised downwards since March because of the world recession, but he said forecasts as such should not determine the acceptability or otherwise of his theory.

Prof. Minford said he expected that total output in the UK would fall by three quarters of a per cent this year compared with 1979 and that unemployment would rise to one and three quarter million by the end of this year

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sion funds and insurance companies will not mind too much, particularly as the company appears to be doing very well at present.

Rational expectations

THE Treasury Committee's Grand Tour of monetary policy yesterday moved from the brochure stage to the first port of call with a session of oral evidence from Professor Patrick Minford of Liverpool University. Minfordia does not seem to be a place in which the committee wants to spend much time, which is a pity, but it was well worth giving the rational expectations version of monetary economics a hearing.

In Patrick Minford's view, as in that of the London Business School the Treasury Committee has missed the point in criticising the detail of the Government's for lack of credibility. How medium-term financial plan for lack of credibility. How the Government's monetary targets are achieved is far from being unimportant. But the principle of making them at all deserves more consideration than the committee has so far given it.

To an economist who believes that economic decisions, including pay bargains, are made on the basis of rational expectations about the future, including future inflation, there is every argument for the Government spelling out its intentions as firmly and as fully as it can. The most important thing, if intentions can be believed, is to know where the Government intends to get to in terms of its monetary policy and its inflation objective. How it gets there will depend on circumstances at the time.

Professor Minford argues that given the gap between where we are now and where we want to get to it would be unwise for the Government to allow the natural increase in the public sector borrowing requirement arising from a recession to take place. He also approves the Government's determination to keep interest rates high until there is clearer evidence that monetary growth is under control.

One of the more thought provoking exchanges in what sometimes threatened to become a dialogue of the deaf was Professor Minford's assertion that firm monetary policies, if properly and publicly planned, were not necessarily "deflationary" in the conventional sense of the word. If wage bargainers and others adjusted their behaviour to reflect future monetary targets there need be no loss of output or jobs.

In general, however, the questions not asked were more interesting than those that were. For instance, if expectations about the future are all important should not the Government publish its forecasts of interest rates?

Behind those bank profits

IN A FEW WEEKS time the big four High Street banks will be announcing something like a 25 p.c. rise in profits to a total of £900 million before tax for the first half of 1980. In the present circumstances, it is not hard to imagine how this news will go down

SECRET

Econ Pol 3

cc BofE
CO
Master

File

10 DOWNING STREET

From the Private Secretary

30 June 1980

Dear John,

As you know, the Chancellor and the Governor called on the Prime Minister this morning to discuss the monetary situation.

The Governor said that he was keen to reduce MLR as soon as it was safe to do so, consistent with the money supply growing within the target range. He and the Chancellor had been considering the possibility of announcing an early reduction. The May money supply figures had been disappointing, though the underlying position was not as bad as they suggested. The main worry now was not lending to the private sector, but public sector borrowing. In 1979/80, the PSBR had overshot by £1.7 billion, despite the policy changes announced in November. This was entirely due to excessive borrowing by the local authorities, though the quarterly profile of total borrowing had been very different from what had been expected. The profile for this year's CGBR, forecast at the time of the budget, was for £2.3 billion of borrowing in the first quarter. The Bank were now estimating that first quarter borrowing would be £4.5 billion on a crude basis, and £3.8 billion after seasonal adjustment - i.e. £1.5 billion above the forecast. Borrowing in July was likely to be fairly low, but the August figure was likely to be large again. The reasons for the high level of borrowing so far this year were not entirely clear. It appeared that there were some deviations on the revenue side; but there was a reasonable prospect that these would be made up later in the year. The main reason, however, seemed to be excess expenditure by central Government. In addition, the local authorities seemed to be overspending. If this was to continue - and there were no obvious reasons for thinking that it would not - it would put at risk the PSBR target and also the monetary target. If the risk of overshooting the monetary target was to be minimised, it was necessary to continue with a large funding programme. Gilts sales were going ahead on a substantial scale. But in order to tap the liquidity of the institutions, the authorities had to offer them the types of security that they wanted - and there was considerable criticism that this involved an excessive debt interest burden in future years. On the other hand, the authorities were not sufficiently tapping personal liquidity. During 1979/80, only £700 million had been raised from National Savings Certificates

/and comparable

SECRET

and comparable instruments. With the continued need for a heavy funding programme it was desirable to raise more funds from this source. He therefore intended to consider very carefully the options for improving the terms of National Savings Certificates and other improvements - such as improving the terms of "Granny Bonds". It had to be recognised, however, that any improvements in this area would be unwelcome to the building societies.

