

TREASURY

Part A

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Part A

Monetary Policy

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1985

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MONETARY CONTROL

I Introduction and Summary

Different indicators are once again giving conflicting signals about monetary conditions. The buoyancy of the real economy, the rise in RPI inflation and the rapid growth in bank lending and broad money point to a degree of monetary ease. But the strong exchange rate, record real interest rates, and the steady growth in M0 suggest that monetary conditions are suitably tight.

2. We judge that the rise of inflation is temporary. It reflects the weakness of the exchange rate earlier in the year, and the sharp rise in interest rates needed to correct it. Monetary policy has been tightened substantially this year: short term interest rates are still 3 per cent higher than they were in December and the exchange rate is over 10 per cent higher than it was in January. We expect inflation to fall sharply over the next year - possibly to 4 per cent by next summer. Looking further ahead, the aim of policy could be to keep it on a downward trend. This may leave little room for further falls in interest rates. But, like the Bank, we see no immediate need for them to rise.

3. Problems in interpreting the monetary indicators are neither new, nor unique to the UK. We have certainly lived with them since 1980. We, like the US, have a sophisticated financial system which has been subject to significant and, at times, abrupt changes as a result of deregulation and increasing competition. Measures of broad money and liquidity have been particularly affected. Since 1980, the growth of sterling M3 has persistently exceeded that of money GDP,

in sharp contrast with the middle and late 1970s. Narrow measures of money - including M1 - have also been distorted by the development of interest bearing current accounts. M0 - largely notes and coins - has not been immune. But the changes affecting it have occurred at a steadier pace and in the event it has proved a useful indicator over a number of years. Given the problems of the monetary aggregates, it is not surprising that the exchange rate has become a useful supplementary guide to policy.

4. The build up of liquidity obviously carries a risk. The risk is that some of it will be spent. We have little idea how much will be used in this way or when. Sterling M3 certainly does not provide a good guide. But some still argue that it is necessary to restrain its growth to ensure against the danger that the authorities will not act quickly enough if it is monetised. However, experience suggests that M0, asset prices (especially house prices) and the exchange rate provide the most reliable warning signs. It is only when these signs have been ignored - as in the early 1970s - that we have got into trouble.

5. The rapid growth of bank lending has been the driving force behind the expansion of liquidity in recent years. The attempt to offset this by selling more debt has driven us into over-funding. But over-funding drains cash from the bank system and the process of relieving cash shortages has led the Bank to buy commercial bills on an increasing scale. The bill mountain was thought to be temporary; but it now stands at £17 billion. If it continues to grow at the present rate, it could double over the MTF period. It opens up opportunities for arbitrage which may compound the problem of bank credit, and it has been a major reason why the 1981 money market arrangements have never operated as intended.

6. Over-funding in the bill mountain is bringing our system of monetary control into disrepute and with it our monetary policy. As the Bank paper makes clear, the Treasury have discussed this issue with them on many occasions. The Chancellor said in his Mansion House Speech in 1983 that we should not normally sell more debt than was needed to fund the PSBR. We must now take steps to implement this policy and reduce the bill mountain significantly.

7. Specifically we should:

(i) stop over-funding. Sell enough debt to fund the PSBR and stop there. This is normal international practice in countries which pursue sound financial policies, including Germany, the US and Switzerland;

(ii) ask the Bank to examine urgently other methods for reducing the scale of the bill mountain.

8. This may lead to a faster growth in sterling M3 at least for a time. So it will be all the more important to keep other indicators on track: that will maintaining high short-term real interest rates and a strong exchange rate. We do not suggest changing the sterling M3 target yet. But we shall need to reconsider the role of sterling M3 and the appropriate target range for it (if any) in the light of experience at Budget time, in the context of the MTFS.

way the Bank operates in the money market provides no assurance that liquid balances could not be converted into spending power (in the simplest case, encashed). This derives from the suggestion that the Bank is always prepared to buy any quantity of bills - to lend any amount to the market - at the going interest rate. There is a second, related, proposition that this certainty of always being able to borrow from the Bank may have increased banks' willingness to lend, and so have added to £M3 growth.

35. These suggestions are discussed further in Annex II. The short point is that it is simply not true that the Bank will buy any quantity of bills. They calculate the amount they need to buy each day to take out the expected market shortage, and to prevent an unwarranted contraction in the monetary base or rise in interest rates. If (as on occasion happens) they are offered more bills than required they limit their purchase to the calculated amount.

36. As to an automatic tripwire, this should in practice be provided by a combination of the exchange rate and M0; and as in the 1970s we would also most likely be alerted by a rise in asset prices. The exchange rate would quickly react to any conversion of £M3 balances into spending power. In practice M0 did rise before the inflationary surges in the early and late 1970s. Both these movements should be sufficient to bring the necessary rises in interest rates in their train.

VII Conclusion and Policy Options

37. The key question is thus about our attitude to the growth of broad money and of £M3 in particular. If we were only concerned at the risk that liquidity could be converted into spending power in the future, then we can probably rely on M0 and the exchange rate to give us warning signals in time to act to prevent it. If we believe, as we do, that the current rapid growth of £M3 carries little direct threat to future inflation, then we should logically be considering whether to raise or abandon the target for £M3 growth. To

do so would open the way to put an end to overfunding and the various problems associated with the seemingly inexorable rise in the Bank's bill mountain. There is also a subsidiary question about possible changes in the arrangements for the Bank's day to day money market operations.

38. To deal with the latter first, the Bank's operations are both more extensive and less flexible than envisaged in 1981. ~~But it was always mistaken to believe - if it ever was - that short term interest rates could be left to the market.~~ The authorities' influence on ^{interest rates} ~~them~~ can be discretionary, or work through seeking to change the monetary base: but either way interest rates are a key mechanism of monetary control. Nevertheless, it may be that the official hand on short term rates has become too rigid, and that techniques should be changed so as to permit greater day to day movement in short term rates.

39. On the central question, the future of the £M3 target, whatever our own conclusion there is of course also the market's reaction to consider. A change which undermined the credibility of policy would raise inflationary expectations and interest rates. In this respect the timing of any change would clearly be important: it would be best to wait until inflation was clearly back on a downward path.

40. The main options are:-

(i) No change. Despite our doubts, we could retain the present target for £M3. We could combine this, if desired, with changes in operating procedure of the kind discussed above and in Annex II. It has to be recognised that this would require continued overfunding and a continued rise in the level of the bill mountain. Despite that, no doubt there would be some overshooting of the £M3 target, leading us in turn to continue publicly questioning the significance of £M3 growth if we felt that in practice it was not endangering downward pressure on inflation.

?
 further effort
 or corporate
 bank etc.
 as in Base 15
 paper

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(ii) Drop the £M3 target. We could combine this explicitly with an end to overfunding. History suggests this is necessary if we are ever to secure a reversal in the growth of the bill mountain. It might be preferable to present this as a suspension of the target, rather than a final break: some of the growth following an end to overfunding might be temporary. Given doubts about the value of £M3 as an indicator, it would arguably be a useful clarification of policy. It would imply greater reliance on MO and the exchange rate, but we would want to make it clear that even without a target we would continue to take account of changes in the growth of broad money in interpreting monetary conditions, in much the same way as we already take account of movements in the exchange rate. This has many attractions, and in some ways is not as far as it looks from how we already operate policy, with persistent £M3 overshooting. But it would be seen as a major break: £M3 has featured as a target aggregate since 1976. An end to the growth of the bill mountain would settle market doubts that have arisen on that score. But the change could not carry credibility without a concerted campaign by the Treasury and Bank to explain the reasons for it, the merits of MO as an indicator, and the way that policy would be operated henceforth.

(iii) Raise the £M3 target range. This option is something of a halfway house between (i) and (ii). This might be combined with other changes: for example a widening of the band, or a decision to reset the target more frequently, as recognition of some uncertainty about where it should be. It would be unwise to renounce overfunding altogether. But it might be possible to announce that it would be gradually phased out, with the aim of first slowing and then stopping the growth of the bill mountain. Other countries have at times changed their targets to what were considered more realistic levels, as we did in 1982. As to credibility, there would be a risk of getting the worst of all worlds:

but it might run less risk than option (ii) of being seen as a loosening of policy.

(iv) Switch to an exchange rate regime. If none of these options seemed attractive we could consider again a more complete break with monetary targets. The practical option, which was reviewed in February, is full membership of the EMS. In effect this would be an admission that steering by the domestic indicators had become too difficult, and that we would do better to try to tie policy to that in a low inflation country like Germany. But where exchange rate pressures come from external shocks, like oil price moves or movements in the dollar, it is often preferable to take some of the strain on the exchange rate rather than allowing it all to be transmitted into the conduct of domestic policy. We concluded in February that membership could not in practice be contemplated at a time when pressures on sterling seemed likely, or with the present level of our currency reserves.

H M TREASURY
JUNE 1985

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Like the Bank we share your concern about ^{need further} policy. The ~~mountain~~ ^{of} ~~disrepute~~ ^{disrepute} ~~to~~ ^{of} ~~the~~ ^{of} ~~Bank~~ ^{of} ~~to~~ ^{of} ~~purchase~~ ^{of} ~~commercial~~ ^{of} ~~bills~~ ^{of} ~~was~~ ^{of} ~~thought~~ ^{of} ~~to~~ ^{of} ~~be~~ ^{of} ~~a~~ ^{of} ~~temporary~~ ^{of} ~~phenomenon~~ ^{of}

Yet we have it has grown into a major new public sector industry. The stock of bills is now £15b

and is well ~~grow~~ ^{grow} to £20 or 25bn if we do nothing. ~~Not just~~ ^{Not just} ~~a~~ ^{of} ~~mountain~~ ^{of} ~~indeed~~ ^{of} ~~but~~ ^{of} ~~a~~ ^{of} ~~real~~ ^{of} ~~vulcano~~ ^{of}.

It is ~~buying~~ ^{buying} ~~the~~ ^{the} ~~whole~~ ^{the} ~~system~~ ^{the} ~~of~~ ^{of} ~~guaranteeing~~ ^{of} ~~control~~ ^{of} ~~into~~ ^{of} ~~disrepute~~ ^{of} ~~and~~ ^{of} ~~with~~ ^{of} ~~it~~ ^{of} ~~our~~ ^{of} ~~monetary~~ ^{of} ~~policy~~ ^{of} ~~is~~ ^{of} ~~the~~ ^{of} ~~Bank~~ ^{of} ~~says~~ ^{of} ~~we~~ ^{of} ~~have~~ ^{of} ~~also~~ ^{of} ~~taken~~ ^{of} ~~issue~~ ^{of} ~~with~~ ^{of} ~~them~~ ^{of} ~~on~~ ^{of} ~~subject~~ ^{of} ~~this~~ ^{of} ~~on~~ ^{of} ~~many~~ ^{of} ~~occasions~~ ^{of} ~~we~~ ^{of} ~~must~~ ^{of} ~~now~~ ^{of} ~~take~~ ^{of} ~~steps~~ ^{of} ~~to~~ ^{of} ~~bring~~ ^{of} ~~it~~ ^{of} ~~to~~ ^{of} ~~an~~ ^{of} ~~end~~ ^{of}. There are three elements

in this

(a) stop overfunding. Sell enough debt to fund the ASB and stop this. This is normal international practice

in countries which pursue ~~so~~ sound financial policy, including

in this

(*) Germany, the US, and Switzerland.

(b) take what other steps we can to prevent local

authorities and others buying from the banks and introduce

a more satisfactory regime for financing export credits.

(c) ask the bank to examine urgently methods dealing

with any residual financing needs without resort

to commercial bills

It provides opportunities for damaging speculation. And it provides a cheap way of increasing bank credit.

Overhead + the high mountains are brought on by being monetary
and will disrepute and write it on monetary policy.

As the Bank paper makes clear, the Treasury have discussed
this issue with them ~~and~~ on many occasions. The Chancellor
said in his Mansion House speech in 1983 that we should not
normally sell more debt than was needed to fund the PSBR.

~~We must now~~ We must now take steps to implement this
policy and reduce the bill mountan significantly.
There are

Specifically we should:



This may lead to a faster growth in M3 - at least for a time.
So it will be all the more important to keep on indicators in check: That
in money supply & L which, and to be a the place where
we should not suggest changing the LM3 target at present.
Which is high short term interest rates, and a strong exchange rate.

It can be reconsidered at Budget time in the context of TFS context.
We don't do it or suggest changing the LM3 target yet. But
~~But there may be some further overshoot of LM3 as a result~~
which would be a further reason for keeping interest rates
high for some time in order to
ar of level ~~reducing~~ ^{highly} ~~expensive~~ ^{expensive} ~~artificially~~ ^{artificially} ~~control~~ ^{control} of M3, to
at Budget time
and a further reduction in inflation.

The build up of liquidity steadily comes a risk.

The risk is that some of it will be spent. ~~Expenditure~~
~~shows~~ that we have little idea how much will be
used in this way or when. $\{M_3$ certainly does not
provide a good guide. But some still agree that it is
also necessary to restrain its growth as an insurance
against the ~~risk~~ ^{danger} that the authorities will not act
quickly enough if it is needed. However experience
suggests that M_0 , asset prices (especially house prices) and
the exchange rate ^{provide} are of the most reliable ^{warning} signals. It
is only when these signs have been ignored ^{- as they were in the 1970s -} that we have
got into trouble.

But the attempt to control liquidity has driven
us into overtrading. ^{In the short term} This has ^{secured} been a
bit of a disaster. $\{M_3$ has risen since then and
is, but overtrading does not help the
banking system; and ~~overtrading~~ ~~has~~ ~~been~~ ~~the~~ ~~cause~~ ~~of~~ ~~the~~ ~~problem~~
has been ~~the~~ ~~cause~~ ~~of~~ ~~the~~ ~~problem~~ ~~of~~ ~~the~~ ~~overtrading~~ ~~and~~ ~~the~~ ~~loss~~ ~~of~~ ~~control~~
scale ~~to~~ ~~be~~ ~~the~~ ~~same~~ ~~as~~ ~~before~~. The balance of
payments ~~is~~ ~~temporary~~; but ~~is~~ ~~not~~ ~~the~~ ~~same~~
~~as~~ ~~before~~, ~~looks~~ ~~abroad~~;
~~with~~ ~~the~~ ~~growth~~ ~~at~~ ~~the~~ ~~present~~ ~~rate~~ ~~it~~ ~~could~~ ~~double~~
over the MTF period. And it has been a major reason
why the ERM was ~~not~~ ~~as~~ ~~intended~~.

