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NOTE OF A MEETING HELD IN THE CHANCELLOR OF THE EXCHEQUER'S ROOM, H.M. TREASURY ON FRIDAY, 6 FEBRUARY, 1981 AT 2.45 P.M.

Present:

Chancellor of the Exchequer
Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr. Burns
Sir Kenneth Couzens
Mr. Ryrie
Mr. Middleton
Mr. Britton
Mr. Monck
Mr. Unwin
Mr. Ridley

Governor of the Bank of England
Deputy Governor
Mr. J.S. Fforde
Mr. E.A.J. George
Mr. C.A.E. Goodhart

MONETARY POLICY AND THE BUDGET

Formulation of monetary policy

The Chancellor saw his main task as to re-establish the credibility of the Government's policy to bring down the rate of inflation. The Treasury and the Bank were already agreed on the fundamental importance of monetary policy for this objective; but the actual movements in the monetary statistics undoubtedly presented a problem. For his part, he doubted whether it would be sensible to set a monetary target subject to explicit exchange rate conditions, although he accepted that the exchange rate would be a consideration in decisions on monetary policy issues. He thought £M3 would have to remain a central feature; but there was a question about the extent to which a £M3 objective should appropriately be qualified or supplemented. The Chancellor thought it would be impracticable, imprudent and inconsistent with his 24 November statement to move immediately at one bound to Monetary Base Control (MBC), but in the long run MBC might offer a better approach than the one the authorities now followed.

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2. The Governor emphasised the importance of reducing the rate of inflation; this had been and would continue to be the Government's main aim. In practice faster progress on this had been made than had been expected despite the monetary and PSBR over-runs; the authorities had been operating with targets which had not themselves signalled a lower rate of inflation, and had not proved controllable. He was anxious not to call in question the achievement of lower inflation by setting monetary objectives which would not credible. £M3 had proved not to be a satisfactory indicator, but it could not be throw aside; the question then was how it should be treated. It would be risky at this point to try to replace £M3 with M1 or M_0; these had not been shown to be clearly superior indicators, although M1 appeared to be better related to money GDP. There was a particular problem about controlling M_0, even if it were established that it had particularly good properties as an indicator. The Governor wished to avoid putting too much weight on any one particular indicator; he would want in the operation of monetary policy to have regard to other things as well as the monetary aggregates. He thought "conditionality" a higher profile word and he would wish to use in talking about monetary targets; but at the same time he found it difficult to put a plausible number on £M3 without any qualifications. More generally he thought the Government should not be too defensive about their record in the monetary area; the fact was that inflation was coming down rapidly.

3. The Chancellor said that the stance of policy could not rest on the inflation rate alone; the exchange rate would not always move in a direction which tended to reduce inflation, and it was important to get people to accept the role of monetary policy in reducing inflation; because of this a reduction in the rate of monetary growth had to remain an objective of policy. Moreover if Ministers ceased to insist on the need for monetary control, the arguments he had used to persuade his colleagues of the need for less public expenditure and less borrowing would lose a large part of their force.

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Exchange rate "conditionality"

4. The Governor expressed the Bank's fear that a continuing high PSBR (they were more pessimistic than the Treasury about the prospects for 1981-82) would tend to keep interest rates higher than would otherwise be desirable; this in turn would put upward pressure on the exchange rate, and would lead to a repeat of this year's monetary over-run, which the Bank thought substantially attributable to the upward movement in the exchange rate. Although he would not wish to suggest any precise exchange rate conditions to be attached to a £M3 target, he would not want a rigid commitment to such a target regardless of economic developments. He noted that both the Swiss and the Germans had been ready to "suspend" monetary targets in the face of undesirable movements in the exchange rate; thus the Swiss had recently raised exchange rates despite falling M_0 to counter rising inflation and a falling exchange rate. The Governor said he was not contemplating a higher target range for £M3 than 6-10 per cent; it was noted that a range of 7-11 per cent (coupled with the acceptance of the recent large base drift) would add very little to the authorities' freedom of manoeuvre, but would risk losing much credibility.

Conditionality and credibility

5. In further discussion it was noted that the authorities had not sought to determine interest rates by reference to movements in £M3, despite what had been seen as a commitment to do this. Although the credibility of the Government's overall counter-inflationary stance had been very well maintained, last November's MLR reduction followed by the large £M3 increase during that month had had a damaging effect on sentiment in financial markets. It was suggested that credibility of policy might actually be strengthened if the Government made clear in advance the circumstances under which they would abstain from tightening monetary policy despite an over-run on £M3 or any other aggregate for which an objective had been specified.