The Governor went on to say that, notwithstanding his worries about Government borrowing and expenditure, he still saw a good prospect of moving MLR down in the near future. First indications of the banking figures for June, based on the weekly reporting of the big banks, suggested an increase for £M3 of 0.3%. With the addition of the smaller banks, an increase of £M3 of about ½% seemed probable. MI was likely to show a fall. The reasons for this outturn, which was well below what had been forecast, were two-fold. First, despite heavy borrowing, there had been massive gilts sales (and this had put extreme pressure on the banks' liquidity). Second, borrowing by the private sector was estimated to be about £270 million, which was a third of what had been forecast. Offsetting this was an estimated £230 million of "bill leak" - which was a somewhat surprising development in view of the termination of the "corset" in the near future. Leaving out the "bill leak", M3 would be inside the target range; taking the "bill leak" into account, it would still be running slightly outside.

The Governor added that the eligible liability figures to be announced next Tuesday would be on the high side, but they would be accompanied by a note indicating that the figure for £M3 was going to be low. The banking figures for July were likely to be good, and for August disappointing.

Against this background, he had come to the conclusion that it should be possible to reduce MLR. There were of course risks - in particular, the prospect of continued overspending, the impact on confidence of the relatively large "bill leak", and the possible impact of an MLR reduction on the exchange rate. On the other hand, as regards the latter, there was no doubt that the present rate for sterling was too high for manufacturing; and the longer that sterling remained high, the greater would be the risk of a precipitous fall. On balance, these risks seemed worth taking - though this was on the basis that, if for any reason the reduction failed to work (.e.g if the funding programme came to a halt), it would be necessary to increase MLR once again.

The question now was when to reduce MLR, and by how much. On the first of these, his inclination was to announce a reduction this coming Thursday. In view of the Cabinet meeting on economic strategy, to do so the following week might make it appear as being in response to pressure from certain members of the Cabinet. As regards the amount of reduction, he had not yet made up his mind; his inclination was to go for a 1 or 2% reduction. If it was 1%, the market would probably be waiting for a further reduction; and this could be more helpful for gilts sales. If there were to be a reduction of 2%, that would be taken as the most that could be expected for some time.

The Governor concluded by saying that he would be considering this whole question further, and if he did decide to recommend finally in favour of moving this Thursday, he would like to see the Prime Minister again on Wednesday evening.

/ The Prime Minister

The Prime Minister said that she was prepared to approve an MLR reduction this week on the basis proposed if the Governor were finally to so recommend. As regards the extent of the reduction, her instinct was to go for 1 or 1½%. She thought this would be psychologically better than a full 2%. The Chancellor indicated that he was in agreement with the Governor. But on the question of the amount, he suggested that it was important to avoid too large an impact on the exchange rate in view of the effect a substantially lower rate would have on the RPI. He had in mind particularly the problem of the social security uprating which had to be announced in the next few weeks, and which could only be held to 16½% if the Government was still reasonably confident that the inflation forecast to November was not going to exceed this figure.

I am sending a copy of this letter to John Beverly (Governor's Office, Bank of England).

Yours ever,

Tim Lankester

John Wiggins, Esq.,
H.M. Treasury.

KRB

Original = CAR

cc: HMT
Econ Pol

10 DOWNING STREET

THE PRIME MINISTER

20 June 1980

Dear Mr Russey,

Thank you for your letter of 3 June about the difficulties the present high level of interest rates are causing for your company.

I know that high interest rates are an unwelcome burden for your own and many other companies. But we must bring down the rate of inflation; and this means gradually reducing money supply growth. Interest rates were increased last year to bring money supply under control. But we do not intend that interest rates should take the full burden of monetary control in the future; that is one reason why we have put so much emphasis on reducing public spending and borrowing.

I sympathise with the worries that you have for the immediate future, but to reduce interest rates prematurely would risk a continuing high rate of inflation which would be far more damaging in the long term to business as well as others in the community. There is no doubt that as our policies bring down the rate of inflation, interest rates will fall, and that is the best way to help business and enterprise. I can assure you that the current high level of nominal short-term rates will be kept only as long as it is necessary to ensure the trend of monetary growth can be maintained in line with the target.

/Finally,

Finally, I would like to say how interested and encouraged I was to read of your company's ambitious plans for the future. I want to wish you and your workforce the best of good fortune in achieving your goals.

Yours sincerely

Margaret Thatcher

G.J. Hussey, Esq.

SECRET

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

9th June 1980

T. Lankester, Esq.,
Private Secretary to the Prime Minister,
No.10, Downing Street

Dear Tim,

BANKING FIGURES

The banking figures for banking May are due to be published tomorrow, and they will show a substantial rise in banks' eligible liabilities (1.7 per cent). Although the Chancellor is away, I am writing to give you a Treasury assessment.

The indications are that the increase in sterling M3 was also high in banking May - about 2 per cent - and the Bank will release this figure to the markets. The details of the counterparts to the increase in the money supply, which will be published next Tuesday, are shown in the attached table. (The money supply figure itself tends to be fairly reliable at this stage, but the counterparts are less so.) Allowing for the May figure, the cumulative growth in sterling M3 since June last year is now 11½ per cent at an annual rate, and the corresponding figure for growth in the 3 months since the beginning of the current target period (February) is 12¼ per cent.