~~occurs~~
The building of liquidity ~~is necessary for a credit~~

with

The ~~cheap~~ role of the bank has also ^{system} ~~frank~~ a ~~rapid~~
rise in bank ~~leverage~~ ^{which} ~~the~~ ^{means} ~~attempts~~ ~~to~~ ~~do~~

~~banking~~ ~~is~~ ~~not~~ ~~to~~ ~~be~~ ~~seen~~ ~~as~~ ~~the~~ ~~last~~ ~~step~~

~~The~~ ~~same~~ ~~great~~

~~thing~~ ~~has~~ ~~been~~ ~~done~~ ~~in~~ ~~the~~ ~~past~~

~~but~~ ~~the~~ ~~real~~ ~~is~~ ~~the~~ ~~force~~

~~Bank~~ ~~leverage~~

A ~~same~~ ~~great~~ ~~thing~~ ~~has~~ ~~been~~ ~~done~~ ~~in~~ ~~the~~ ~~past~~

~~The~~ ~~same~~ ~~thing~~ ~~has~~ ~~been~~ ~~done~~ ~~in~~ ~~the~~ ~~past~~

force behind the ~~expansion~~ of banking. And ~~the~~ ~~attempts~~

often ~~fail~~ ~~by~~ ~~the~~ ~~fact~~ ~~that~~ ~~the~~ ~~same~~ ~~thing~~ ~~has~~ ~~been~~ ~~done~~ ~~in~~ ~~the~~ ~~past~~

~~done~~ ~~in~~ ~~the~~ ~~past~~

II What are the short term prospects for inflation?

4. The recent inflation increase - as measured by the RPI - from around 5 per cent to 7 per cent largely reflects two factors, both of which we expect to be temporary.

X 5. The first is the exchange rate fall in the second half of last year which increased import prices and gave companies the opportunity to widen their profit margins. It also meant higher oil prices expressed in terms of sterling; petrol prices are currently 11 per cent higher than a year ago.

6. The second factor has been the effect on mortgage rates of the higher level of interest rates. The timing and extent of the interest rate increase was associated with the exchange rate weakness but a higher level of interest rates was appropriate for domestic reasons as money demand was rising faster than expected; in particular world trade and exports were stronger than anticipated.

X 7. Both of these influences on prices should unwind in coming months. The increase in mortgage rates last July will fall out of the year on year comparison in August; and the 2 point rise early this year will disappear next Spring. Even if mortgage rates do not fall from today's levels this would have the effect of reducing inflation by 1½ per cent next summer compared with today's rate.

X 8. In addition the exchange rate has now recovered last year's fall and import price growth is already moderating. Firms will find it more difficult to raise prices and already oil prices in sterling terms are some 10 per cent lower than in January. If the normal relationship of petrol prices to oil prices holds they could be down by nearly as much by next summer.

9. On the basis of the present level of the exchange rate and world oil prices our present expectation is that inflation

would be below 5 per cent by next summer. This is not contradicted by present information on house price increases. Recently there has been some very modest signs of quickening but average increases are below 10 per cent on a year earlier, and rising at around the same rate as over the last two years. There is nothing to suggest that we face the difficult conditions of the early or late seventies when rapid house price increases anticipated an upturn in the general inflation rate (see Annex III, Chart 2).

III Are conditions tight enough to keep inflation declining in the longer term?

10. Abstracting from these temporary influences we estimate that the underlying rate of inflation has shown only a small increase in recent months. Unit labour costs in manufacturing industry have been rising by less than 5 per cent a year after making allowance for the effect of the Budget which reduced the average rates of National Insurance Contributions. Although this is faster than competitor countries it does not point to higher inflation arising from labour costs. And the lower inflation rate in the autumn should reduce the pressure for larger wage increases, though the settlement rate in the next pay round could well be a little higher than the 5½-6 per cent of the last year or so.

X 11. In general terms it can be argued that the underlying inflation rate has been on a plateau of around 5 per cent over the past two years; for part of the time the recorded rate was helped by special factors, particularly the mortgage rate; and for part of the time the recorded rate has been damaged by those same factors. Although the actual inflation rate may fall below 5 per cent in 1986-87 the underlying inflation rate is only likely to decline slowly. Maintaining the monetary policy implied by this year's MTF5 may not leave much room for interest rate reductions but we do not, at present, see any need for a further increase.

12. It is right to be cautious about the speed with which we bring down inflation. A policy stance designed to produce a sharp fall would put pressure on companies and would have adverse effects on output and unemployment. The implication is that we should stick to our strategy and not over-react to the high levels of inflation we are experiencing this summer; levels whose origins lie in monetary conditions that have already been corrected and the influence of the mortgage rate on the RPI.

IV Choice of monetary targets and indicators

13. In a sophisticated and fast changing financial system like ours, it is not easy to decide what monetary indicators to look at and how to interpret them. The difficulties are most obvious when, as at present, the different indicators are giving conflicting signals.

X 14. Taking narrow money first, in principle the obvious indicator to choose would be a measure of cash and balances held for transactions purposes - perhaps the aggregate of notes, coin and current accounts. But the figures here have been greatly distorted in recent years by the growth and heavy marketing by banks of interest bearing sight deposits. This has lead to funds previously held at longer term, so as to attract interest, being switched into sight deposits; and it also seems to have resulted in a growth of interest bearing sight deposits at the expense of non-interest bearing sight deposits.

Growth of transactions money, 12 months to May 1985 (%)

MO	Non-interest bearing M1	Interest bearing M1	Total M1
5.5	4.1	43.8	15.8

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15. It was this distortion to the current account figures that lead us to choose a narrower measure still, M0 (the total of notes, coin and bankers' balances at the Bank of England) as our preferred measure of narrow money. This measure has also been affected by structural and technical change, such as the growing use of credit cards and cash dispensers. But these changes seem to have been taking place at a steady pace, giving a fairly steady velocity trend for M0 over a long period which we have been able to take into account in setting targets for it.

16. Despite these features, many still doubt that an aggregate that consists largely of notes and coin can be an adequate indicator of monetary conditions in a sophisticated financial system. It may be that the Treasury and Bank could have done more to explain with more conviction the merits of M0 as an indicator: it is certainly clear that without some more concerted effort of that kind the market is unlikely to switch its focus from £M3 to M0.

17. Turning to the **wider measures of money**, an £M3 overshoot is scarcely a new phenomenon. As the following table shows, £M3 has exceeded its target over most of the period since 1979, only coming within it for the 2 years (1982-84) after a deliberate decision to raise the ranges originally announced for those years. Despite this we have brought inflation down.

£M3 performance against target : % growth at annual rate

	Target range	Outturn	Growth of money GDP (financial years)
Jun 1979 - Oct 1980	7-11	16.2	19.8
Feb 1980 - Apr 1981	7-11	19.4	13.8
Feb 1981 - Apr 1982	6-10	12.8	10.1
Feb 1982 - Apr 1983	8-12	11.2	9.4
Feb 1983 - Apr 1984	7-11	9.8	7.9
Feb 1984 - Apr 1985	6-10	11.9	7.0

On the one hand this gives a more certain relationship between bank reserves/narrow measures of money and broader measures, ~~with which they are also concerned.~~ On the other hand, because the reserve requirements in effect constitute a tax on bank intermediation, the system tends to lead to credit being channelled in other ways than through domestic bank lending. In other words, it causes disintermediation: including disintermediation through the uncontrolled offshore markets.

22. We have deliberately set our face against mandatory reserve requirements for banks in the UK that would drive sterling business offshore. Such disintermediation would, we have argued, distort the money figures to little real purpose. But we should, perhaps, not be surprised if against this background the result of the liberalisation since the abolition of exchange controls and the corset in 1979/80 has been a greater degree of intermediation via banks - and a faster growth of bank lending and a faster growth of the broader aggregates in relation to narrow money and the monetary base - than in countries like the US and Germany.

23. Finally, the exchange rate has come to play a larger part in our assessment of monetary conditions. Although on occasion movements in the exchange rate can reflect events that have little direct relevance to domestic monetary conditions, more normally there is an effect on inflationary pressures. In practice, we have found the exchange rate a useful supplementary guide to policy: often a more useful guide than £M3.

V Control of £M3 and bank lending: overfunding v. short term interest rates

24. Annex II contains an account of the techniques we have used to seek to control monetary growth, and some of the operational problems we have had. If we want to rein back £M3 growth, in the short term there is a choice between using funding policy and raising short term interest rates.

25. Using **funding**, that is selling extra gilts, will in effect raise long term interest rates. Some investors - probably mainly the institutions - will as a result move out of bank deposits and buy gilts instead. But with a given PSBR the effect of this transaction is to contract the monetary base, and it can create money market shortages which, if not relieved, would lead to a sharp rise in short term interest rates as well. Unless such a rise is thought warranted by monetary conditions, the Bank will relieve these shortages by adding ^{to} its holding of commercial bills (the bill mountain). This combination of "overfunding" and money market assistance does not reduce the total of credit extended: what it does is, in effect, to neutralise some of the impact of the rise in private sector borrowing from the banks by financing part of it with less liquid forms of savings - invested in gilts and recycled via the Bank's purchase of commercial bills. We know from experience that overfunding does have a reasonably reliable and early impact on £M3, at least in the short run.

26. Changing **short term interest rates**, on the other hand, will have at best a delayed effect on £M3 and bank lending. Despite the political importance of the mortgage rate, we have on occasion - as at present - been through periods of very high short term interest rates. But on each occasion there has been little discernible effect on £M3. There is an impact on non interest-bearing forms of money including M0. But on £M3 the short run effect could, even, be perverse.

27. But if short term interest rates are uncertain and slow acting in their effect on £M3 and bank lending, they can be expected to have a more substantial effect on the real economy - with a rise adding to the financial pressures on large and small companies, both directly and through the exchange rate. Overfunding, on the other hand, probably has much less effect on the real economy - partly because long term interest rates have less effect than short rates. It does, at least in the short term, reduce total liquidity in the economy. But equally it can be argued that the effect on £M3 is mainly cosmetic - like the corset, affecting the

X target aggregate, but not inflationary pressures. Another possibility is that, although there is a short run effect, in the longer term overfunding does not even reduce £M3. That would be the case, for example, if the extra sales of gilts and higher long rates were crowding potential private sector borrowers out of the long term capital market, and forcing them to borrow from the banks instead.

28. With the persistent tendency of £M3 to overshoot the targets set for it since 1979, we have regularly been faced with the choice of whether to seek to rein it back by raising short term interest rates, or by overfunding. Each time we have reviewed the choice in abstract, as we did in the summer of 1982 and last year, we have concluded that it was preferable to control £M3 without overfunding; and on each occasion in practice we have subsequently concluded that reliance on interest rates alone did not offer a sure enough prospect of reducing £M3 growth, and that gilts sales should therefore be increased. The result has been the steady acquisition by the Bank since 1979 of a massive stock of short term paper - in effect short term loans to the banking system. The total has now reached around £17bn, rising from a negligible figure in 1979.

29. The sheer scale of this bill mountain is now creating a range of technical, presentational and other problems. These are discussed more fully in Annex II, but briefly:-

(i) It looks absurd. This in itself does not help the credibility of policy. The Bank of England's holding of commercial bills is now equivalent to about 15% of £M3, and the proportion has been steadily rising by 3-4% a year.

(ii) Because the stock of bills matures and has to be turned over every 4-6 weeks, it creates regular huge daily shortages in the money markets that the Bank has to relieve by purchasing new bills. The Bank is thus

intervening more regularly and at longer maturities than originally envisaged under the operational arrangements instituted in 1981 giving the authorities a higher profile in the setting of short term market rates. This is not necessarily a drawback. It was a fallacy to envisage, if it was in 1981, that interest rates could in some way "be left to the market". To achieve monetary control the authorities have to be able to act on interest rates. The only question is whether to achieve that influence on rates by following an automatic quantitative rule for dealing in the money market (as with monetary base control), or through a more discretionary policy.

(iii) The scale of daily shortages makes it easier for the authorities to influence rates. But large scale dealing in the bill market can make it hard to avoid opening up opportunities for "round-tripping" arbitrage transactions between bills and bank deposits. Failure here artificially inflates the £M3 numbers and confuses the interpretation of monetary conditions.

IV Is the growth of broad liquidity a problem?

30. We thus come back to the question of whether we should be seeking to restrain rapid growth of £M3, and whether growth of £M3 and other measures of broad liquidity should be of concern. If it is, then - as in the past - we are likely to have to contemplate further overfunding, and a further rise in the bill mountain, as the only reliable means of doing so. If we believe the rapid growth of £M3 is of less concern, or that its effects can be offset by tightening monetary conditions in other respects - eg. by raising short term interest rates - then we have the prospect of breaking out of the cycle of ever increasing additions to the bill mountain and beginning to reduce the problems that it has brought in its train.

31. Some argue that a rise in broad liquidity, as measured by £M3, constitutes an actual problem: that it will inevitably lead to faster inflation. Others that it is only a potential problem: a liquidity overhang that could in some circumstances be converted into spending power and hence lead to inflation. Support for both propositions is seen in the history of the early 1970's when, it is argued, it was the growth of £M3 that gave the best warning of coming inflation.

32. Table 1 and Charts 1 and 2 in Annex III show the growth of M0, £M3 and some other indicators against the path of inflation since 1970. They show that both £M3 and M0 gave warning of the inflation of the early 1970s. Conditions in 1972-74 were ^{in any case} very different from today's. The exchange rate was weak, fiscal policy was lax, interest rates had for a long time been kept artificially low and an incomes policy was breaking down. Moreover, the international environment was highly inflationary, reflected most dramatically in the oil price rise in late 1973. The conditions today, both domestic and international, are totally different. There is certainly no sign - see Annex III Chart 2 - of asset prices taking off in the way they did in 1972-74 sometime before inflation took off. Had we been operating then as we do today, then the movement in M0, the exchange rate and asset prices would have led us to take action even without a target for £M3.

33. Nevertheless concern on this front - on either thesis - might point to the need to act now to restrain the growth of broad liquidity. On the liquidity overhang theory, this would represent a necessary insurance against not being able to react fast enough if and when the time came. By historical standards the present liquidity overhang is not particularly high. But this is the case for continuing to seek to restrain the growth of £M3, and not changing the target set for it.

34. The alternative approach is to make sure we have adequate defences to ^{prevent} ensure that broad liquidity ^{being} is ~~not~~ converted into spending power. In this respect it is argued that the

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way the Bank operates in the money market provides no assurance that liquid balances could not be converted into spending power (in the simplest case, encashed). This derives from the suggestion that the Bank is always prepared to buy any quantity of bills - to lend any amount to the market - at the going interest rate. There is a second, related, proposition that this certainty of always being able to borrow from the Bank may have increased banks' willingness to lend, and so have added to £M3 growth.

35. These suggestions are discussed further in Annex II. The short point is that it is simply not true that the Bank will buy any quantity of bills. They calculate the amount they need to buy each day to take out the expected market shortage, and to prevent an unwarranted contraction in the monetary base or rise in interest rates. If (as on occasion happens) they are offered more bills than required they limit their purchase to the calculated amount.