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6. The alternative view was that prior announcement of an "alibi" would do little to strengthen the credibility of policy; the authorities had been able in practice to have regard to movements in the inflation rate and the exchange rate, despite the unsatisfactory monetary statistics, but the attachment of a variety of rather vague qualifications to a new target would deprive its achievement of much of its impact.

The determination of short term interest rates

7. The question was raised how, if interest rates were not to move by reference to changes in £M3, short-term interest rates were to be set. One approach might be to set a target for £M3 which could be presented as consistent with the Government's fiscal stance and with some fall in interest rates over the coming year, while making clear that interest rates during the year would be set mainly by reference to movements in the narrow monetary aggregates and the exchange rate. Such an approach would in effect acknowledge that changes in interest rates have no clear and preditable impact on £M3 within a year, and may even have a perverse impact on £M3. At the same time it would be sensible to be cautious in undertaking to set short-term interest rates by reference to movements in the narrow monetary aggregates, without regard to movements in the exchange rate or the real economy; it was noted that if the authorities had been steering in recent months by M1, short-term rates would be likely to be a good deal lower than they were now. For the future, we could well find the narrower aggregates accelerating so as to restore a more normal relationship with money GDP, but at the same time falling inflation, decelerating £M3 and an uncomfortably high exchange rate might seem to call for lower interest rates.

The £M3 target

8. The point was made that some of the difference in emphasis as between the Bank's and the Treasury's approach reflected differences in the analysis of the recent past. The Bank thought the appreciating exchange rate had actually added to monetary growth, essentially through its effect in exacerbating the financial

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imbalance between the personal and the company sectors; the Bank saw this situation continuing, and thus feared a continuing monetary over-run associated with an appreciating exchange rate. The Treasury accepted that the sectoral imbalance, and the very high personal sector surplus in particular, tended to add to the demand for money; but the reduction in the price level resulting from the appreciation of the exchange rate had an impact the other way, and the Treasury's stock adjustment model of financial flows suggested that some deceleration in £M3 should be in prospect. It was suggested that 6-10 per cent target range should be reaffirmed, but that its medium-term character should be emphasised, so as to reduce the degree of commitment to meeting the target within any particular period. Moreover, it was questionable whether rolling forward the target at 6 month intervals would be consistent with this more medium-term approach. It was suggested, however, that the Government should not become too rigidly committed tc fiscal policy adjustments as the only means of keeping £M3 on track, with interest rate movements directed towards the narrower aggregates; there could be circumstances in which the use of the instruments might appropriately be reversed.

9. The Chancellor said he had found the discussion very helpful in clarifying how the Treasury and the Bank interpreted the past and the present situation; there seemed to be little difference between what they would actually do in any given situation (the Governor had said they would not have wanted markedly different interest rates, even if policy had been formulated with explicit qualifications), but there were some differences of emphasis in the presentation of the future policy stance.

Monetary control

20. In the course of a brief discussion the Chancellor indicated that he would wish to present the changes foreshadowed in his 24 November statement as consistent with a subsequent move to MBC, although not necessarily requiring this. He would be content for the Bank to undertake their consultations on this basis;

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he noted that the proposals for ensuring the effective operation of the discount market would not exclude substantially greater variability of short-term interest rates. It would be important for the authorities over the next few months to learn as much as possible from the behaviour of M_0 and M2 (about which new information should shortly become available). The Chancellor emphasised the urgent need to make progress on the future arrangements for assuring the Bank's income following the abolition of the cash ratio; he would need to know before the Budget how the issue was to be taken forward. Sir Douglas Wass said that two ideas had been canvassed: a levy on the banking system, and some delay in the payment to the Treasury of the profits of the Issue Department. He doubted whether the Bank would be well advised to pursue the second possibility, despite the fact that it was not inconsistent with the arrangements currently prescribed by Treasury Minute; it would mean the Bank would in effect be financed from public funds, and its dependence on them would need to be reported to Parliament. This could well precipitate demands that the Bank should be financed directly from Votes, rather than by the artificial device of detaining funds owed to the Treasury. The Governor noted the Chancellor's concern, and undertook to discuss the issue further with Sir Douglas Wass.

JW

(A.J. WIGGINS)
10 February 1981

Distribution

Those present
Mrs. Lomax
Mr. Turnbull