The central government borrowing requirement was substantial in banking May (nearly £1.5 billion) and in particular was considerably greater than the level of gilt sales. The high level of central government borrowing is in contrast to the exceptionally low borrowing of recent months, and indeed, as we expected, is somewhat higher than the normal level forecast for this financial year. The bank lending

/figure

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figure is mildly encouraging, although less so than appears at first sight. There is estimated to have been a substantial leakage of acceptances to the non-bank private sector (about £300 million) which means that recorded growth of bank lending will have understated the underlying increase. External factors, in contrast to recent months were expansionary.

It would be wrong to look at the May money supply figure in isolation, just as it was wrong to put too much weight on the very low figures in February, March and April. It is important to focus on a run of recent figures, and those for the last six months probably give a better indication of the underlying trend. Nevertheless the May figure confirms that it is right at present to be cautious on interest rates.

I am copying this letter to John Beverly (Bank of England).

Yours ever,

M.A. HALL

ANNEX

STERLING M3 AND ITS COUNTERPARTS

£ billion, seasonally adjusted

	Banking March	Banking April	Banking May
CGBR (minus=surplus)	+0.57	-0.58	+1.46
Less sales of central government debt to non-bank private sector	-0.25	-0.78	-0.51
(of which, gilts)	(-0.17)	(-0.80)	(-0.41)
Net other public sector	-0.14	+0.27	-0.26
Sterling bank lending to:			
Private sector	+0.43	+1.53	+0.38
Overseas	+0.10	+0.24	-0.20
DCE	+0.71	+0.68	+1.09
External and foreign currency finance	-0.23	-0.31	+0.29
Net non-deposit liabilities, etc	-0.23	-0.20	-0.17
Change in £M3	+0.25	+0.17	+1.22
(percentage)	(0.4)	(0.3)	(2.1)

CHANGE IN £M3 IN RECENT MONTHS

	% seasonally adjusted
Increase at annual rate mid-June to mid-May (11 months)	11.6
Increase at annual rate mid-February to mid-May (3 months)	12.2
Increase at annual rate mid-November to mid-May (6 months)	9.0

10 DOWNING STREET

THE PRIME MINISTER

9 June, 1980

Dear Mr. Newton.

Thank you for your letter of 9 May. As you rightly say, monetary policy is at the heart of the Government's economic policies, and I welcome the opportunity to explain why this is so.

A progressive reduction in the rate of growth of the money supply is essential if we are to achieve the permanent reduction in inflation which in turn is vital for our economic revival. This is clear from observation of the relationship between monetary growth and inflation over many years and not just over a short period. It is true that over long periods of time there have been trend changes in the ratio between current price national output and the money supply (i.e. the income velocity of circulation) due, for example, to changing institutional arrangements. But these changes in velocity have been small by comparison with the accompanying changes in the money supply or the level of prices. Over a period of years variations in monetary growth and inflation are seen to be closely related, and the reasons for the crucial role of monetary growth in determining inflation have been set out in the very substantial volume of academic literature on the subject.

You attached to your letter a graph showing for this country the relationship between inflation and the rate of growth of the money supply over the past five years. The period over which you have chosen to draw your graph not only follows close on one of the biggest shocks to hit Western industrialised economies since the War, namely the fourfold increase in the price of oil in late 1973, but also the monetary expansion of 1972-73.

/There

There are many factors which affect prices in the short run, including world prices, and these can temporarily obscure the longer run relationship. They do not invalidate it.

Although special factors can be important in the short run, I cannot accept your suggestion that we should concentrate on them at the expense of the fundamental longer term influences. This is the kind of thinking that has bedevilled British economic policy since the War and the Government is determined not to make the same mistake. Moreover, it is simply not possible in practice to control many of the factors which bear directly on inflation in the short run even if that were appropriate. It is obviously not within our power to control the price of oil and other world prices. Attempts to control wages directly by means of incomes policies have clearly failed to cure inflation, and they have undoubtedly had a damaging effect on incentives and the operation of the labour market. Policy towards nationalised industry prices and the rate at which VAT is levied must be governed primarily by longer term structural considerations, and clearly inflation in the long run cannot be controlled by direct action on particular, individual prices.

Finally, you suggest that different levels of the money supply in relation to national income in different countries are inconsistent with the Government's view of the key role of monetary policy. I cannot agree; for it is rates of monetary growth that are relevant for inflation, not levels of the money supply in relation to income. The definition of money, the institutions which provide it, and the demand to hold it differ widely between countries. We would not expect there to be any simple relationship across countries between these ratios and inflation rates. We should instead look at rates of growth of the money supply and rates of inflation in different countries. If we allow for time lags, trend changes in velocity, and differences in rates of economic growth, it can be seen that countries with

/low

low monetary growth generally have low inflation and those with high monetary growth generally have high inflation. This is quite consistent with the Government's views on monetary policy.

I hope that this letter will help you to understand more clearly the basis for the Government's policies.