36. As to an automatic tripwire, this should in practice be provided by a combination of the exchange rate and MO; and as in the 1970s we would also most likely be alerted by a rise in asset prices. The exchange rate would quickly react to any conversion of £M3 balances into spending power. In practice MO did rise before the inflationary surges in the early and late 1970s. Both these movements should be sufficient to bring the necessary rises in interest rates in their train.

VII Conclusion and Policy Options

37. The key question is thus about our attitude to the growth of broad money and of £M3 in particular. If we ^{are} ~~were~~ only concerned at the risk that liquidity could be converted into spending power in the future, then we can probably rely on MO and the exchange rate to give us warning signals in time to act to prevent it. If we believe, as we do, that the current rapid growth of £M3 carries little direct threat to future inflation, then we should logically be considering whether to raise or abandon the target for £M3 growth. To

do so would open the way to put an end to overfunding and the various problems associated with the seemingly inexorable rise in the Bank's bill mountain. There is also a subsidiary question about possible changes in the arrangements for the Bank's day to day money market operations.

38. To deal with the latter first, the Bank's operations are both more extensive and less flexible than envisaged in 1981. But it was always mistaken to believe - if it ever was - that short term interest rates could be left to the market. The authorities' influence on them can be discretionary, or work through seeking to change the monetary base: but either way interest rates are a key mechanism of monetary control. Nevertheless, it may be that the official hand on short term rates has become too rigid, and that techniques should be changed so as to permit greater day to day movement in short term rates.

39. On the central question, the future of the £M3 target, whatever our own conclusion there is of course also the market's reaction to consider. A change which undermined the credibility of policy would raise inflationary expectations and interest rates. In this respect the timing of any change would clearly be important: it would be best to wait until inflation was clearly back on a downward path.

40. The main options are:-

(i) No change. Despite our doubts, we could retain the present target for £M3. We could combine this, if desired, with changes in operating procedure of the kind discussed above and in Annex II. It has to be recognised that this would require continued overfunding and a continued rise in the level of the bill mountain. Despite that, no doubt there would be some overshooting of the £M3 target, leading us in turn to continue publicly questioning the significance of £M3 growth if we felt that in practice it was not endangering downward pressure on inflation. 0

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(ii) Drop the £M3 target. We could combine this explicitly with an end to overfunding. History suggests this is necessary if we are ever to secure a reversal in the growth of the bill mountain. It might be preferable to present this as a suspension of the target, rather than a final break: some of the growth following an end to overfunding might be temporary. Given doubts about the value of £M3 as an indicator, it would arguably be a useful clarification of policy. It would imply greater reliance on MO and the exchange rate. *But* we would want to make it clear that even without a target we would continue to take account of changes in the growth of broad money in interpreting monetary conditions. *This* *would be* in much the same way as we already take account of movements in the exchange rate. This has many attractions, and in some ways is not as far as it looks from how we already operate policy, with persistent £M3 overshooting. But it would be seen as a major break: £M3 has featured as a target aggregate since 1976. An end to the growth of the bill mountain would settle market doubts that have arisen on that score. But the change could not carry credibility without a concerted campaign by the Treasury and Bank to explain the reasons for it, the merits of MO as an indicator, and the way that policy would be operated henceforth.

(iii) Raise the £M3 target range. This option is something of a halfway house between (i) and (ii). This might be combined with other changes: for example a widening of the band, or a decision to reset the target more frequently, as recognition of some uncertainty about where it should be. It would be unwise to renounce overfunding altogether. But it might be possible to announce that it would be gradually phased out, with the aim *of* first slowing and then stopping the growth of the bill mountain. Other countries have at times changed their targets to what were considered more realistic levels, as we did in 1982. As to credibility, there would be a *risk of* getting the worst of all worlds:

X 18. The explanation lies in developments over the period that have affected the nature of £M3 and the private sector's demand for liquid assets. Bank deposits have become a more attractive way of holding savings, and this combined with other structural changes has diminished the significance of £M3 and other broader aggregates as monetary indicators. Much of the increase is in institutional funds held on deposit at banks as part of investment portfolios. The result is that the velocity of £M3, which rose sharply between 1974 and 1980, has since 1980 been steadily declining (see Annex III (Chart 5)).

19. One traditional attraction of the £M3 aggregate is the familiar statistical link with the PSBR. But it is clear that in recent years growth of £M3 has not been caused by excessive growth of the PSBR. Our performance here in relation to other countries has been good (see Annex III table 2).

X X 20. It has been the buoyant demand for private sector credit - leading to a very rapid increase in bank lending - that has been the driving force behind £M3 growth. But like the rise in bank deposits that has financed it, this growth of bank lending does not seem in itself to have added to inflationary pressures. In the last three years bank lending has grown at an average rate of 18 per cent, while money GDP has been growing at around 8 per cent.

21. It is important here to recognise both the similarities and differences between monetary control in the UK and in other countries. Annex 1 describes the operation of monetary policy in the US, Germany and Switzerland. In all three countries the authorities place emphasis on the control of a narrow aggregate (in Switzerland, M0; in the US, M1; and in Germany, Central Bank Money - CBM). In the US and Germany there is also a concern with broader aggregates. But in those countries policy operates through a system of mandatory ratios between banks' reserves - that is their cash and deposits at the central bank - and their other liabilities.

but it might run less risk than option (ii) of being seen as a loosening of policy.

(iv) Switch to an exchange rate regime. If none of these options seemed attractive we could consider again a more complete break with monetary targets. The practical option, which was reviewed in February, is full membership of the EMS. In effect this would be an admission that steering by the domestic indicators had become too difficult, and that we would do better to try to tie policy to that in a low inflation country like Germany. But where exchange rate pressures come from external shocks, like oil price moves or movements in the dollar, it is often preferable to take some of the strain on the exchange rate rather than allowing it all to be transmitted into the conduct of domestic policy. We concluded in February that membership could not in practice be contemplated at a time when pressures on sterling seemed likely, or with the present level of our currency reserves.

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will be ^{around 4} ~~below 5~~ per cent a year from now. This is not contradicted by present information on house price increases. Recently there has been some very modest and patchy signs of quickening but average increases remain ^{less than} below 10 per cent on a year earlier, ~~at~~ ^{up} around the same rate of increase as over the last two years. There is nothing to suggest that we face the difficult conditions of the early or late seventies when rapid house price increases anticipated an upturn in the general inflation rate (see Chart 2).

15. Abstracting from these temporary influences we estimate that the underlying rate of inflation has shown only a small increase in recent months. The underlying inflation rate has been on a plateau of around 5 per cent over the past two years and more; for part of the time the recorded rate was helped by special factors, particularly the mortgage rate; and for part of the time the recorded rate has been damaged by those same factors. Although the recorded inflation rate is likely to fall ^{sharply over the next year} below 5 per cent in 1986-87 the underlying inflation rate will probably only decline slowly. Maintaining the monetary policy implied by this year's MTFs may not leave much room for interest rate reductions but we do not, at present, see any need for a further increase. A significantly tighter monetary stance designed to secure a faster fall in inflation would, in the short term, have adverse effects on output and thus employment.

II Choice of monetary targets and indicators

16. Taking **narrow money** first, in principle the obvious indicator to choose would be a measure of cash and balances held for transactions purposes - perhaps the aggregate of notes, coin and current accounts. But the figures here have been greatly distorted in recent years by the growth and heavy marketing by banks of interest bearing sight deposits. This has led to funds previously held at longer term, ~~so as to attract interest~~, being switched into sight deposits; and it also seems to have resulted, not surprisingly, in a growth of interest bearing sight deposits at the expense of non-interest bearing sight deposits.

~~Annex Table 2~~

~~ANNEX III~~

TABLES AND CHARTS

Table 1: Monetary aggregates, exchange rate inflation, money GDP and PSBR/GDP ratio, since 1969-70

8 ~~Table 2: Fiscal deficits in 7 major countries, 1979-1985~~

Chart 1: Monetary growth and inflation since 1970

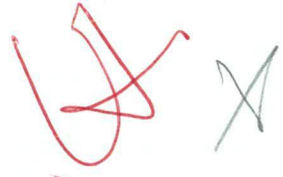
Chart 2: Assets prices (house and land prices) since 1970

Chart 3: M0 and money GDP since 1965

Chart 4: £M3 and money GDP since 1965

Chart 5: Velocity of £M3

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MONETARY POLICYI Summary and Conclusion

modest
Different indicators are once again giving conflicting signals about monetary conditions. The buoyancy of the real economy, the rise in RPI inflation and the rapid growth in bank lending and broad money point to a degree of monetary ease. But the strong exchange rate, high real interest rates, and the ~~steady~~ growth in M0 suggest that monetary conditions are suitably tight.

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3. Problems in interpreting the monetary indicators are neither new, nor unique to the UK. We have certainly lived with them since 1980. We, like the US, have a sophisticated financial system which has been subject to significant and, at times, abrupt changes as a result of deregulation and increasing competition. Measures of broad money and liquidity have been particularly affected. Since 1980, the growth

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of sterling M3 has persistently exceeded that of money GDP, in sharp contrast ~~with~~ the middle and late 1970s. Narrow measures of money - including M1 - have also been distorted by the development of interest bearing current accounts. M0 - largely notes and coins - has not been immune. But the changes affecting it have occurred at a steadier pace and, in the event, it has proved a useful indicator over a number of years. Given the problems of the monetary aggregates, it is not surprising that the exchange rate has become a useful supplementary guide to policy.

4. The build up of liquidity obviously carries a risk. The risk is that some of it will be spent. We have little idea how much will be used in this way or when. Sterling M3 certainly does not provide a good guide. But some still argue that it is necessary to restrain its growth to ensure against the danger that the authorities will not act quickly enough if it is monetised. However, experience suggests that M0, asset prices (especially house prices) and the exchange rate provide the most reliable warning signs. It is only when these signs have been ignored - as in the early 1970s - that we have got into trouble.

5. The rapid growth of bank lending has been the driving force behind the expansion of liquidity in recent years. The attempt to offset this by selling more debt has driven us into over-funding. But over-funding drains cash from the banking system and the process of relieving cash shortages has led the Bank to buy commercial bills on an increasing scale. The bill mountain was thought to be temporary; but it now stands at £17 billion. If it continues to grow at the present rate, it could double over the MTF5 period. It opens up opportunities for arbitrage which may compound the problem of bank credit, and it has been a major reason why the 1981 money market arrangements have never operated as intended.

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6. Over-funding and the bill mountain are ^{in danger of} bringing our system of monetary control into disrepute and with it our monetary policy. As the Bank paper makes clear, the Treasury have discussed this issue with them on many occasions. The Chancellor said in his Mansion House Speech in 1983 that we should not normally sell more debt than was needed to fund the PSBR. We must now take steps to implement this policy and reduce the bill mountain significantly.

7. Specifically we should:

(i) stop over-funding. Sell enough debt to fund the PSBR and stop there. This is normal international practice in countries which pursue sound financial policies, including Germany, the US and Switzerland;

(ii) ask the Bank to examine urgently other methods for reducing the scale of the bill mountain.

8. This may lead to a faster growth in sterling M3, at least for a time. So it will be all the more important to keep other indicators on track: that will mean maintaining high short-term real interest rates and a strong exchange rate. We do not suggest changing the sterling M3 target yet. But, in the light of experience, we shall need to reconsider the role of sterling M3 and the appropriate target range for it (if any), at Budget time, in the context of the MTFS.



MONETARY CONTROL

I Introduction and Summary

Different indicators are once again giving conflicting signals about monetary conditions. The buoyancy of the real economy, the rise in RPI inflation and the rapid growth in bank lending and broad money point to a degree of monetary ease. But the strong exchange rate, record real interest rates, and the steady growth in M0 suggest that monetary conditions are suitably tight.

2. We judge that the rise of inflation is temporary. It reflects the weakness of the exchange rate earlier in the year, and the sharp rise in interest rates needed to correct it. Monetary policy has been tightened substantially this year: short term interest rates are still 3 per cent higher than they were in December and the exchange rate is over 10 per cent higher than it was in January. We expect inflation to fall sharply over the next year - possibly to 4 per cent by next summer. Looking further ahead, the aim of policy could be to keep it on a downward trend. This may leave little room for further falls in interest rates. But, like the Bank, we see no immediate need for them to rise.

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in sharp contrast with the middle and late 1970s. Narrow measures of money - including M1 - have also been distorted by the development of interest bearing current accounts. M0 - largely notes and coins - has not been immune. But the changes affecting it have occurred at a steadier pace and in the event it has proved a useful indicator over a number of years. Given the problems of the monetary aggregates, it is not surprising that the exchange rate has become a useful supplementary guide to policy.

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6. Over-funding in the bill mountain is bringing our system of monetary control into disrepute and with it our monetary policy. As the Bank paper makes clear, the Treasury have discussed this issue with them on many occasions. The Chancellor said in his Mansion House Speech in 1983 that we should not normally sell more debt than was needed to fund the PSBR. We must now take steps to implement this policy and reduce the bill mountain significantly.

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TABLE 2

CENTRAL GOVERNMENT
FISCAL DEFICIT AS PERCENT OF GDP

	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
Canada	1.8	2.7	1.6	5.0	6.2	5.8	5.0
US	(0.6)	1.2	0.9	3.8	4.1	3.4	4.4
Japan	4.8	4.2	3.6	3.4	3.3	2.4	1.7
France	0.7	(0.3)	1.8	2.6	3.3	3.3	3.3
Germany	2.8	3.1	3.9	3.4	2.7	2.3	1.7
Italy	9.5	8.0	11.9	12.7	11.8	13.5	12.2
UK	3.3	3.7	3.1	2.4	3.5	3.4	2.8

IMF figures () = Surplus

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MONETARY CONTROL ^{Policy}



4 Introduction and Summary and Conclusions

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We do not suggest changing the sterling M3 target yet. But, ^{in the light of experience,} we shall need to reconsider the role of sterling M3 and the appropriate target range for it (if any), ~~in the light of experience~~ at Budget time, in the context of the MTFs.

Inflation:
~~Q1~~ What are the Short term prospects for inflation?

