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MONETARY AFFAIRS

The Governor of the Bank of England called on the Chancellor at 11, Downing Street on Wednesday, 4 March, 1981 at 9.30 a.m. The Deputy Governor and Sir Douglas Wass were also present.

2. The Governor noted the Budget decisions taken on direct and indirect taxation. He saw these as indications of the picture the Government wished to present in the Medium Term Financial Strategy, and as intended to provide a satisfactory basis for a reduction in interest rates. He wondered whether the MTFS did not place undue emphasis on the links between the PSBR and £M3; and he doubted whether, even with the very tight fiscal stance, any substantial further reduction in interest rates would be possible after an initial cut in the budget of 2 per cent. He thought it important that Ministers should avoid encouraging expectations of such further reductions. The Budget would give a sharp upward impetus to the rate of inflation, and to inflationary expectations; and any further fall in the exchange rate would compound this effect. Given that there would be no clear prospect of a further reduction in inflation beyond what had already been achieved, it seemed unlikely that yields on long gilts would fall. He recognised that the lower PSBR would make the Bank's task in the financial markets somewhat easier; but he remained very pessimistic about the outlook for the real economy, and the Budget decisions only confirmed him in his pessimism. UK export competitiveness had been drastically weakened (and it was even possible that the tough Budget might make this problem worse by leading to upward pressure on the exchange rate), while the tax increases would still further reduce the scope for revival of the domestic economy.

3. The Chancellor asked whether a significantly higher PSBR would have been sustainable. The forecast of the 1981-82 PSBR

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had deteriorated by some £3 billion since last November, and if taxes were not increased substantially there would be no prospect whatever of lower interest rates. As for the decision on income tax, the effect on output in 1981-82 would hardly be perceptible. The Governor questioned how far the PSBR benefit of higher taxes would be offset by the adverse impact on it through lower activity. He would himself have preferred to avoid the double indexation of the specific duties; in general he thought the severity of the Budget would occasion great surprise. The Deputy Governor pointed out that the benefit in terms of easier funding from the increases in indirect taxes was likely to be substantially offset by the increase in the demand for money occasioned by the higher price level, and the impact on financial markets of the deterioration in inflationary expectations.

4. As to the size of the reduction in MLR, the Governor thought more than 2 per cent would not be feasible; but at least 2 per cent would be needed to prevent the reception of the Budget from being unduly unfavourable. Sir Douglas Wass wondered whether it might not be safer to go for only 1 per cent, but the Governor thought some major change in circumstances would be required before such a decision would be appropriate. He noted that the February banking figures would be known with reasonable certainty on 6 March, and it was agreed that the size of the cut in MLR would need to be agreed with the Prime Minister that day.

Tax on bank deposits

5. The Governor repeated his concern about the Government's decision on the tax on bank profits. At the rate Ministers were contemplating, the yield would be very large in relation to profits; the National Westminster Bank, for example, would be paying around £100 million, or half their retained profits. The tax would reduce the PSBR, but - since it would in the first instance reduce banks' non-deposit liabilities - it would not reduce £M3. In the Governor's view this made it difficult for the Government to use the argument that the tax made it possible for them to help industry; and the banks would certainly argue

that it made it more difficult for them to help industry. There was a risk that the banks might become much more reluctant to co-operate with the Government in industrial rescue cases; they might be inclined to say that the Government should do the job themselves with the money they were taking from the banks.

JW

(A.J. WIGGINS)
5 March 1981

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