Yours sincerely

Margaret Thatcher

Michael Meacher, Esq MP

CSO A01734

MR IBBS (CPRS)

cc Sir Robert Armstrong
   Mr Whitmore

REAL INTEREST RATES

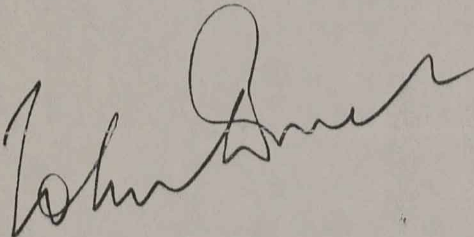
You may be interested in the attached table.

Differentials in real interest rates contribute to pressure on exchange rates. At present it seems impossible to set UK interest rates at levels low enough not to force up the exchange rate, yet high enough to act as a check to money and credit expansion.

There are many possible measures of real interest rates: the attached table shows the borrowers' Euro-currency 3 months rate less the lenders' current rate of inflation. This measure is shown for seven countries.

The table shows Italy and United Kingdom to be good places to lend money to - presumably one reason for the strength of sterling; and Germany to be the least attractive to lenders. It also shows (along the leading diagonal) that despite high nominal rates, real interest rates are negative in most countries: a situation which has developed quite rapidly over the past few months.

This has implications for the current pressure to reduce MLR in the United Kingdom.



A J BOREHAM

6 June 1980

REAL INTEREST RATES[1]

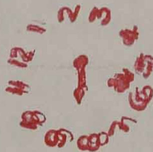
Lender / Borrower CPI / 3 mnths rate	ITALY	UNITED KINGDOM	FRANCE	JAPAN	HOLLAND	UNITED STATES	GERMANY
ITALY	- 9¾	- 4¾	2¾	10¼	9¼	1¼	9¾
UNITED KINGDOM	- 11¼	- 6¼	1¼	8¾	7¾	- ¼	8¼
FRANCE	- 16	- 10¾	- 3¼	4¼	3¼	- 4¾	3¾
JAPAN	- 16¼	- 11¼	- 3¾	3¾	2¾	- 5¼	3¼
HOLLAND	- 17½	- 12¼	- 4¾	2½	1½	- 6¼	2¼
UNITED STATES	- 18½	- 13½	- 6	1½	½	- 7½	1
GERMANY	- 19½	- 23½	- 7	½	- ½	- 8½	0

SOURCES

Prices:(CPI) Economist week 31 May to 6 June 1980 average of latest 3 months compared with previous 3 months. (To nearest ½ per cent.)

Euro currency interest rates (3 months): F.T. 31 May 1980 (To nearest ¼ per cent.)

[1]Figures in cells are borrowers' rate of interest less lenders' consumer price index.



B.C.

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

5th June, 1980

T. Lankester, Esq.,
Private Secretary,
10, Downing Street

Dear Tim,

MONETARY TARGETS, BANK LENDING AND INTEREST RATES

Events this week in the foreign exchange markets, and some of the newspaper comment on them, suggest that there may have been some misunderstanding of the Government's policies. In this connection the Chancellor thought the Prime Minister would like to see a note prepared by Peter Middleton here yesterday, which he fully endorses. I attach a copy.

I also attach some material on which the Prime Minister might draw in answering Questions this afternoon about monetary policy.

Yours

John

A.J. WIGGINS

The Government's policy objectives

The Government are pursuing a monetary target. They do not have specific objectives for interest rates or the exchange rates.

The commitment to reduce progressively the rate of monetary growth is central to the Government's economic strategy. We have already made substantial progress. The rate of monetary growth has slowed down considerably since the measures [the Chancellor] took in November and is now well below the rate we inherited. In part this has been because of the abnormally low public sector borrowing in the first quarter of 1980.

Interest rates

The Government want to see a reduction in interest rates as soon as confidence is established that the growth of the money supply is firmly in the target range. Provided money supply is under control, the path of any specific element in the expansion of domestic credit - and in particular that of bank lending - would not by itself be a reason for resisting a reduction in interest rates.

We cannot be precise about when it will be possible for interest rates to fall, but the current high level of nominal short term rates will be kept as long as is necessary to ensure the trend of monetary growth can be maintained in line with the target. The cuts we have announced in public spending and borrowing are designed to make it possible to achieve the monetary targets with lower rates.

Lower interest rates are an integral part of the Government's policy. When reductions are achieved, they will in no sense represent a change in the direction of that policy.

C

1. Financial Secretary (if you agree) cc Chancellor of the Exchequ
2. Mr Davies

Chief Secretary
Minister of State (L)
Minister of State (C)
Sir Douglas Wass
Mr Ryrie
Mr Hancock
Mr Britton
Mr Lavelle
Mr Riley
Mr Fforde B/Eng
Mr Ridley
Mr Burns

1. Last night's television and the line which appeared in this morning's Financial Times suggest that over the next few days we should make a major effort to get over - at least to the media - the following. Government policy is not based on either:

a. a particular objectives for the exchange rate

b. a particular objective for interest rates.