- 9 4. The recent inflation increase - as measured by the RPI - from around 5 per cent to 7 per cent largely reflects two factors, both of which we expect to be temporary.
- 10 5. The first is the exchange rate fall in the second half of last year which increased import prices and gave companies the opportunity to widen their profit margins. It also meant higher oil prices expressed in terms of sterling; petrol prices are currently 11 per cent higher than a year ago.
- 11 6. The second factor has been the effect on mortgage rates of the higher level of interest rates. The timing and extent of the interest rate increase was associated with the exchange rate weakness but a higher level of interest rates was appropriate for domestic reasons as money demand was rising faster than expected; in particular world trade and exports were stronger than has been foreseen.
- 12 7. Both of these influences on prices should unwind in coming months. The increase in mortgage rates last July will fall out of the year on year comparison in August; and the 2 point rise early this year will disappear next Spring. Even if mortgage rates do not fall at all from today's levels this would have the effect of reducing inflation by $1\frac{1}{2}$ per cent next summer compared with today's rate.
- 13 8. In addition the exchange rate has now recovered ~~the~~ ~~whole of~~ last year's fall and import price growth is already moderating. Firms will find it less easy to raise prices and already oil prices in sterling terms are some 10 per cent lower than in January. If the normal relationship of petrol prices to oil prices holds they could be down by nearly as much by next summer.
- 14 9. On the basis of the present level of the exchange rate and world oil prices our present expectation is that inflation will be ~~below 5~~ per cent a year from now. This is not around 4

contradicted by present information on house price increases. Recently there has ^{ye} been some very modest and patchy signs of quickening but average increases remain below 10 per cent on a year earlier, at around the same rate of increase as over the last two years. There is nothing to suggest that we face the difficult conditions of the early or late seventies when rapid house price increases anticipated an upturn in the general inflation rate (see ~~Annex A~~, Chart 2).

15 10. Abstracting from these temporary influences we estimate that the underlying rate of inflation has shown only a small increase in recent months. The underlying inflation rate has been on a plateau of around 5 per cent over the past two years and more; for part of the time the recorded rate was helped by special factors, particularly the mortgage rate; and for part of the time the recorded rate has been damaged by those same factors. Although the recorded inflation rate is likely to fall below ^{fairly sharply over the next year} ~~5 per cent in 1986-87~~ the underlying inflation rate will probably only decline slowly. Maintaining the monetary policy implied by this year's MTFS may not leave much room for interest rate reductions but we do not, at present, see any need for a further increase. A significantly tighter monetary stance designed to secure a faster fall in inflation would, in the short term, have adverse effects on output and thus employment.

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16 11. Taking **narrow money** first, in principle the obvious indicator to choose would be a measure of cash and balances held for transactions purposes - perhaps the aggregate of notes, coin and current accounts. But the figures here have been greatly distorted in recent years by the growth and heavy marketing by banks of interest bearing sight deposits. This has lead to funds previously held at longer term, so as to attract interest, being switched into sight deposits; and it also seems to have resulted, not surprisingly, in a growth of interest bearing sight deposits at the expense of non-interest bearing sight deposits.

Growth of transactions money, 12 months to May 1985 (%)

MO	Non-interest bearing M1	Interest bearing M1	Total M1
5.5	4.1	43.8	15.8

17 ~~12.~~ It was this distortion to the current account figures that led us to choose a narrower measure still, MO (the total of notes, coin and bankers' balances at the Bank of England) as our preferred measure of narrow money. This measure has also been affected by structural and technical change, such as the growing use of credit cards and cash dispensers. But these changes seem to have been taking place at a predictable pace, giving a fairly steady velocity trend for MO over a long period which we have been able to take into account in setting targets for it.

18 ~~13.~~ Despite these features, many still doubt that an aggregate that consists largely of notes and coin can be an adequate indicator of monetary conditions in a sophisticated financial system. It may be that the Treasury and Bank could have done more to explain with more conviction the merits of MO as an indicator: it is certainly clear that without some more concerted effort of that kind the market is unlikely to switch its focus from £M3 to MO.

19 ~~14.~~ Turning to the **wider measures of money**, a £M3 overshoot is scarcely a new phenomenon. As the following table shows, £M3 has exceeded its target over most of the period since 1979, only coming within it for the 2 years (1982-84) after a deliberate decision to raise the ranges originally announced for those years. Despite this we have brought inflation down.

£M3 performance against target: % growth at annual rate

£M3 performance against target : % growth at annual rate

	Target range	Outturn	Growth of money GDP (financial years)
Jun 1979 - Oct 1980	7-11	16.2	19.8
Feb 1980 - Apr 1981	7-11	19.4	13.8
Feb 1981 - Apr 1982	6-10	12.8	10.1
Feb 1982 - Apr 1983	8-12	11.2	9.4
Feb 1983 - Apr 1984	7-11	9.8	7.9
Feb 1984 - Apr 1985	6-10	11.9	7.0

2015. The explanation lies in developments over the period that have affected the nature of £M3 and the private sector's demand for liquid assets. As real short-term interest rates have turned from negative to positive, bank deposits have become a more attractive way of holding savings, and this combined with other structural changes has diminished the significance of £M3 and other broader aggregates as monetary indicators. Much of the increase is in institutional funds held on deposit at banks as part of investment portfolios. The result is that the velocity of £M3, which rose sharply between 1974 and 1980, has since 1980 been steadily declining (see ~~Annex 214~~ Chart 5).

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The driving force behind £M3 growth has been the buoyant demand for private sector credit, leading to a rapid increase in bank lending. But like the rise in bank deposits that has financed it, this growth of bank lending does not seem in itself to have added to inflationary pressures. In the last three years bank lending has grown at an average rate of 18 per cent, while money GDP has been growing at around 8 per cent.

outline

22 The rapid growth of bank lending is not entirely surprising. We have deliberately encouraged the UK banking system to operate on shore - unlike the United States and Germany. Since 1979, we have abolished compulsory cash ratios, exchange controls, and the supplementary special deposit scheme (the corset). These developments have left our banking system remarkably free of artificial constraints - a situation that has strengthened London's position as a major financial centre.

23 Bank lending has been less of a problem in other countries. But they differ from us ~~too~~ in putting the main emphasis on narrower measures of money - M0 in Switzerland, M1 in the ~~U~~ited States and central bank money in Germany. With less concern about the growth of liquidity, the role of funding is also different in other countries: the normal rule is to sell enough debt to fund the PSBR but no more. ~~24~~ Finally, the exchange rate has come to play a larger part in our assessment of monetary conditions. Although on occasion movements in the exchange rate can reflect events that have little direct relevance to domestic monetary conditions, more normally there is an effect on inflationary pressures and expectations. In practice, we have found the exchange rate a useful supplementary guide to policy: often a more useful guide than £M3 .

III *Monetary Control:*
Control of £M3 and bank lending: overfunding ^{and} short term interest rates

25. ~~In order to control £M3 , There are essentially two different approaches.~~ ^{to controlling £M3 .} We can either ~~start~~ ^{seek} to control bank lending directly via short term interest rates, or ~~monitor~~ ^{neutralise} the effect on liquidity by over-funding.

26. The effect of over-funding - that is, selling more debt than is ~~intended~~ ^{needed} to finance the PSBR - is to raise long term interest rates. Some investors - probably mainly the institutions - will as a result move out of bank deposits and buy gilts instead. But with a given PSBR the effect

of this transaction is to contract the monetary base, and ~~it can~~ create money market shortages which, if not relieved, would lead to a sharp rise in short term interest rates. ~~as well.~~ Unless such a rise is thought warranted by monetary conditions, the Bank will relieve these shortages by adding to its holding of commercial bills (the bill mountain).

822 Overfunding has a reasonably reliable impact on £M3, at least in the short run.

27 26. Changing short term interest rates, on the other hand, has at best a delayed effect on £M3 and bank lending. Indeed, the short run effect can even be perverse.

28 27. But if short term interest rates are uncertain and slow acting in their effect on £M3 and bank lending, they can be expected to have a more substantial effect on the real economy - with a rise adding to the financial pressures on large and small companies, both directly and through the exchange rate. Overfunding, on the other hand, probably has much less effect on the real economy - partly because long term interest rates have less effect than short rates. It is also arguable that although there is a short run effect, overfunding does not greatly reduce £M3 in the longer term. That would be the case, for example, if the extra sales of gilts and higher long rates were crowding potential corporate borrowers out of the long term capital market, and forcing them to borrow from the banks instead.

29 28. With the persistent tendency of £M3 to overshoot the targets set for it since 1979, we have regularly been faced with the choice of whether to seek to rein it back by raising short term interest rates, or by overfunding. Each time we have reviewed the choice (~~in abstract,~~ as we did in the summer of 1982 and ^{again} last year, we have concluded that it was preferable to (~~control £M3 without~~ ^{avoid} overfunding; and on each occasion in practice we have subsequently concluded that reliance on ^{short term} interest rates alone did not offer a sure enough prospect of reducing £M3 growth, and that gilts sales should

therefore be increased. The result has been the steady acquisition by the Bank since 1979 of a massive stock of short term ^{commercial} paper - in effect short term loans to the banking system. The total has now reached around £17bn, rising from a negligible figure in 1979.

30 29. The sheer scale of this bill mountain is now creating a range of technical, presentational and other problems. Not only does it look absurd, but because the stock of bills matures and has to be turned over every 4-6 weeks, it creates regular huge daily shortages in the money markets that the Bank has to relieve by purchasing new bills. The Bank is thus intervening more regularly and at longer maturities than originally envisaged under the operational arrangements instituted in 1981, giving the authorities a higher profile in the setting of short term market rates. The scale of daily shortages makes it easier for the authorities to influence rates. But large scale dealing in the bill market can make it hard to avoid opening up opportunities for "round-tripping" arbitrage transactions between bills and bank deposits. Failure here artificially inflates the £M3 numbers and confuses the interpretation of monetary conditions.

IV ~~30~~ Is the growth of broad liquidity a problem?

31 30. We thus come back to the question of whether we should be seeking to restrain the growth of £M3, and if so what rate of growth is appropriate. The more we are concerned about the growth of sterling M3, the more we are likely to have to contemplate further overfunding, and a further rise in the bill mountain, as the only reliable means of controlling it. If we believe the rapid growth of £M3 is of less concern, or that its effects can be offset by tightening monetary conditions in other ^{ways} respects - eg. by persisting with a policy of high real short term interest rates and a strong exchange rate - then we have the prospect of breaking out of the cycle of ever increasing additions to the bill mountain and beginning to reduce the problems

that it has brought in its train.

32. Table 1 and Charts 1 and 2 ~~in Annex III~~ show the growth of M0, £M3 and some other indicators against the path of inflation since 1970. They show that both £M3 and M0 gave warning of the inflation of the early 1970s. Conditions in 1972-74 were very different from today's. The exchange rate was weak, fiscal policy was lax, interest rates had for a long time been kept artificially low and an incomes policy was breaking down. Moreover, the international environment was highly inflationary, reflected most dramatically in the oil price rise in late 1973. ~~the~~ Conditions today, both domestic and international, are totally different. There is certainly no sign ~~of~~ ~~see Annex III Chart 2~~ of asset prices taking off in the way they did in 1972-74 sometime before inflation took off. ^(see chart 2) Had we been operating then as we do today, then the movement in M0, the exchange rate and asset prices would have led us to take action even without a target for £M3.

①

SECRET

DRAFT LETTER

From : Mrs Lomax

To : A Turnbull Esq
10 Downing Street

MONETARY POLICY

As you know, it has been decided that the Treasury and Bank will submit separate papers for next Tuesday's discussion. I attach the Treasury paper. The Bank will be letting you have theirs separately.

I am copying this letter and the paper to John Bartlett (Governor of the Bank of England's office). You kindly undertook to arrange for the paper to be sent to Sir Alan Walters over the weekend, and I enclose an extra copy for the purpose.

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The Treasury paper deals primarily with ^{current} monetary conditions and the policy framework, and the ~~related~~ related problems of M3 and networking. The Technical ^{raised by Sir A Walters} ~~issues about the operating money market operations~~ and the workings of the 1981 arrangements as ~~discussed~~ discussed ~~are~~ in some detail in the Bank's paper the separate paper by the Bank, which you already have

SECRET

MONETARY CONTROL

I Introduction and Summary

There has been recent criticism and misunderstanding about the operation of monetary policy, and we are facing difficulties, both in the interpretation of conditions and the methods of control. The current divergence between broad money and other indicators has drawn attention to other longer standing problems about the operation of policy. These relate to the choice of targets and indicators, and, at a more technical level, the techniques of control, particularly the way the Bank operates in the money markets and the process of "overfunding" with the resulting growth of the bill mountain. It is right to take stock.

2. The most immediate question is whether monetary conditions are suitably tight to bring us back to a declining path for inflation. The various indicators do not all point in the same direction. Real short-term interest rates are at a historically high level; the monetary base (M0) is growing at a satisfactory rate, well within its target range; the £ is firm, and has risen against all currencies since earlier in the year. On the other hand bank lending and the wider measures of money and liquidity are growing very fast, with M3 well above the top of its range. Our assessment (paragraphs 4-12 below) is that the recent rise in inflation reflects conditions that had become too loose last year and the short run impact of the higher interest rates needed to correct them. We believe that current conditions are tight enough to bring inflation back to a downward trend. There may not be much room for interest rate reductions but neither do we see any need for an increase.

3. The rest of the paper deals with longer standing problems, many of which have been reviewed on several occasions in the past. The fundamental issue, which underlies the others, is the choice of monetary targets and indicators.

(i) Interpreting monetary conditions in a sophisticated financial system like ours is not easy. M0 has had a steady velocity trend and proved a useful indicator in recent years. The exchange rate has also proved a useful supplementary guide to policy. But M3 has persistently exceeded its targets and grown faster than money GDP and inflation. Along with other measures of broad liquidity, it has been greatly affected by structural changes - which are certain to continue in future - and a rise in the demand for liquid assets as a form of savings (paragraphs 13-23).

(ii) "Overfunding" has seemed a more reliable way to seek to contain M3 than raising short term interest rates. The process involves the Government borrowing more than it needs to cover its deficit, with the Bank offsetting the resulting cash shortages by short term lending to the market, mainly in the form of acquisition of commercial bills. But it has led to a £17bn bill mountain. This looks absurd; represents a large structural distortion in financial markets; and complicates official day to day market operations. And M3 has still exceeded its target range (paragraphs 24-29).

(iii) There is some dispute over the extent to which growth of broad liquidity constitutes an inflationary danger. The danger of a liquidity overhang is that it might be converted into spending power at some future date. Some argue that it is right to try to restrain liquidity growth as an insurance against the risk of not being able to act quickly enough when the time came. But on the other hand, there are indicators - the exchange rate, M0, asset prices - likely to give early warning

of any inflationary pressures from this source, signalling the need for a rise in interest rates to contain them (paragraphs 30-33).

(iv) The arrangements for the Bank's operations in the money markets have turned out to be less flexible than originally envisaged when the present system was set up in 1981, partly because of the growth of the bill mountain. But interest rates whether influenced directly or indirectly are a key mechanism of monetary control. It was mistaken to believe in 1981 - if it was - that rates could be "left to the market". The practical question is whether we have adequate techniques for influencing interest rates, and whether these are sufficiently reliable to react quickly to a sudden move to spend liquid balances and the inflationary threat that would imply. We are satisfied that they are, and that we can and would react quickly in response to adverse movements in the monetary base, the exchange rate and asset prices. (It is not true to suggest the Bank are prepared to supply liquidity to the market without limit) (paragraphs 34-36).

