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NOTE ON THE SEMINAR HELD AT 1500 HOURS ON WEDNESDAY 18 JULY IN THE PRIME MINISTER'S ROOM AT THE HOUSE OF COMMONS

Present:

Prime Minister
Chancellor of the Exchequer
Chief Secretary
Financial Secretary
Governor of the Bank of England
Chief Cashier
Mr. Adam Ridley
Mr. David Wolfson
Sir John Hunt
Sir Douglas Wass
Sir Kenneth Berrill
Mr. Michael Bridgeman
Mr. Peter Middleton
Mr. Clive Whitmore
Mr. Tim Lankester

The seminar had before it three papers from the Treasury - one on "Monetary Objectives and Prospects", the second on "Funding the PSBR and the Gilts Market", and a third on the "Monetary Base".

Monetary Objectives and Prospects

1. Introducing the Treasury paper, the Chancellor said that the achievement of the monetary target was a crucial element in the Government's strategy. It would inevitably involve a monetary squeeze, and this in turn would mean high interest rates until bank lending to the private sector fell significantly from its present high level.

2. In discussion, it was pointed out that what evidence there was suggested that bank lending in July was continuing at a high level; so there could be no question of an early cut in MLR. By the autumn there would no doubt be growing criticism from industry if interest rates remained high. The Government would have to ride this out. Confidence would quickly disappear if the Government appeared to resile from the monetary target, and this would undermine the prospects of recovery in the medium term. Even though bank lending was relatively insensitive to changes in interest rates, this did not imply that the present level of interest rates was unnecessarily high. In present circumstances, the markets would not accept a fall in MLR, and bank lending would in due

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course respond in the desired direction. Bank lending might fall off somewhat as a result of the likely slowing down of economic activity, and this would help to bring interest rates down. But with GDP in nominal terms growing twice as fast as the monetary target, interest rates were almost bound to stay relatively high. Other important influences would be the level of wage increases over the coming round, and the Government's success - or otherwise - in sticking to cash limits.

3. It was further argued that the post-Budget forecast for the PSBR must not be exceeded. This required, amongst other things, that the assets disposals programme was successfully implemented. Assets disposals would not affect the PSFD, and there was likely to be some substitution of asset purchases for purchases of gilts. On the other hand, there was little doubt that, if the programme was not achieved, gilts sales would have to be larger; and this would push up interest rates.

4. The composition of the assets to be disposed of still had to be settled. If it were decided to make a major sale of BNOC assets in preference to BP shares, it might be difficult to achieve the full £1 billion by the end of the financial year. But provided the sale was tied up in principle by then, and provided there was a substantial advance payment, the markets might accept a few months slippage without confidence being undermined.

5. It was also suggested that large sales of New Town land and property ought to be possible. The £70 million offered by the Secretary of State for the Environment for 1979-80 was disappointingly small. It might not be possible to do more than this in 1979-80; but a bigger effort should be made for 1980-81. DOE should mount an exercise to locate properties which could be sold.

6. Summing up this part of the discussion, the Prime Minister said that the seminar generally endorsed the Treasury's paper. She would consider further how the work on disposal of New Town assets might be intensified.

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Funding the PSBR and the Gilts Market

7. The Prime Minister said that she had one principal concern about the Treasury paper - namely, the arguments advanced in favour of continuing to offer long dated stocks at current high nominal yields. If the Government were serious in its aim of bringing inflation and interest rates down, borrowing long was surely expensive. On the other hand, if inflation were to continue at a high rate, the Government was in effect defrauding the investor.

8. In discussion, the following points were made -

i. the basic approach of the authorities was to fund the PSBR as cost-effectively as possible. This involved offering a wide range of gilt-edged stock. The pension funds and the life offices, which now accounted for a major proportion of gilt sales, liked to keep a sizeable portion of their portfolios in longer stocks. Since the authorities had to obtain finance on such a large scale, they had to cater to the institutions' requirements.

ii. even on relatively optimistic assumptions about the rate of inflation, the real cost of borrowing long on present yields was still cheap by historical standards, and it was only slightly greater than the cost of medium-term borrowing.

iii. if the authorities refused to offer longer stock to the institutions, they would be more reluctant to buy gilts and this would tend to push up yields on short and medium term stocks.

iv. with more shorts, the volume of stock maturing each year would increase and this would add to the authorities' refinancing burden.

v. if inflation did continue at a high rate, investors in long gilts would indeed suffer; but in that case the Government was <u>not</u> paying out too much on its borrowing.

vi. the authorities should continue to look carefully at the relative cost of borrowing on different time-scales. Given the present slight real cost advantage of borrowing over 10 years and shorter compared with borrowing over 20 years, there might be a case for greater emphasis on the medium and shorter end.

9. Summing up this part of the discussion, the Prime Minister said that she was still not entirely convinced by the arguments put forward. However, she was prepared to leave it to the Bank's and Treasury's judgement as to how much reliance should continue to be placed on long-term borrowing. She accepted the proposal that a new long tap should be announced on Friday. She was strongly opposed to the issue of index linked stock.

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Monetary Base

10. The Governor said that the Bank had recently published a paper on monetary base control (MBC), which was intended to provoke comments and contribute to the on-going debate on this subject. The Bank were also working on a paper which would propose the abolition of the system of reserve asset control. The reserve asset requirement had not been successful as a control on the monetary supply. Its abolition was one change which the proponents of MBC wanted. The Bank proposed to get rid of the reserve asset requirement before consulting more widely on the monetary base proposals. The Bank intended to hold discussions with officials in Germany, Switzerland and The Netherlands later in the autumn on possible MBC systems; the BIS were planning a meeting on MBC in November; and after this, the Bank might hold a seminar on MBC with academics, bankers and market operators.

11. The Governor went on to say that he had an open mind about the merits of MBC. The present methods of controlling the money supply were imperfect. However, he was by no means certain that there would be any net gain from moving over to an MBC system. If it did turn out to be an attractive proposition, it would not make it any easier to avoid high interest rates. Nonetheless, the Bank were ready to examine various MBC options in detail.

12. In a short discussion, it was argued that, while MBC would not be painless in that there would be no way of avoiding high interest rates if monetary growth had to be brought down, it might still offer the prospect of better control. On the other hand, its introduction would involve a major structural change for the banking system. Before there could be any serious thought of its being introduced, all the possible weaknesses and implications of the system would have to be thoroughly considered. There was a strong case for getting on with this work, rather than wait until the late

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autumn. The Treasury and the Bank could jointly consider possible MBC schemes, and this work could proceed alongside the Bank's work on abolishing reserve asset requirements. In due course, a detailed paper might be published as a basis for consultation and discussion; but before doing so, it would be necessary to consider the possible market objections - since publication of such a paper might itself have an upsetting effect.

Summing up, the Prime Minister said that there appeared to be sufficient merit in MBC to justify a more detailed study than the Bank and Treasury had so far undertaken. They should now prepare a joint study, which would consider a variety of possible concrete schemes. After the study was completed, it would be for consideration whether it should be published and what form consultation on it should take.

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19 July 1979