2. Policy is based on controlling the money supply without excessive interest rates. For this reason the Government has planned cuts in public expenditure and a lower PSBR. The lower EEC contribution will contribute to the lower PSBR when we begin to benefit from it next year.

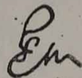
3. Over the past 6 months £M3 has been growing at a low rate. M1 has actually fallen and all the other aggregates are growing at low rates. So there is a presumption that lower interest rates are on the way. This would be absolutely consistent with the policy. But, because monetary growth in the last few months has been affected by exceptional factors - particularly the very low CGBR - ~~because~~ we want to be confident that the growth of the money supply is firmly in the target range.

4. We must get rid of the idea that lower interest rates would be a u turn - which could only be true if we had been following an interest rate policy. We must also avoid the impression that any change when it comes would be the result of pressure from the CBI and others who seem to be suggesting a relaxation of the policy. It would be the result of the authorities' confidence that the money supply was firmly under control.

5. It is very important not to engage in speculation about the

precise month when a change in interest rates might take place. We shall wish to give the next set of money supply figures the best possible presentation - starting next Tuesday when the clearing bank and eligible liabilities figures come out. This will need to be based on the sort of considerations in para 3. We will advise you further on this when we are clearer about the numbers. But we must first do all we can to get rid of the idea that an early reduction in interest rates is ruled out for reasons connected with either interest rate objectives unconnected with developments in the money supply or with maintainin the exchange rate at whatever its highest past level has been. And we certainly cannot have it thought that lower interest rates - one of the main objectives of government policy - would be a u turn.

6. The note which Mr Bridgeman sent to the Chancellor yesterday and which was used by him on television last night provides a framework round which you will be able to talk in order to bring out the above points.



P E MIDDLETON
4 June 1980

Published Papers

The following published paper(s) enclosed on this file have been removed and destroyed. Copies may be found elsewhere in The National Archives.

House of Commons Hansard	03/06/80
Columns 1241-1246	Prime Minister (Engagements)

Signed CAWayland Date 18 March 2010

PREM Records Team

Econ Pol

1

PRIME MINISTER

Interest Rates

You asked for a report on this morning's meeting in the Treasury on monetary policy.

The general conclusion of the meeting was that, as and when the market provides a lead, the opportunity should be taken to reduce MLR. But it would be inadvisable to try and lead the market by reducing MLR in advance. This, it is felt, would give the impression that the Government were not serious about the monetary target.

The Treasury think it most unlikely that market rates will move down appreciably before the May banking figures come out. The best that they expect is that market rates will come down after the May figures have been absorbed.

But the Treasury will not know precisely what the banking figures for May look like until this weekend. First impressions are that the figure of lending to the private sector is not as high as had been feared, though still too high; but that the sterling M3 figure will show a rise of 1½-2%. This is because of a very high CGBR figure of around £1½ billion only half of which has been mopped up by funding.

The banking figures come out next Tuesday; the money supply figures the Thursday of the following week.

The Chancellor is arranging to see the clearing bank chairmen shortly. He will, I am sure, raise the question of credit cards - though he doesn't believe much can be achieved.

On the wider question of quantitative controls, the Treasury are opposed on three grounds: first, it would go against the Government's market philosophy (and indeed it was strongly argued against in the Green Paper on monetary control). Second, they doubt

/ whether

whether it would work - borrowers would find ways of getting round the controls. Thirdly, to the extent that controls did work, interest rates would be even higher as borrowers bid up the price of funds.

Notwithstanding these points, I have asked for information on Carter's measures, which included direct controls on lending. These controls were actually taken off very quickly - may be because they were not working or, in view of the falling demand, for funds, because they were no longer necessary.

TL

2 June 1980

COMMERCIAL IN CONFIDENCE

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

30 May 1980

T Lankester Esq
No 10 Downing Street

Dear Tim,

JAPANESE ISSUE IN LONDON CAPITAL MARKET

I enclose for your own information a minute by Michael Bridgeman about the imminent issue of £25 million convertible bonds by a Japanese company on the London capital market. The Chancellor does not regard this as a particularly sensitive matter, and is content to leave it entirely to your discretion whether the Prime Minister is informed.

Yours ever,

M A HALL
Private Secretary

COMMERCIAL IN CONFIDENCE

FINANCIAL SECRETARY

cc Chancellor
Sir D Wass
Sir K Couzens
Mr Ryrie
Mr Barratt
Mr Middleton
Mr Lavelle
Mr Dixon
Mr Unwin
Mrs Lomax
Mr Riley

JAPANESE ISSUE IN THE LONDON CAPITAL MARKET

The Bank have asked me to warn you that they have been asked for timing consent to the issue on 16 June of £25 million convertible bonds by a Japanese company by means of a placing.