(v) The final section of the paper sets out the main policy options on the central issue: the choice of targets and indicators and the role of £M3 (paragraph 40).

II What are the short term prospects for inflation?

4. The recent inflation increase - as measured by the RPI - from around 5 per cent to 7 per cent largely reflects two factors, both of which we expect to be temporary.

5. The first is the exchange rate fall in the second half of last year which increased import prices and gave companies the opportunity to widen their profit margins. It also meant higher oil prices expressed in terms of sterling; petrol prices are currently 11 per cent higher than a year ago.

6. The second factor has been the effect on mortgage rates of the higher level of interest rates. The timing and extent of the interest rate increase was associated with the exchange rate weakness but a higher level of interest rates was appropriate for domestic reasons as money demand was rising faster than expected; in particular world trade and exports were stronger than anticipated.

7. Both of these influences on prices should unwind in coming months. The increase in mortgage rates last July will fall out of the year on year comparison in August; and the 2 point rise early this year will disappear next Spring. Even if mortgage rates do not fall from today's levels this would have the effect of reducing inflation by $1\frac{1}{2}$ per cent next summer compared with today's rate.

8. In addition the exchange rate has now recovered last year's fall and import price growth is already moderating. Firms will find it more difficult to raise prices and already oil prices in sterling terms are some 10 per cent lower than in January. If the normal relationship of petrol prices to oil prices holds they could be down by nearly as much by next summer.

9. On the basis of the present level of the exchange rate and world oil prices our present expectation is that inflation

would be below 5 per cent by next summer. This is not contradicted by present information on house price increases. Recently there has been some very modest signs of quickening but average increases are below 10 per cent on a year earlier, and rising at around the same rate as over the last two years. There is nothing to suggest that we face the difficult conditions of the early or late seventies when rapid house price increases anticipated an upturn in the general inflation rate (see Annex III, Chart 2).

III Are conditions tight enough to keep inflation declining in the longer term?

10. Abstracting from these temporary influences we estimate that the underlying rate of inflation has shown only a small increase in recent months. Unit labour costs in manufacturing industry have been rising by less than 5 per cent a year after making allowance for the effect of the Budget which reduced the average rates of National Insurance Contributions. Although this is faster than competitor countries it does not point to higher inflation arising from labour costs. And the lower inflation rate in the autumn should reduce the pressure for larger wage increases, though the settlement rate in the next pay round could well be a little higher than the 5½-6 per cent of the last year or so.

11. In general terms it can be argued that the underlying inflation rate has been on a plateau of around 5 per cent over the past two years; for part of the time the recorded rate was helped by special factors, particularly the mortgage rate; and for part of the time the recorded rate has been damaged by those same factors. Although the actual inflation rate may fall below 5 per cent in 1986-87 the underlying inflation rate is only likely to decline slowly. Maintaining the monetary policy implied by this year's MTF5 may not leave much room for interest rate reductions but we do not, at present, see any need for a further increase.

12. It is right to be cautious about the speed with which we bring down inflation. A policy stance designed to produce a sharp fall would put pressure on companies and would have adverse effects on output and unemployment. The implication is that we should stick to our strategy and not over-react to the high levels of inflation we are experiencing this summer; levels whose origins lie in monetary conditions that have already been corrected and the influence of the mortgage rate on the RPI.

IV Choice of monetary targets and indicators

13. In a sophisticated and fast changing financial system like ours, it is not easy to decide what monetary indicators to look at and how to interpret them. The difficulties are most obvious when, as at present, the different indicators are giving conflicting signals.

14. Taking **narrow money** first, in principle the obvious indicator to choose would be a measure of cash and balances held for transactions purposes - perhaps the aggregate of notes, coin and current accounts. But the figures here have been greatly distorted in recent years by the growth and heavy marketing by banks of interest bearing sight deposits. This has lead to funds previously held at longer term, so as to attract interest, being switched into sight deposits; and it also seems to have resulted in a growth of interest bearing sight deposits at the expense of non-interest bearing sight deposits.

Growth of transactions money, 12 months to May 1985 (%)

MO	Non-interest bearing M1	Interest bearing M1	Total M1
5.5	4.1	43.8	15.8

15. It was this distortion to the current account figures that lead us to choose a narrower measure still, M0 (the total of notes, coin and bankers' balances at the Bank of England) as our preferred measure of narrow money. This measure has also been affected by structural and technical change, such as the growing use of credit cards and cash dispensers. But these changes seem to have been taking place at a steady pace, giving a fairly steady velocity trend for M0 over a long period which we have been able to take into account in setting targets for it.

16. Despite these features, many still doubt that an aggregate that consists largely of notes and coin can be an adequate indicator of monetary conditions in a sophisticated financial system. It may be that the Treasury and Bank could have done more to explain with more conviction the merits of M0 as an indicator: it is certainly clear that without some more concerted effort of that kind the market is unlikely to switch its focus from £M3 to M0.

17. Turning to the **wider measures of money**, an £M3 overshoot is scarcely a new phenomenon. As the following table shows, £M3 has exceeded its target over most of the period since 1979, only coming within it for the 2 years (1982-84) after a deliberate decision to raise the ranges originally announced for those years. Despite this we have brought inflation down.

£M3 performance against target : % growth at annual rate

	Target range	Outturn	Growth of money GDP (financial years)
Jun 1979 - Oct 1980	7-11	16.2	19.8
Feb 1980 - Apr 1981	7-11	19.4	13.8
Feb 1981 - Apr 1982	6-10	12.8	10.1
Feb 1982 - Apr 1983	8-12	11.2	9.4
Feb 1983 - Apr 1984	7-11	9.8	7.9
Feb 1984 - Apr 1985	6-10	11.9	7.0

18. The explanation lies in developments over the period that have affected the nature of £M3 and the private sector's demand for liquid assets. Bank deposits have become a more attractive way of holding savings, and this combined with other structural changes has diminished the significance of £M3 and other broader aggregates as monetary indicators. Much of the increase is in institutional funds held on deposit at banks as part of investment portfolios. The result is that the velocity of £M3, which rose sharply between 1974 and 1980, has since 1980 been steadily declining (see Annex III Chart 5).

19. One traditional attraction of the £M3 aggregate is the familiar statistical link with the PSBR. But it is clear that in recent years growth of £M3 has not been caused by excessive growth of the PSBR. Our performance here in relation to other countries has been good (see Annex III table 2).

20. It has been the buoyant demand for private sector credit - leading to a very rapid increase in bank lending - that has been the driving force behind £M3 growth. But like the rise in bank deposits that has financed it, this growth of bank lending does not seem in itself to have added to inflationary pressures. In the last three years bank lending has grown at an average rate of 18 per cent, while money GDP has been growing at around 8 per cent.

21. It is important here to recognise both the similarities and differences between monetary control in the UK and in other countries. Annex 1 describes the operation of monetary policy in the US, Germany and Switzerland. In all three countries the authorities place emphasis on the control of a narrow aggregate (in Switzerland, M0; in the US, M1; and in Germany, Central Bank Money - CBM). In the US and Germany there is also a concern with broader aggregates. But in those countries policy operates through a system of mandatory ratios between banks' reserves - that is their cash and deposits at the central bank - and their other liabilities.

On the one hand this gives a more certain relationship between bank reserves/narrow measures of money and broader measures, with which they are also concerned. On the other hand, because the reserve requirements in effect constitute a tax on bank intermediation, the system tends to lead to credit being channelled in other ways than through domestic bank lending. In other words, it causes disintermediation: including disintermediation through the uncontrolled offshore markets.

22. We have deliberately set our face against mandatory reserve requirements for banks in the UK that would drive sterling business offshore. Such disintermediation would, we have argued, distort the money figures to little real purpose. But we should, perhaps, not be surprised if against this background the result of the liberalisation since the abolition of exchange controls and the corset in 1979/80 has been a greater degree of intermediation via banks - and a faster growth of bank lending and a faster growth of the broader aggregates in relation to narrow money and the monetary base - than in countries like the US and Germany.

23. Finally, the **exchange rate** has come to play a larger part in our assessment of monetary conditions. Although on occasion movements in the exchange rate can reflect events that have little direct relevance to domestic monetary conditions, more normally there is an effect on inflationary pressures. In practice, we have found the exchange rate a useful supplementary guide to policy: often a more useful guide than £M3.

V Control of £M3 and bank lending: overfunding v. short term interest rates

24. Annex II contains an account of the techniques we have used to seek to control monetary growth, and some of the operational problems we have had. If we want to rein back £M3 growth, in the short term there is a choice between using funding policy and raising short term interest rates.

25. Using **funding**, that is selling extra gilts, will in effect raise long term interest rates. Some investors - probably mainly the institutions - will as a result move out of bank deposits and buy gilts instead. But with a given PSBR the effect of this transaction is to contract the monetary base, and it can create money market shortages which, if not relieved, would lead to a sharp rise in short term interest rates as well. Unless such a rise is thought warranted by monetary conditions, the Bank will relieve these shortages by adding^{to} its holding of commercial bills (the bill mountain). This combination of "overfunding" and money market assistance does not reduce the total of credit extended: what it does is, in effect, to neutralise some of the impact of the rise in private sector borrowing from the banks by financing part of it with less liquid forms of savings - invested in gilts and recycled via the Bank's purchase of commercial bills. We know from experience that overfunding does have a reasonably reliable and early impact on £M3, at least in the short run.

26. Changing **short term interest rates**, on the other hand, will have at best a delayed effect on £M3 and bank lending. Despite the political importance of the mortgage rate, we have on occasion - as at present - been through periods of very high short term interest rates. But on each occasion there has been little discernible effect on £M3. There is an impact on non interest-bearing forms of money including M0. But on £M3 the short run effect could, even, be perverse.

27. But if short term interest rates are uncertain and slow acting in their effect on £M3 and bank lending, they can be expected to have a more substantial effect on the real economy - with a rise adding to the financial pressures on large and small companies, both directly and through the exchange rate. Overfunding, on the other hand, probably has much less effect on the real economy - partly because long term interest rates have less effect than short rates. It does, at least in the short term, reduce total liquidity in the economy. But equally it can be argued that the effect on £M3 is mainly cosmetic - like the corset, affecting the

target aggregate, but not inflationary pressures. Another possibility is that, although there is a short run effect, in the longer term overfunding does not even reduce £M3 . That would be the case, for example, if the extra sales of gilts and higher long rates were crowding potential private sector borrowers out of the long term capital market, and forcing them to borrow from the banks instead.

28. With the persistent tendency of £M3 to overshoot the targets set for it since 1979, we have regularly been faced with the choice of whether to seek to rein it back by raising short term interest rates, or by overfunding. Each time we have reviewed the choice in abstract, as we did in the summer of 1982 and last year, we have concluded that it was preferable to control £M3 without overfunding; and on each occasion in practice we have subsequently concluded that reliance on interest rates alone did not offer a sure enough prospect of reducing £M3 growth, and that gilts sales should therefore be increased. The result has been the steady acquisition by the Bank since 1979 of a massive stock of short term paper - in effect short term loans to the banking system. The total has now reached around £17bn , rising from a negligible figure in 1979.

29. The sheer scale of this bill mountain is now creating a range of technical, presentational and other problems. These are discussed more fully in Annex II, but briefly:-

(i) It looks absurd. This in itself does not help the credibility of policy. The Bank of England's holding of commercial bills is now equivalent to about 15% of £M3 , and the proportion has been steadily rising by 3-4% a year.

(ii) Because the stock of bills matures and has to be turned over every 4-6 weeks, it creates regular huge daily shortages in the money markets that the Bank has to relieve by purchasing new bills. The Bank is thus

intervening more regularly and at longer maturities than originally envisaged under the operational arrangements instituted in 1981 giving the authorities a higher profile in the setting of short term market rates. This is not necessarily a drawback. It was a fallacy to envisage, if it was in 1981, that interest rates could in some way "be left to the market". To achieve monetary control the authorities have to be able to act on interest rates. The only question is whether to achieve that influence on rates by following an automatic quantitative rule for dealing in the money market (as with monetary base control), or through a more discretionary policy.

(iii) The scale of daily shortages makes it easier for the authorities to influence rates. But large scale dealing in the bill market can make it hard to avoid opening up opportunities for "round-tripping" arbitrage transactions between bills and bank deposits. Failure here artificially inflates the £M3 numbers and confuses the interpretation of monetary conditions.

IV Is the growth of broad liquidity a problem?

30. We thus come back to the question of whether we should be seeking to restrain rapid growth of £M3, and whether growth of £M3 and other measures of broad liquidity should be of concern. If it is, then - as in the past - we are likely to have to contemplate further overfunding, and a further rise in the bill mountain, as the only reliable means of doing so. If we believe the rapid growth of £M3 is of less concern, or that its effects can be offset by tightening monetary conditions in other respects - eg. by raising short term interest rates - then we have the prospect of breaking out of the cycle of ever increasing additions to the bill mountain and beginning to reduce the problems that it has brought in its train.

31. Some argue that a rise in broad liquidity, as measured by £M3, constitutes an actual problem: that it will inevitably lead to faster inflation. Others that it is only a potential problem: a liquidity overhang that could in some circumstances be converted into spending power and hence lead to inflation. Support for both propositions is seen in the history of the early 1970's when, it is argued, it was the growth of £M3 that gave the best warning of coming inflation.

32. Table 1 and Charts 1 and 2 in Annex III show the growth of M0, £M3 and some other indicators against the path of inflation since 1970. They show that both £M3 and M0 gave warning of the inflation of the early 1970s. Conditions in 1972-74 were very different from today's. The exchange rate was weak, fiscal policy was lax, interest rates had for a long time been kept artificially low and an incomes policy was breaking down. Moreover, the international environment was highly inflationary, reflected most dramatically in the oil price rise in late 1973. The conditions today, both domestic and international, are totally different. There is certainly no sign - see Annex III Chart 2 - of asset prices taking off in the way they did in 1972-74 sometime before inflation took off. Had we been operating then as we do today, then the movement in M0, the exchange rate and asset prices would have led us to take action even without a target for £M3.

33. Nevertheless concern on this front - on either thesis - might point to the need to act now to restrain the growth of broad liquidity. On the liquidity overhang theory, this would represent a necessary insurance against not being able to react fast enough if and when the time came. By historical standards the present liquidity overhang is not particularly high. But this is the case for continuing to seek to restrain the growth of £M3, and not changing the target set for it.

34. The alternative approach is to make sure we have adequate defences to ensure that broad liquidity is not converted into spending power. In this respect it is argued that the

way the Bank operates in the money market provides no assurance that liquid balances could not be converted into spending power (in the simplest case, encashed). This derives from the suggestion that the Bank is always prepared to buy any quantity of bills - to lend any amount to the market - at the going interest rate. There is a second, related, proposition that this certainty of always being able to borrow from the Bank may have increased banks' willingness to lend, and so have added to £M3 growth.

