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NOTE OF A MEETING HELD AT NO.11, DOWNING STREET AT 4 P.M. ON WEDNESDAY 1 JULY 1981

GR 3/7

Present:

Chancellor of the Exchequer (in the chair)
Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr. Burns
Sir Kenneth Couzens
Mr. Ryrie
Mr. Middleton
Mr. Monck
Mr. Lavelle
Mr. Ridley

Governor of the Bank of England
Mr. J.S. Fforde) Bank of England
Mr. A.D. Loehnis)

MONETARY AND EXCHANGE MARKET POLICY

The Governor briefly reviewed recent developments in the foreign exchange markets. The dollar remained very strong, with the Federal Funds rate still in the 19½ to 20 per cent area. Moreover 3-month euro dollars were 9/16 per cent higher than on 30 June. Overall the sterling rate was 4 per cent down on the week against the dollar, and the effective exchange rate 2¾ per cent down. Total support for sterling amounted to about $400 million over the previous four weeks - in other words the Bank still had $100 million left of the initial support authorisation given at the beginning of June. It was difficult to identify any specific factors contributing to the present situation; there were signs of some re-assessment of the status of sterling, as well as of some doubts emerging about the progress of UK economic policies. It was also possible that we were seeing some adverse impact from the Civil Service dispute. The weakness in the foreign exchange markets was paralleled in the gilts market, where shorts were three-eighths of a point down, and longs three-quarters of a point, while equities had moved up somewhat. So far the movement this week had been less abrupt than the fall in sterling a month ago.

2. In discussion it was suggested that much of the weakness of sterling could be explained as simply the obverse to a very strong dollar; US overnight rates were now 8 per cent or more higher than sterling rates, and three-month rates were 5 per cent higher. Moreover the success the US Administration had so far had in implementing their economic policies and the high reputation they enjoyed in financial circles were important positive factors in favour of the dollar. Similarly the weakening in the oil price told in favour of the dollar, and against sterling.

3. The Governor said he did not see the present situation as calling for any fiscal response from the Government even if this were feasible. However, it would be important to avoid giving any flavour of a weakening of fiscal policy; and a settlement of the Civil Service dispute would undoubtedly help. It was noted that the announcement on 1 July of the measures to recoup the loss of revenue from the reduction in the derv duty could be a favourable factor; and it appeared that the underlying PSBR (i.e. abstracting from the effects of the Civil Service dispute) was tending below what had been expected at the time of the Budget. On the other hand, the Civil Service dispute now seemed likely to add £¾ billion to the 1981-82 PSBR, of which £½ billion was the "permanent" cost in terms of higher interest payments. Overall the PSBR now seemed likely to be £¼ billion higher than expected at the time of the Budget.

4. It was noted that the estimates of the underlying growth of sterling M3 suggested a relatively low rate of monetary expansion; 9 per cent over the last twelve months, 4 per cent over the last six months and 3 per cent over the last three months. But the fact that the dispute had continued so long, and that it would cast its shadow into next year even if settled

in the next four weeks meant that it could well be undesirable now to base policy exclusively on assessments of the underlying position.

5. The Governor said that, although measured growth of sterling M3 in banking June suggested an increase of only 0.1 per cent, there were now persistent easy conditions in the money markets, and there were signs that the "underlying" growth of bank lending would prove inconsistent with the monetary targets. There was particular anxiety about the trends in lending to the personal sector, but further analysis was needed of the three components - lending for consumption, lending to unincorporated businesses, and lending for house purchase. A report would be coming to Ministers shortly.

6. Discussion then turned to the appropriate domestic policy response to the situation in the foreign exchange markets. Recent and prospective monetary figures would not seem consistent with an administered increase in MLR; but some hardening of UK market rates would undoubtedly be helpful from the external standpoint. It was generally agreed that it would be better to achieve this objective through the new arrangements for the Bank's intervention in financial markets - the expected shortage on 3 July would provide an occasion for this, and it should be possible to edge both 7 day and 3 month rates up to around 13 per cent.

7. There was general recognition in further discussion that there were monetary policy as well as exchange rate arguments for this hardening in UK short-term rates; bank lending to the personal sector had not fallen as the forecast would have suggested, while the consequences of the Civl Service dispute were giving increasing cause for concern. Moreover intervention, although in no sense to be regarded as an instrument of monetary policy, would have the helpful side effect of tending to tighten the position in the money markets. It was agreed in the light

of the discussion that it would be sensible for the Bank of England to be in a position over the next few days to intervene on a moderate scale, so as to remove any impression that the Government were indifferent to the level of the exchange rate. At the same time, however, there should be no question of defending any particular rate, e.g. $1.90.

Conclusions

8. The following decisions were taken:-

(i) The Bank would use the new techniques for intervening in the money markets to put upward pressure on short-term interest rates in the context of the expected market shortage on 3 July; and

(ii) the Chancellor gave authority for the Bank to intervene to the tune of $500 million in support of the sterling exchange rate over the following week.

JW

A.J. WIGGINS
2 July 1981

Distribution:-
Those present