2. It was recognised at the time of abolishing exchange control that we would have neither a logical basis nor the powers to object to foreign issues on the London capital markets. They were no different in principle from the institutions buying equivalent securities in the secondary market which, of course, they are entirely free to do. Under the Control of Borrowing Order, foreign borrowers are on all fours with residents, ie subject only to timing consent. The Bank therefore consider that they have no option but to give the necessary consent.

3. However, there is clearly a political awkwardness about capital outflows in this particularly conspicuous form, which could attract criticism at a time when British industry is under severe financial pressure. However, the Bank do think that they can use their powers over timing to regulate the pace of foreign issues in general, and of Japanese convertibles in particular, limiting the latter to say one every other month at most.

J. M. B.

J M BRIDGEMAN
28 May 1980

cc Masters Set
Stats - RPI

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Econ Pol

NOTE FOR THE RECORD

The Chancellor of the Exchequer called on the Prime Minister at 0900 hours today. They covered the following points in discussion:

I Interest rates and credit

The Chancellor handed the Prime Minister the attached note. He said that it was too early to be thinking of a reduction in MLR: there would have to be clearer evidence that M3 was coming under control. He also rejected the notion of imposing direct controls. This would be counter to the Government's whole philosophy, and it would scarcely affect the wider monetary aggregates - and to the extent that it did, it would push interest rates up further. His main concern was the continued high level of lending to industry to finance excessive pay settlements. By contrast, lending to persons over the last 3 months comprised only 11% of the increase in the clearers' lending. The Prime Minister said that she was unhappy to hear that lending to persons was continuing to increase at all. Although it was only a relatively small proportion of the total increase in lending, it still made up a large amount in absolute terms. The Chancellor ought to consider ways of cutting back the use of credit cards - or at least, making sure that they showed the real rate of interest charged when advertising their use. On the latter point, the Chancellor replied that the Consumer Credit Act would in due course make the publication of the real rate of interest obligatory; he would let the Prime Minister have a note on this. He did not think there was a case for trying to control the use of credit cards directly.

II RPI prospects

The Chancellor said that the RPI prospects, even after July, were gloomy in view of the 20%+ earnings figures which were now emerging. It was absolutely crucial to

/ get

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get wage settlements coming down in both the public and private sectors. The Prime Minister said that the Chancellor ought to consider using some of the EEC Budget savings to moderate the increase in the RPI - for example, on gas prices. If the RPI continued to "go wrong", then wage settlements would not come down. The Chancellor said that he would need the EEC Budget savings to provide a margin against nationalised industry overspends, and to bring interest rates down. In any case, the amounts at stake could only have a very marginal effect on the RPI - the crucial element in the increases was the increase in wages.

III <u>EEC Budget and Mr. Heseltine</u>

The Prime Minister agreed with the Chancellor that EEC Budget savings should not be used to make good DOE's public expenditure cuts, as Mr. Heseltine was informally proposing.

TL.

<u>15 May 1980</u>

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PRIME MINISTER

Meeting with the Chancellor of the Exchequer
0900 hours : Thursday 15 May

I understand that the Chancellor will raise the following points:

I Interest rates and credit

Following your discussion with him at Tuesday's breakfast, the Chancellor has been thinking further about this and wishes to report back to you. My guess is that he will take the line that, firstly, interest rates must stay up awhile: for although the M3 figure for April is only +¼%, this conceals a massive increase in bank lending to the private sector (£1500 million) offset by negative Government borrowing and substantial gilts' sales. Secondly, that it is not worth introducing direct controls on credit. Direct controls would not have any effect on the wider definitions of credit creation (including acceptances), and to the extent that they did hold down M3, they would tend to push up interest rates still further. There may have been a political/~~domestic~~ cosmetic argument for introducing controls when there was a risk that we would have to put MLR up still higher; but when it is a question of sticking where we are, I doubt whether controls would be justified.

II RPI prospects

The Chancellor will reveal that the Treasury's latest assessment is that the RPI will go up after July in view of the worsening wage situation. In other words, the loss of last year's VAT increases is expected only to be temporary. If we are to believe this - and the latest earnings figures and the increase in oil prices make it plausible - it makes it all the more important that we focus on public sector pay in the coming weeks; and also

/ possibly

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possibly on considering how we are going to accelerate the slow-down in private sector settlements. In the latter context, you might ask the Chancellor whether he sees anything substantial coming from the TUC/CBI talks which the two sides agreed to set in motion at last week's NEDC meeting.

III Home defence

The Chancellor is worried that the Home Secretary's proposals, to be considered at OD, will increase the pressure for further public expenditure - though the "first steps" are only going to cost £5 million in 1983/84.

IV EEC Budget and Mr. Heseltine

The Chancellor will seek your support in rejecting a request from Mr. Heseltine that EEC Budget savings should be used to make good DOE's public expenditure cuts.

You were going to take up with the Chancellor the question of whether Sir Douglas Wass should attend the economic strategy meeting at Chequers on 16 July.