35. These suggestions are discussed further in Annex II. The short point is that it is simply not true that the Bank will buy any quantity of bills. They calculate the amount they need to buy each day to take out the expected market shortage, and to prevent an unwarranted contraction in the monetary base or rise in interest rates. If (as on occasion happens) they are offered more bills than required they limit their purchase to the calculated amount.

36. As to an automatic tripwire, this should in practice be provided by a combination of the exchange rate and M0; and as in the 1970s we would also most likely be alerted by a rise in asset prices. The exchange rate would quickly react to any conversion of £M3 balances into spending power. In practice M0 did rise before the inflationary surges in the early and late 1970s. Both these movements should be sufficient to bring the necessary rises in interest rates in their train.

VII Conclusion and Policy Options

37. The key question is thus about our attitude to the growth of broad money and of £M3 in particular. If we were only concerned at the risk that liquidity could be converted into spending power in the future, then we can probably rely on M0 and the exchange rate to give us warning signals in time to act to prevent it. If we believe, as we do, that the current rapid growth of £M3 carries little direct threat to future inflation, then we should logically be considering whether to raise or abandon the target for £M3 growth. To

do so would open the way to put an end to overfunding and the various problems associated with the seemingly inexorable rise in the Bank's bill mountain. There is also a subsidiary question about possible changes in the arrangements for the Bank's day to day money market operations.

38. To deal with the latter first, the Bank's operations are both more extensive and less flexible than envisaged in 1981. But it was always mistaken to believe - if it ever was - that short term interest rates could be left to the market. The authorities' influence on them can be discretionary, or work through seeking to change the monetary base: but either way interest rates are a key mechanism of monetary control. Nevertheless, it may be that the official hand on short term rates has become too rigid, and that techniques should be changed so as to permit greater day to day movement in short term rates.

39. On the central question, the future of the £M3 target, whatever our own conclusion there is of course also the market's reaction to consider. A change which undermined the credibility of policy would raise inflationary expectations and interest rates. In this respect the timing of any change would clearly be important: it would be best to wait until inflation was clearly back on a downward path.

40. The main options are:-

(i) No change. Despite our doubts, we could retain the present target for £M3. We could combine this, if desired, with changes in operating procedure of the kind discussed above and in Annex II. It has to be recognised that this would require continued overfunding and a continued rise in the level of the bill mountain. Despite that, no doubt there would be some overshooting of the £M3 target, leading us in turn to continue publicly questioning the significance of £M3 growth if we felt that in practice it was not endangering downward pressure on inflation.

(ii) Drop the £M3 target. We could combine this explicitly with an end to overfunding. History suggests this is necessary if we are ever to secure a reversal in the growth of the bill mountain. It might be preferable to present this as a suspension of the target, rather than a final break: some of the growth following an end to overfunding might be temporary. Given doubts about the value of £M3 as an indicator, it would arguably be a useful clarification of policy. It would imply greater reliance on M0 and the exchange rate, but we would want to make it clear that even without a target we would continue to take account of changes in the growth of broad money in interpreting monetary conditions, in much the same way as we already take account of movements in the exchange rate. This has many attractions, and in some ways is not as far as it looks from how we already operate policy, with persistent £M3 overshooting. But it would be seen as a major break: £M3 has featured as a target aggregate since 1976. An end to the growth of the bill mountain would settle market doubts that have arisen on that score. But the change could not carry credibility without a concerted campaign by the Treasury and Bank to explain the reasons for it, the merits of M0 as an indicator, and the way that policy would be operated henceforth.

(iii) Raise the £M3 target range. This option is something of a halfway house between (i) and (ii). This might be combined with other changes: for example a widening of the band, or a decision to reset the target more frequently, as recognition of some uncertainty about where it should be. It would be unwise to renounce overfunding altogether. But it might be possible to announce that it would be gradually phased out, with the aim of first slowing and then stopping the growth of the bill mountain. Other countries have at times changed their targets to what were considered more realistic levels, as we did in 1982. As to credibility, there would be a risk of getting the worst of all worlds:

but it might run less risk than option (ii) of being seen as a loosening of policy.

(iv) Switch to an exchange rate regime. If none of these options seemed attractive we could consider again a more complete break with monetary targets. The practical option, which was reviewed in February, is full membership of the EMS. In effect this would be an admission that steering by the domestic indicators had become too difficult, and that we would do better to try to tie policy to that in a low inflation country like Germany. But where exchange rate pressures come from external shocks, like oil price moves or movements in the dollar, it is often preferable to take some of the strain on the exchange rate rather than allowing it all to be transmitted into the conduct of domestic policy. We concluded in February that membership could not in practice be contemplated at a time when pressures on sterling seemed likely, or with the present level of our currency reserves.

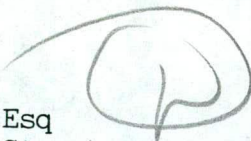
H M TREASURY
JUNE 1985

SECRET

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To : A Turnbull Esq
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MONETARY CONTROLI Introduction and Summary

There has been recent criticism and misunderstanding about the operation of monetary policy, and we are facing difficulties, both in the interpretation of conditions and the methods of control. The current divergence between broad money and other indicators has drawn attention to other longer standing problems about the operation of policy. These relate to the choice of targets and indicators, and, at a more technical level, the techniques of control, particularly the way the Bank operates in the money markets and the process of "overfunding" with the resulting growth of the bill mountain. It is right to take stock.

2. The most immediate question is whether monetary conditions are suitably tight to bring us back to a declining path for inflation. The various indicators do not all point in the same direction. Real short-term interest rates are at a historically high level; the monetary base (MO) is growing at a satisfactory rate, well within its target range; the £ is firm, and has risen against all currencies since earlier in the year. On the other hand bank lending and the wider measures of money and liquidity are growing very fast, with £M3 well above the top of its range. Our assessment (paragraphs 4-12 below) is that the recent rise in inflation reflects conditions that had become too loose last year and the short run impact of the higher interest rates needed to correct them. We believe that current conditions are tight enough to bring inflation back to a downward trend. There may not be much room for interest rate reductions but neither do we see any need for an increase.

3. The rest of the paper deals with longer standing problems, many of which have been reviewed on several occasions in the past. The fundamental issue, which underlies the others, is the choice of monetary targets and indicators.

(i) Interpreting monetary conditions in a sophisticated financial system like ours is not easy. M0 has had a steady velocity trend and proved a useful indicator in recent years. The exchange rate has also proved a useful supplementary guide to policy. But M3 has persistently exceeded its targets and grown faster than money GDP and inflation. Along with other measures of broad liquidity, it has been greatly affected by structural changes - which are certain to continue in future - and a rise in the demand for liquid assets as a form of savings (paragraphs 13-23).

(ii) "Overfunding" has seemed a more reliable way to seek to contain M3 than raising short term interest rates. The process involves the Government borrowing more than it needs to cover its deficit, with the Bank offsetting the resulting cash shortages by short term lending to the market, mainly in the form of acquisition of commercial bills. But it has led to a £17bn bill mountain. This looks absurd; represents a large structural distortion in financial markets; and complicates official day to day market operations. And M3 has still exceeded its target range (paragraphs 24-29).

(iii) There is some dispute over the extent to which growth of broad liquidity constitutes an inflationary danger. The danger of a liquidity overhang is that it might be converted into spending power at some future date. Some argue that it is right to try to restrain liquidity growth as an insurance against the risk of not being able to act quickly enough when the time came. But on the other hand, there are indicators - the exchange rate, M0, asset prices - likely to give early warning

of any inflationary pressures from this source, signalling the need for a rise in interest rates to contain them (paragraphs 30-33).

(iv) The arrangements for the Bank's operations in the money markets have turned out to be less flexible than originally envisaged when the present system was set up in 1981, partly because of the growth of the bill mountain. But interest rates whether influenced directly or indirectly are a key mechanism of monetary control. It was mistaken to believe in 1981 - if it was - that rates could be "left to the market". The practical question is whether we have adequate techniques for influencing interest rates, and whether these are sufficiently reliable to react quickly to a sudden move to spend liquid balances and the inflationary threat that would imply. We are satisfied that they are, and that we can and would react quickly in response to adverse movements in the monetary base, the exchange rate and asset prices. (It is not true to suggest the Bank are prepared to supply liquidity to the market without limit) (paragraphs 34-36).

(v) The final section of the paper sets out the main policy options on the central issue: the choice of targets and indicators and the role of £M3 (paragraph 40).

II What are the short term prospects for inflation?

4. The recent inflation increase - as measured by the RPI - from around 5 per cent to 7 per cent largely reflects two factors, both of which we expect to be temporary.

5. The first is the exchange rate fall in the second half of last year which increased import prices and gave companies the opportunity to widen their profit margins. It also meant higher oil prices expressed in terms of sterling; petrol prices are currently 11 per cent higher than a year ago.

6. The second factor has been the effect on mortgage rates of the higher level of interest rates. The timing and extent of the interest rate increase was associated with the exchange rate weakness but a higher level of interest rates was appropriate for domestic reasons as money demand was rising faster than expected; in particular world trade and exports were stronger than anticipated.

7. Both of these influences on prices should unwind in coming months. The increase in mortgage rates last July will fall out of the year on year comparison in August; and the 2 point rise early this year will disappear next Spring. Even if mortgage rates do not fall from today's levels this would have the effect of reducing inflation by $1\frac{1}{2}$ per cent next summer compared with today's rate.

8. In addition the exchange rate has now recovered last year's fall and import price growth is already moderating. Firms will find it more difficult to raise prices and already oil prices in sterling terms are some 10 per cent lower than in January. If the normal relationship of petrol prices to oil prices holds they could be down by nearly as much by next summer.

9. On the basis of the present level of the exchange rate and world oil prices our present expectation is that inflation

would be below 5 per cent by next summer. This is not contradicted by present information on house price increases. Recently there has been some very modest signs of quickening but average increases are below 10 per cent on a year earlier, and rising at around the same rate as over the last two years. There is nothing to suggest that we face the difficult conditions of the early or late seventies when rapid house price increases anticipated an upturn in the general inflation rate (see Annex III, Chart 2).

III Are conditions tight enough to keep inflation declining in the longer term?

10. Abstracting from these temporary influences we estimate that the underlying rate of inflation has shown only a small increase in recent months. Unit labour costs in manufacturing industry have been rising by less than 5 per cent a year after making allowance for the effect of the Budget which reduced the average rates of National Insurance Contributions. Although this is faster than competitor countries it does not point to higher inflation arising from labour costs. And the lower inflation rate in the autumn should reduce the pressure for larger wage increases, though the settlement rate in the next pay round could well be a little higher than the 5½-6 per cent of the last year or so.

11. In general terms it can be argued that the underlying inflation rate has been on a plateau of around 5 per cent over the past two years; for part of the time the recorded rate was helped by special factors, particularly the mortgage rate; and for part of the time the recorded rate has been damaged by those same factors. Although the actual inflation rate may fall below 5 per cent in 1986-87 the underlying inflation rate is only likely to decline slowly. Maintaining the monetary policy implied by this year's MTF5 may not leave much room for interest rate reductions but we do not, at present, see any need for a further increase.

12. It is right to be cautious about the speed with which we bring down inflation. A policy stance designed to produce a sharp fall would put pressure on companies and would have adverse effects on output and unemployment. The implication is that we should stick to our strategy and not over-react to the high levels of inflation we are experiencing this summer; levels whose origins lie in monetary conditions that have already been corrected and the influence of the mortgage rate on the RPI.

IV Choice of monetary targets and indicators

13. In a sophisticated and fast changing financial system like ours, it is not easy to decide what monetary indicators to look at and how to interpret them. The difficulties are most obvious when, as at present, the different indicators are giving conflicting signals.

14. Taking **narrow money** first, in principle the obvious indicator to choose would be a measure of cash and balances held for transactions purposes - perhaps the aggregate of notes, coin and current accounts. But the figures here have been greatly distorted in recent years by the growth and heavy marketing by banks of interest bearing sight deposits. This has lead to funds previously held at longer term, so as to attract interest, being switched into sight deposits; and it also seems to have resulted in a growth of interest bearing sight deposits at the expense of non-interest bearing sight deposits.

Growth of transactions money, 12 months to May 1985 (%)

MO	Non-interest bearing M1	Interest bearing M1	Total M1
5.5	4.1	43.8	15.8

15. It was this distortion to the current account figures that lead us to choose a narrower measure still, M0 (the total of notes, coin and bankers' balances at the Bank of England) as our preferred measure of narrow money. This measure has also been affected by structural and technical change, such as the growing use of credit cards and cash dispensers. But these changes seem to have been taking place at a steady pace, giving a fairly steady velocity trend for M0 over a long period which we have been able to take into account in setting targets for it.

16. Despite these features, many still doubt that an aggregate that consists largely of notes and coin can be an adequate indicator of monetary conditions in a sophisticated financial system. It may be that the Treasury and Bank could have done more to explain with more conviction the merits of M0 as an indicator: it is certainly clear that without some more concerted effort of that kind the market is unlikely to switch its focus from £M3 to M0.

17. Turning to the **wider measures of money**, an £M3 overshoot is scarcely a new phenomenon. As the following table shows, £M3 has exceeded its target over most of the period since 1979, only coming within it for the 2 years (1982-84) after a deliberate decision to raise the ranges originally announced for those years. Despite this we have brought inflation down.

£M3 performance against target : % growth at annual rate

	Target range	Outturn	Growth of money GDP (financial years)
Jun 1979 - Oct 1980	7-11	16.2	19.8
Feb 1980 - Apr 1981	7-11	19.4	13.8
Feb 1981 - Apr 1982	6-10	12.8	10.1
Feb 1982 - Apr 1983	8-12	11.2	9.4
Feb 1983 - Apr 1984	7-11	9.8	7.9
Feb 1984 - Apr 1985	6-10	11.9	7.0

18. The explanation lies in developments over the period that have affected the nature of £M3 and the private sector's demand for liquid assets. Bank deposits have become a more attractive way of holding savings, and this combined with other structural changes has diminished the significance of £M3 and other broader aggregates as monetary indicators. Much of the increase is in institutional funds held on deposit at banks as part of investment portfolios. The result is that the velocity of £M3, which rose sharply between 1974 and 1980, has since 1980 been steadily declining (see Annex III Chart 5).

19. One traditional attraction of the £M3 aggregate is the familiar statistical link with the PSBR. But it is clear that in recent years growth of £M3 has not been caused by excessive growth of the PSBR. Our performance here in relation to other countries has been good (see Annex III table 2).