If there is any more time, you might ask the Chancellor whether he has advanced his thinking on the possibility of providing some further relief for the manufacturing industry - to offset the effect of the high exchange rate.

S. J. Pike
Duty Clerk
pp TPL

14 May 1980

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Copy for PM

DRAFT MINUTE FROM THE CHANCELLOR TO THE PRIME MINISTER

BANK LENDING AND INTEREST RATES

You expressed concern earlier this week about the continuing high rate of bank lending, particularly to the personal sector, and the high level of interest rates. You also asked about the possibility of introducing some form of direct control over bank lending.

2. The recent behaviour of bank lending to the private sector has certainly been worrying. In the four months to mid-April it grew at a seasonally adjusted monthly rate of about £1 billion, rather higher than in the preceding six months and well in excess of the target rate of growth of the money supply. It is largely because of this that we have had to maintain interest rates at their current high levels.

3. A sectoral breakdown of the recent increases in bank lending is shown in the attached table. Lending to banks through the main credit card organisations, Access and Barclaycard, is indistinguishably included in the category "bank lending to persons other than for house purchase". The table also shows lending to consumers by Finance Houses and other consumer credit grantors.

4. Interpretation of the figures is complicated by seasonal factors, but it appears that consumer credit lending is now growing substantially slower than bank lending as a whole.

In the last 3 months lending to persons other than for house purchase has comprised only 11% of the increase in clearers' lending; and represents just 16% of clearers' outstanding lending (about 11% for all banks). Lending by Finance Houses, a large part of which is financed indirectly by banks, has clearly decelerated.

5. It is lending to manufacturing industry that has been particularly buoyant in recent months. The monthly pattern has been complicated by the impact of the steel strike and other factors, but the figures clearly suggest that it is the company sector, whose liquidity is under pressure from cost increases, that has been the main contributor to the recent increases in bank lending.

6. I do not believe we can look to quantitative controls as a means of reducing the growth of bank lending while avoiding high interest rates. We have argued strongly against this in the Green Paper on monetary control, and certainly the introduction of some form of quantitative control on bank lending would sit very oddly with my announcement in the Budget of the abolition of the corset.

7. Furthermore, it is unrealistic to think that a substantial reduction in bank lending can be achieved by acting on personal and other non-corporate borrowers alone; they form too small a proportion of the total. The imposition of an effective quantitative control would therefore inevitably mean putting an artificial obstacle in the way of companies who need to

raise additional finance. They would be forced to look outside the banking system for finance and this would almost certainly be more costly to them. A considerable volume of business would probably move offshore into the euro-sterling market; this could well mean a permanent loss to British banks and a devaluation of our monetary statistics. Because of this and other forms of "disintermediation" the impact on the underlying availability of credit would be extremely limited, and we would merely in practice be distorting the working of the financial system. Market analysts would be aware of the distortions and take them into account in assessing monetary trends; in such circumstances simply meeting the target would not be enough.

8. Monetary growth has slowed down considerably since the measures I took in November, and in recent months has been at or below the bottom end of the target range. However, the recent improvement owes much to a temporary reduction in Central Government borrowing: in the four months to mid-April it was running at a seasonally adjusted monthly rate of only about £80 million, compared with about £950 million in the preceeding six months and an average of over £750 million which we expect for 1980-81. (This may have been partly responsible for the recent high bank lending figures.) As a more normal rate of Central Government borrowing re-emerges - it already has in banking May - there may well be some acceleration in monetary growth at current levels of interest rates. Certainly I do not believe that the recent slow down in monetary growth is sufficiently firmly based for us to be able to reduce MLR yet.

9. As you know, the Bank has had to take steps in the early months of this year to ease pressure on the liquidity of the banking system caused by the combination of continued rapid growth of bank lending, heavy gilt sales and low public sector borrowing. This was necessary to avoid substantial upward movements in short term market interest rates, and inevitably also in banks' base rates, which would not have been justified on monetary control grounds.

10. You also expressed concern about the extent to which the banks are helping small firms in financial difficulties. In fact, the clearing banks have a number of special schemes to provide small firms with loan and equity finance; and the number of these schemes has increased markedly over the last year or so. These schemes are in addition to the normal range of banking services which the clearing banks provide and which include not only overdrafts and term loans but also instalment credit, hire purchase, leasing, factoring and invoice discounting. Anecdotal evidence suggests that small firms are being squeezed by larger firms not paying promptly and that this is adding to their cash pressures; but so far there have been no reports of any noticeable increase in the rate of failures among small companies. The cash pressures on small firms mean that bank lending to this sector has almost certainly increased.

11. The Bank of England's current lending guidance asks banks to give priority, within the bounds of banking prudence, to the provision of finance for working capital and fixed investment

by manufacturing industry, for the expansion of exports and for the saving of imports. But for prudential reasons we must avoid any suggestion that the authorities are urging banks to act in any way inconsistently with their normal commercial criteria. It would be very difficult to reconcile putting pressure on the banks to increase their lending in this area with our continued exhortations, in public and in private, to restrict their overall lending. The need for restraint is particularly strong now in view of the acceleration in monetary growth which may occur in the next few months if bank lending does not turn down. The longer the downturn is put off the longer it will be before we can see a significant reduction in interest rates.