20. It has been the buoyant demand for private sector credit - leading to a very rapid increase in bank lending - that has been the driving force behind £M3 growth. But like the rise in bank deposits that has financed it, this growth of bank lending does not seem in itself to have added to inflationary pressures. In the last three years bank lending has grown at an average rate of 18 per cent, while money GDP has been growing at around 8 per cent.

21. It is important here to recognise both the similarities and differences between monetary control in the UK and in other countries. Annex 1 describes the operation of monetary policy in the US, Germany and Switzerland. In all three countries the authorities place emphasis on the control of a narrow aggregate (in Switzerland, M0; in the US, M1; and in Germany, Central Bank Money - CBM). In the US and Germany there is also a concern with broader aggregates. But in those countries policy operates through a system of mandatory ratios between banks' reserves - that is their cash and deposits at the central bank - and their other liabilities.

On the one hand this gives a more certain relationship between bank reserves/narrow measures of money and broader measures, with which they are also concerned. On the other hand, because the reserve requirements in effect constitute a tax on bank intermediation, the system tends to lead to credit being channelled in other ways than through domestic bank lending. In other words, it causes disintermediation: including disintermediation through the uncontrolled offshore markets.

22. We have deliberately set our face against mandatory reserve requirements for banks in the UK that would drive sterling business offshore. Such disintermediation would, we have argued, distort the money figures to little real purpose. But we should, perhaps, not be surprised if against this background the result of the liberalisation since the abolition of exchange controls and the corset in 1979/80 has been a greater degree of intermediation via banks - and a faster growth of bank lending and a faster growth of the broader aggregates in relation to narrow money and the monetary base - than in countries like the US and Germany.

23. Finally, the **exchange rate** has come to play a larger part in our assessment of monetary conditions. Although on occasion movements in the exchange rate can reflect events that have little direct relevance to domestic monetary conditions, more normally there is an effect on inflationary pressures. In practice, we have found the exchange rate a useful supplementary guide to policy: often a more useful guide than $\pounds 3$.

V Control of $\pounds 3$ and bank lending: overfunding v. short term interest rates

24. Annex II contains an account of the techniques we have used to seek to control monetary growth, and some of the operational problems we have had. If we want to rein back $\pounds 3$ growth, in the short term there is a choice between using funding policy and raising short term interest rates.

25. Using **funding**, that is selling extra gilts, will in effect raise long term interest rates. Some investors - probably mainly the institutions - will as a result move out of bank deposits and buy gilts instead. But with a given PSBR the effect of this transaction is to contract the monetary base, and it can create money market shortages which, if not relieved, would lead to a sharp rise in short term interest rates as well. Unless such a rise is thought warranted by monetary conditions, the Bank will relieve these shortages by adding ^{to} its holding of commercial bills (the bill mountain). This combination of "overfunding" and money market assistance does not reduce the total of credit extended: what it does is, in effect, to neutralise some of the impact of the rise in private sector borrowing from the banks by financing part of it with less liquid forms of savings - invested in gilts and recycled via the Bank's purchase of commercial bills. We know from experience that overfunding does have a reasonably reliable and early impact on £M3, at least in the short run.

26. Changing **short term interest rates**, on the other hand, will have at best a delayed effect on £M3 and bank lending. Despite the political importance of the mortgage rate, we have on occasion - as at present - been through periods of very high short term interest rates. But on each occasion there has been little discernible effect on £M3. There is an impact on non interest-bearing forms of money including M0. But on £M3 the short run effect could, even, be perverse.

27. But if short term interest rates are uncertain and slow acting in their effect on £M3 and bank lending, they can be expected to have a more substantial effect on the real economy - with a rise adding to the financial pressures on large and small companies, both directly and through the exchange rate. Overfunding, on the other hand, probably has much less effect on the real economy - partly because long term interest rates have less effect than short rates. It does, at least in the short term, reduce total liquidity in the economy. But equally it can be argued that the effect on £M3 is mainly cosmetic - like the corset, affecting the

target aggregate, but not inflationary pressures. Another possibility is that, although there is a short run effect, in the longer term overfunding does not even reduce £M3 . That would be the case, for example, if the extra sales of gilts and higher long rates were crowding potential private sector borrowers out of the long term capital market, and forcing them to borrow from the banks instead.

28. With the persistent tendency of £M3 to overshoot the targets set for it since 1979, we have regularly been faced with the choice of whether to seek to rein it back by raising short term interest rates, or by overfunding. Each time we have reviewed the choice in abstract, as we did in the summer of 1982 and last year, we have concluded that it was preferable to control £M3 without overfunding; and on each occasion in practice we have subsequently concluded that reliance on interest rates alone did not offer a sure enough prospect of reducing £M3 growth, and that gilts sales should therefore be increased. The result has been the steady acquisition by the Bank since 1979 of a massive stock of short term paper - in effect short term loans to the banking system. The total has now reached around £17bn , rising from a negligible figure in 1979.

29. The sheer scale of this bill mountain is now creating a range of technical, presentational and other problems. These are discussed more fully in Annex II, but briefly:-

(i) It looks absurd. This in itself does not help the credibility of policy. The Bank of England's holding of commercial bills is now equivalent to about 15% of £M3 , and the proportion has been steadily rising by 3-4% a year.

(ii) Because the stock of bills matures and has to be turned over every 4-6 weeks, it creates regular huge daily shortages in the money markets that the Bank has to relieve by purchasing new bills. The Bank is thus

intervening more regularly and at longer maturities than originally envisaged under the operational arrangements instituted in 1981 giving the authorities a higher profile in the setting of short term market rates. This is not necessarily a drawback. It was a fallacy to envisage, if it was in 1981, that interest rates could in some way "be left to the market". To achieve monetary control the authorities have to be able to act on interest rates. The only question is whether to achieve that influence on rates by following an automatic quantitative rule for dealing in the money market (as with monetary base control), or through a more discretionary policy.

(iii) The scale of daily shortages makes it easier for the authorities to influence rates. But large scale dealing in the bill market can make it hard to avoid opening up opportunities for "round-tripping" arbitrage transactions between bills and bank deposits. Failure here artificially inflates the £M3 numbers and confuses the interpretation of monetary conditions.

IV Is the growth of broad liquidity a problem?

30. We thus come back to the question of whether we should be seeking to restrain rapid growth of £M3, and whether growth of £M3 and other measures of broad liquidity should be of concern. If it is, then - as in the past - we are likely to have to contemplate further overfunding, and a further rise in the bill mountain, as the only reliable means of doing so. If we believe the rapid growth of £M3 is of less concern, or that its effects can be offset by tightening monetary conditions in other respects - eg. by raising short term interest rates - then we have the prospect of breaking out of the cycle of ever increasing additions to the bill mountain and beginning to reduce the problems that it has brought in its train.

31. Some argue that a rise in broad liquidity, as measured by £M3, constitutes an actual problem: that it will inevitably lead to faster inflation. Others that it is only a potential problem: a liquidity overhang that could in some circumstances be converted into spending power and hence lead to inflation. Support for both propositions is seen in the history of the early 1970's when, it is argued, it was the growth of £M3 that gave the best warning of coming inflation.

32. Table 1 and Charts 1 and 2 in Annex III show the growth of M0, £M3 and some other indicators against the path of inflation since 1970. They show that both £M3 and M0 gave warning of the inflation of the early 1970s. Conditions in 1972-74 were very different from today's. The exchange rate was weak, fiscal policy was lax, interest rates had for a long time been kept artificially low and an incomes policy was breaking down. Moreover, the international environment was highly inflationary, reflected most dramatically in the oil price rise in late 1973. The conditions today, both domestic and international, are totally different. There is certainly no sign - see Annex III Chart 2 - of asset prices taking off in the way they did in 1972-74 sometime before inflation took off. Had we been operating then as we do today, then the movement in M0, the exchange rate and asset prices would have led us to take action even without a target for £M3.

33. Nevertheless concern on this front - on either thesis - might point to the need to act now to restrain the growth of broad liquidity. On the liquidity overhang theory, this would represent a necessary insurance against not being able to react fast enough if and when the time came. By historical standards the present liquidity overhang is not particularly high. But this is the case for continuing to seek to restrain the growth of £M3, and not changing the target set for it.

34. The alternative approach is to make sure we have adequate defences to ensure that broad liquidity is not converted into spending power. In this respect it is argued that the

way the Bank operates in the money market provides no assurance that liquid balances could not be converted into spending power (in the simplest case, encashed). This derives from the suggestion that the Bank is always prepared to buy any quantity of bills - to lend any amount to the market - at the going interest rate. There is a second, related, proposition that this certainty of always being able to borrow from the Bank may have increased banks' willingness to lend, and so have added to £M3 growth.

35. These suggestions are discussed further in Annex II. The short point is that it is simply not true that the Bank will buy any quantity of bills. They calculate the amount they need to buy each day to take out the expected market shortage, and to prevent an unwarranted contraction in the monetary base or rise in interest rates. If (as on occasion happens) they are offered more bills than required they limit their purchase to the calculated amount.

36. As to an automatic tripwire, this should in practice be provided by a combination of the exchange rate and M0; and as in the 1970s we would also most likely be alerted by a rise in asset prices. The exchange rate would quickly react to any conversion of £M3 balances into spending power. In practice M0 did rise before the inflationary surges in the early and late 1970s. Both these movements should be sufficient to bring the necessary rises in interest rates in their train.

VII Conclusion and Policy Options

37. The key question is thus about our attitude to the growth of broad money and of £M3 in particular. If we were only concerned at the risk that liquidity could be converted into spending power in the future, then we can probably rely on M0 and the exchange rate to give us warning signals in time to act to prevent it. If we believe, as we do, that the current rapid growth of £M3 carries little direct threat to future inflation, then we should logically be considering whether to raise or abandon the target for £M3 growth. To

do so would open the way to put an end to overfunding and the various problems associated with the seemingly inexorable rise in the Bank's bill mountain. There is also a subsidiary question about possible changes in the arrangements for the Bank's day to day money market operations.

38. To deal with the latter first, the Bank's operations are both more extensive and less flexible than envisaged in 1981. But it was always mistaken to believe - if it ever was - that short term interest rates could be left to the market. The authorities' influence on them can be discretionary, or work through seeking to change the monetary base: but either way interest rates are a key mechanism of monetary control. Nevertheless, it may be that the official hand on short term rates has become too rigid, and that techniques should be changed so as to permit greater day to day movement in short term rates.

39. On the central question, the future of the £M3 target, whatever our own conclusion there is of course also the market's reaction to consider. A change which undermined the credibility of policy would raise inflationary expectations and interest rates. In this respect the timing of any change would clearly be important: it would be best to wait until inflation was clearly back on a downward path.

40. The main options are:-

(i) No change. Despite our doubts, we could retain the present target for £M3. We could combine this, if desired, with changes in operating procedure of the kind discussed above and in Annex II. It has to be recognised that this would require continued overfunding and a continued rise in the level of the bill mountain. Despite that, no doubt there would be some overshooting of the £M3 target, leading us in turn to continue publicly questioning the significance of £M3 growth if we felt that in practice it was not endangering downward pressure on inflation.

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(ii) Drop the £M3 target. We could combine this explicitly with an end to overfunding. History suggests this is necessary if we are ever to secure a reversal in the growth of the bill mountain. It might be preferable to present this as a suspension of the target, rather than a final break: some of the growth following an end to overfunding might be temporary. Given doubts about the value of £M3 as an indicator, it would arguably be a useful clarification of policy. It would imply greater reliance on M0 and the exchange rate, but we would want to make it clear that even without a target we would continue to take account of changes in the growth of broad money in interpreting monetary conditions, in much the same way as we already take account of movements in the exchange rate. This has many attractions, and in some ways is not as far as it looks from how we already operate policy, with persistent £M3 overshooting. But it would be seen as a major break: £M3 has featured as a target aggregate since 1976. An end to the growth of the bill mountain would settle market doubts that have arisen on that score. But the change could not carry credibility without a concerted campaign by the Treasury and Bank to explain the reasons for it, the merits of M0 as an indicator, and the way that policy would be operated henceforth.

(iii) Raise the £M3 target range. This option is something of a halfway house between (i) and (ii). This might be combined with other changes: for example a widening of the band, or a decision to reset the target more frequently, as recognition of some uncertainty about where it should be. It would be unwise to renounce overfunding altogether. But it might be possible to announce that it would be gradually phased out, with the aim of first slowing and then stopping the growth of the bill mountain. Other countries have at times changed their targets to what were considered more realistic levels, as we did in 1982. As to credibility, there would be a risk of getting the worst of all worlds:

but it might run less risk than option (ii) of being seen as a loosening of policy.

(iv) Switch to an exchange rate regime. If none of these options seemed attractive we could consider again a more complete break with monetary targets. The practical option, which was reviewed in February, is full membership of the EMS. In effect this would be an admission that steering by the domestic indicators had become too difficult, and that we would do better to try to tie policy to that in a low inflation country like Germany. But where exchange rate pressures come from external shocks, like oil price moves or movements in the dollar, it is often preferable to take some of the strain on the exchange rate rather than allowing it all to be transmitted into the conduct of domestic policy. We concluded in February that membership could not in practice be contemplated at a time when pressures on sterling seemed likely, or with the present level of our currency reserves.

H M TREASURY
JUNE 1985

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Policy

MONETARY CONTROL →

(A)

1 Introduction and Summary and Conclusions

Different indicators are once again giving conflicting signals about monetary conditions. The buoyancy of the real economy, the rise in RPI inflation and the rapid growth in bank lending and broad money point to a degree of monetary ease. But the strong exchange rate, ^{high} record real interest rates, and the steady growth in M0 suggest that monetary conditions are suitably tight.

2. We judge that the rise of inflation is temporary. It reflects the weakness of the exchange rate earlier in the year, and the sharp rise in interest rates needed to correct it. Monetary policy has been tightened substantially this year: short term interest rates are still 3 per cent higher than they were in December and the exchange rate is over 10 per cent higher than it was in January. We expect inflation to fall sharply over the next year - possibly to 4 per cent by next summer. Looking further ahead, the aim of policy ^{sh}ould be to keep it on a downward trend. This may leave little room for further falls in interest rates. But, like the Bank, we see no immediate need for them to rise.

3. Problems in interpreting the monetary indicators are neither new, nor unique to the UK. We have certainly lived with them since 1980. We, like the US, have a sophisticated financial system which has been subject to significant and, at times, abrupt changes as a result of deregulation and increasing competition. Measures of broad money and liquidity have been particularly affected. Since 1980, the growth of sterling M3 has persistently exceeded that of money GDP,

in sharp contrast with the middle and late 1970s. Narrow measures of money - including M1 - have also been distorted by the development of interest bearing current accounts. M0 - largely notes and coins - has not been immune. But the changes affecting it have occurred at a steadier pace and in the event it has proved a useful indicator over a number of years. Given the problems of the monetary aggregates, it is not surprising that the exchange rate has become a useful supplementary guide to policy.