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SECTORAL DISTRIBUTION OF BANK LENDING

1. Clearers

	percentage increase at annual rate 3 months to mid April*	percentage increase 12 months to mid April	Percent of total outstanding
Total personal	7	28	23
(of which advances to persons, other than for house purchase)	(13)	(27)	(16)
Manufacturing	31	27	27
Other production	12	30	15
Financial	-5	3	7
Services	27	36	28
(of which leasing)	(6)	(38)	(1)
Total advances	18	28	100
Total, including acceptances	26	32	

2. All banks

	3 months to mid February*	12 months to mid February	
Total personal	13	28	17
(of which advances to persons, other than for house purchase)	(13)	(26)	(11)
Manufacturing	22	26	28
Other production	25	29	12
Financial	17	26	14
Services	39	24	29
Total advances	25	34	100
Total, including acceptances	24	26	

*3 months not seasonally adjusted

3. HP and Consumer Credit Grantors

	3 months to end March (annual rate)**	12 months to end March	
Finance House	15	21	79
Retailers	29	19	21
Total	18	21	100

**seasonally adjusted

SECRET

Prime Minister ②
S.J. Pike
Duty Clerk 6.5.

Econ Pol

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

6 May 1980

T P Lankester Esq
Private Secretary to the
Prime Minister

MS

Dear Tim,

BANKING FIGURES

The banking figures for the month to mid-April are due to be published tomorrow and they will show that there was a substantial rise (2.9%) in banks' eligible liabilities. But a large element of this rise was seasonal and preliminary indications are that the associated increase in sterling M3 was just ¼%. The Bank will release this figure to the markets when the banking figures are published.

This modest increase means that the cumulated growth of sterling M3 in the 10 months since June last year has come down to about 10% (at an annual rate), within the 7-11% range. Over the last six months, the rate of growth has been less than this, and just below the bottom end of the target range.

The direct public sector influence on money supply growth in banking April was strongly contractionary. The central government was in surplus and there were moderately large sales of gilts. However a worrying feature of the outturn is that there was a massive increase in bank lending to the private sector of £1½ billion. We had expected the figures to bounce back somewhat after the modest increase in banking March, but this record rise suggests yet again that the long awaited downturn has not started.

The continued buoyancy of bank lending is one of the factors that cause the Chancellor to be cautious about reducing MLR in the near future. We are currently revising our view of the prospects for monetary growth over the next few months, but there is a significant possibility that it will be higher than the figures of

/the last

SECRET

the last three months. We certainly do not expect the public sector to be in surplus as last month. The market seems to be expecting an early fall in interest rates and tomorrow's figures might encourage this expectation; the full details of the increase in bank lending will not be published until next week. The Chancellor will be careful in the meanwhile not to encourage unjustified optimism.

The Prime Minister may like to know that the Bank are planning to announce on Thursday a further rolling forward of the special measures taken to relieve the tight liquidity position in the money markets. Although three month interest rates have remained around 17-17½% in recent weeks, to unwind the special measures on the present schedule would cause severe shortages in the money markets in the middle of the month. The result would be upward pressure on short term interest rates and distortions to banks' balance sheets across make-up day. There will certainly be presentational difficulties in announcing further relief, although with careful briefing we should be able to avoid heavy criticism. We will be able to argue that there are signs that monetary growth is coming under control and that a further <u>rise</u> in short term interest rates was not necessary at this juncture. It is, however, becoming increasingly difficult to argue that the special measures are temporary; they are an inevitable consequence of relatively low monetary growth combined with high bank lending to the private sector. We are working on a longer term solution to this structural problem.

I am copying this letter to John Beverly (Bank of England).

Yours

John

J WIGGINS
Private Secretary

ANNEX

STERLING M3 AND ITS COUNTERPARTS

	Banking April, £ billion seasonally adjusted
CGBR (minus = surplus)	-0.58
Less sales of central government debt to non-bank private sector	-0.77
(of which, gilts)	(-0.80)
Net other public sector	+0.22
Sterling bank lending to:	
Private sector	+1.55
Overseas	+0.23
DCE	+0.65
External and foreign currency finance	-0.11
Net non-deposit liabilities, etc	-0.38
Change in £M3	+0.17

CHANGE IN £M3 IN RECENT MONTHS

	% seasonally adjusted
Monthly average banking July-October (4 months)	1.2
" " " November-February (4 months)	0.6
" " " March	0.4
" " " April	0.3

- 6 MAY 1980

PART 3 ends:-

SS Ind to PM.

~~Note for Record Chan Ex~~/PM 2-5-80

PART 4 begins:-

HMT to TPL 6-5-80