4. The build up of liquidity obviously carries a risk. The risk is that some of it will be spent. We have little idea how much will be used in this way or when. Sterling M3 certainly does not provide a good guide. But some still argue that it is necessary to restrain its growth to ensure against the danger that the authorities will not act quickly enough if it is monetised. However, experience suggests that M0, asset prices (especially house prices) and the exchange rate provide the most reliable warning signs. It is only when these signs have been ignored - as in the early 1970s - that we have got into trouble.

5. The rapid growth of bank lending has been the driving force behind the expansion of liquidity in recent years. The attempt to offset this by selling more debt has driven us into over-funding. But over-funding drains cash from the bank^{ing} system and the process of relieving cash shortages has led the Bank to buy commercial bills on an increasing scale. The bill mountain was thought to be temporary; but it now stands at £17 billion. If it continues to grow at the present rate, it could double over the MTFS period. It opens up opportunities for arbitrage which may compound the problem of bank credit, and it has been a major reason why the 1981 money market arrangements have never operated as intended.

6. Over-funding ^{and} in the bill mountain ^{are} is bringing our system of monetary control into disrepute and with it our monetary policy. As the Bank paper makes clear, the Treasury have discussed this issue with them on many occasions. The Chancellor said in his Mansion House Speech in 1983 that we should not normally sell more debt than was needed to fund the PSBR. We must now take steps to implement this policy and reduce the bill mountain significantly.

7. Specifically we should:

(i) stop over-funding. Sell enough debt to fund the PSBR and stop there. This is normal international practice in countries which pursue sound financial policies, including Germany, the US and Switzerland;

(ii) ask the Bank to examine urgently other methods for reducing the scale of the bill mountain.

X 8. This may lead to a faster growth in sterling M3, at least for a time. So it will be all the more important to keep other indicators on track: that will ^{mean} maintaining high short-term real interest rates and a strong exchange rate.

We do not suggest changing the sterling M3 target yet. But, ^{in the light of experience,} we shall need to reconsider the role of sterling M3 and the appropriate target range for it (if any), ~~in the light of experience~~ at Budget time, in the context of the MTFs.

44
Inflation:
What are the short term prospects for inflation?

9 4. The recent inflation increase - as measured by the RPI - from around 5 per cent to 7 per cent largely reflects two factors, both of which we expect to be temporary.

10 5. The first is the exchange rate fall in the second half of last year which increased import prices and gave companies the opportunity to widen their profit margins. It also meant higher oil prices expressed in terms of sterling; petrol prices are currently 11 per cent higher than a year ago.

11 6. The second factor has been the effect on mortgage rates of the higher level of interest rates. The timing and extent of the interest rate increase was associated with the exchange rate weakness but a higher level of interest rates was appropriate for domestic reasons as money demand was rising faster than expected; in particular world trade and exports were stronger than has been foreseen.

12 7. Both of these influences on prices should unwind in coming months. The increase in mortgage rates last July will fall out of the year on year comparison in August; and the 2 point rise early this year will disappear next Spring. Even if mortgage rates do not fall at all from today's levels this would have the effect of reducing inflation by 1½ per cent next summer compared with today's rate.

13 8. In addition the exchange rate has now recovered ~~the whole of~~ last year's fall and import price growth is already moderating. Firms will find it less easy to raise prices and already oil prices in sterling terms are some 10 per cent lower than in January. If the normal relationship of petrol prices to oil prices holds they could be down by nearly as much by next summer.

14 9. On the basis of the present level of the exchange rate and world oil prices our present expectation is that inflation will be below 5 per cent a year from now. This is not

contradicted by present information on house price increases. Recently there has been some very modest and patchy signs of quickening but average increases remain below 10 per cent on a year earlier, at around the same rate of increase as over the last two years. There is nothing to suggest that we face the difficult conditions of the early or late seventies when rapid house price increases anticipated an upturn in the general inflation rate (see ~~Annex A~~, Chart 2).

15 10. Abstracting from these temporary influences we estimate that the underlying rate of inflation has shown only a small increase in recent months. The underlying inflation rate has been on a plateau of around 5 per cent over the past two years and more; for part of the time the recorded rate was helped by special factors, particularly the mortgage rate; and for part of the time the recorded rate has been damaged by those same factors. Although the recorded inflation rate is likely to fall below 5 per cent in 1986-87 the underlying inflation rate will probably only decline slowly. Maintaining the monetary policy implied by this year's MTFS may not leave much room for interest rate reductions but we do not, at present, see any need for a further increase. A significantly tighter monetary stance designed to secure a faster fall in inflation would, in the short term, have adverse effects on output and thus employment.

+ 11.41 Choice of monetary targets and indicators

16 11. Taking **narrow money** first, in principle the obvious indicator to choose would be a measure of cash and balances held for transactions purposes - perhaps the aggregate of notes, coin and current accounts. But the figures here have been greatly distorted in recent years by the growth and heavy marketing by banks of interest bearing sight deposits. This has led to funds previously held at longer term, so as to attract interest, being switched into sight deposits; and it also seems to have resulted, not surprisingly, in a growth of interest bearing sight deposits at the expense of non-interest bearing sight deposits.

Growth of transactions money, 12 months to May 1985 (%)

MO	Non-interest bearing M1	Interest bearing M1	Total M1
5.5	4.1	43.8	15.8

17 ~~12.~~ It was this distortion to the current account figures that led us to choose a narrower measure still, MO (the total of notes, coin and bankers' balances at the Bank of England) as our preferred measure of narrow money. This measure has also been affected by structural and technical change, such as the growing use of credit cards and cash dispensers. But these changes seem to have been taking place at a predictable pace, giving a fairly steady velocity trend for MO over a long period which we have been able to take into account in setting targets for it.

18 ~~13.~~ Despite these features, many still doubt that an aggregate that consists largely of notes and coin can be an adequate indicator of monetary conditions in a sophisticated financial system. It may be that the Treasury and Bank could have done more to explain with more conviction the merits of MO as an indicator: it is certainly clear that without some more concerted effort of that kind the market is unlikely to switch its focus from £M3 to MO.

19 ~~14.~~ Turning to the **wider measures of money**, a £M3 overshoot is scarcely a new phenomenon. As the following table shows, £M3 has exceeded its target over most of the period since 1979, only coming within it for the 2 years (1982-84) after a deliberate decision to raise the ranges originally announced for those years. Despite this we have brought inflation down.

£M3 performance against target : % growth at annual rate

£M3 performance against target : % growth at annual rate

	Target range	Outturn	Growth of money GDP (financial years)
Jun 1979 - Oct 1980	7-11	16.2	19.8
Feb 1980 - Apr 1981	7-11	19.4	13.8
Feb 1981 - Apr 1982	6-10	12.8	10.1
Feb 1982 - Apr 1983	8-12	11.2	9.4
Feb 1983 - Apr 1984	7-11	9.8	7.9
Feb 1984 - Apr 1985	6-10	11.9	7.0

20/15. The explanation lies in developments over the period that have affected the nature of £M3 and the private sector's demand for liquid assets. As real short-term interest rates have turned from negative to positive, bank deposits have become a more attractive way of holding savings, and this combined with other structural changes has diminished the significance of £M3 and other broader aggregates as monetary indicators. Much of the increase is in institutional funds held on deposit at banks as part of investment portfolios. The result is that the velocity of £M3, which rose sharply between 1974 and 1980, has since 1980 been steadily declining (see ~~Annex 11~~ Chart 5).

21/16. The driving force behind £M3 growth has been the buoyant demand for private sector credit, leading to a rapid increase in bank lending. But like the rise in bank deposits that has financed it, this growth of bank lending does not seem in itself to have added to inflationary pressures. In the last three years bank lending has grown at an average rate of 18 per cent, while money GDP has been growing at around 8 per cent.

22 The rapid growth of bank lending is not entirely surprising. We have deliberately encouraged the UK banking system to operate on shore - unlike the United States and Germany. Since 1979, we have abolished compulsory cash ratios, exchange controls, and the supplementary special deposit scheme (the corset). These developments have left our banking system remarkably free of artificial constraints - a situation that has strengthened London's position as a major financial centre.

23 Bank lending has been less of a problem in other countries. But they differ from us ~~too~~ in putting the main emphasis on narrower measures of money - M0 in Switzerland, M1 in the ~~United States~~ and central bank money in Germany. With less concern about the growth of liquidity, the role of funding is also different in other countries: the normal rule is to sell enough debt to fund the PSBR but no more. ~~24~~ Finally, the exchange rate has come to play a larger part in our assessment of monetary conditions. Although on occasion movements in the exchange rate can reflect events that have little direct relevance to domestic monetary conditions, more normally there is an effect on inflationary pressures and expectations. In practice, we have found the exchange rate a useful supplementary guide to policy: often a more useful guide than £M3.

Monetary Control:

III ~~IV~~ Control of £M3 and bank lending: overfunding ^{and} short term interest rates

~~24~~ 24. ✓ In order to control £M3, ^{to controlling £M3.} There are essentially two different approaches. We can either ^{seek} ~~start~~ to control bank lending directly via short term interest rates, or ^{neutralise} ~~monitor~~ the effect on liquidity by over-funding.

25. The effect of over-funding - that is, selling more debt than is ~~intended~~ ^{needed} to finance the PSBR - is to raise long term interest rates. Some investors - probably mainly the institutions - will as a result move out of bank deposits and buy gilts instead. But with a given PSBR the effect

X

of this transaction is to contract the monetary base, and ~~it can~~ create money market shortages which, if not relieved, would lead to a sharp rise in short term interest rates. ~~as well.~~ Unless such a rise is thought warranted by monetary conditions, the Bank will relieve these shortages by adding to its holding of commercial bills (the bill mountain).

ster.

Overfunding has a reasonably reliable impact on £M3, at least in the short run.

27 26. Changing short term interest rates, on the other hand, has at best a delayed effect on £M3 and bank lending. Indeed, the short run effect can even be perverse.

28 27. But if short term interest rates are uncertain and slow acting in their effect on £M3 and bank lending, they can be expected to have a more substantial effect on the real economy - with a rise adding to the financial pressures on large and small companies, both directly and through the exchange rate. Overfunding, on the other hand, probably has much less effect on the real economy - partly because long term interest rates have less effect than short rates. It is also arguable that although there is a short run effect, overfunding does not greatly reduce £M3, in the longer term. That would be the case, for example, if the extra sales of gilts and higher long rates were crowding potential corporate borrowers out of the long term capital market, and forcing them to borrow from the banks instead.

09

29 28. With the persistent tendency of £M3 to overshoot the targets set for it since 1979, we have regularly been faced with the choice of whether to seek to rein it back by raising short term interest rates, or by overfunding. Each time we have reviewed the choice (~~in abstract,~~) as we did in the summer of 1982 and last year, we have concluded that it was preferable to (~~control £M3 without~~) overfunding; and on each occasion in practice we have subsequently concluded that reliance on ^{short term} interest rates alone did not offer a sure enough prospect of reducing £M3 growth, and that gilts sales should

again

therefore be increased. The result has been the steady acquisition by the Bank since 1979 of a massive stock of short term paper - in effect short term loans to the banking system. The total has now reached around £17bn, rising from a negligible figure in 1979.

30 29. The sheer scale of this bill mountain is now creating a range of technical, presentational and other problems. Not only does it look absurd, but because the stock of bills matures and has to be turned over every 4-6 weeks, it creates regular huge daily shortages in the money markets that the Bank has to relieve by purchasing new bills. The Bank is thus intervening more regularly and at longer maturities than originally envisaged under the operational arrangements instituted in 1981, giving the authorities a higher profile in the setting of short term market rates. The scale of daily shortages makes it easier for the authorities to influence rates. But large scale dealing in the bill market can make it hard to avoid opening up opportunities for "round-tripping" arbitrage transactions between bills and bank deposits. Failure here artificially inflates the £M3 numbers and confuses the interpretation of monetary conditions.

IV Is the growth of broad liquidity a problem?

31 30. We thus come back to the question of whether we should be seeking to restrain the growth of £M3, and if so what rate of growth is appropriate. The more we are concerned about the growth of sterling M3, the more we are likely to have to contemplate further overfunding, and a further rise in the bill mountain, as the only reliable means of controlling it. If we believe the rapid growth of £M3 is of less concern, or that its effects can be offset by tightening monetary conditions in other ^{ways} respects - eg. by persisting with a policy of high real short term interest rates and a strong exchange rate - then we have the prospect of breaking out of the cycle of ever increasing additions to the bill mountain and beginning to reduce the problems

that it has brought in its train.

9 32. Table 1 and Charts 1 and 2 in Annex III show the growth of M0, £M3 and some other indicators against the path of inflation since 1970. They show that both £M3 and M0 gave warning of the inflation of the early 1970s. Conditions in 1972-74 were very different from today's. The exchange rate was weak, fiscal policy was lax, interest rates had for a long time been kept artificially low and an incomes policy was breaking down. Moreover, the international environment was highly inflationary, reflected most dramatically in the oil price rise in late 1973. ~~The~~ Conditions today, both domestic and international, are totally different. There is certainly no sign ~~see Annex III Chart 2~~ of asset prices taking off in the way they did in 1972-74 sometime before inflation took off. ~~Had we been operating then as we do today, then~~ the movement in M0, the exchange rate and asset prices would have led us to take action even without a target for £M3.

HM Treasury
June 1985

SECRET

CHANCELLOR

FROM : D PERETZ

DATE : 20 JUNE 1985

(D)

cc Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Lavelle
Mr Lankester
Mr Sedgwick
Mr H Davies

PAPER ON MONETARY POLICY

I attach a revised draft paper on monetary policy for the Prime Minister's meeting next week.

2. The structure follows that you outlined at your meeting on 17 June. We have also taken account of points made at the meeting with the Bank yesterday. You will see that the first three paragraphs incorporate a summary and guide to the rest of the paper. The Annexes are bulky, particularly Annex II. But we think it important to deal there with the points that Sir A Walters and others have raised.

3. Sir P Middleton is away today, and Mr Cassell engaged giving evidence to the TCSC. But they have seen an earlier draft, and this version includes their comments, and those of others.

4. The paper will need to go to No. 10 tomorrow, once it has been amended to take in your own comments. I attach a draft private secretary covering letter for the purpose. I understand Mr Turnbull will be arranging to get a copy to Sir Alan Walters in Washington.

5. As we promised at yesterday's meeting, I have also sent copies of this draft to the Bank.

DLP

D PERETZ

SECRET

The rapid growth of bank lending is not entirely surprising. We have deliberately encouraged the UK banking system to operate on more-~~like~~ like the United States and Germany. Since 1979, we have abolished compulsory loan ratios, exchange controls and the supplementary special deposit scheme. The bank is a banking system that, by international standards, ~~is remarkably free from direct controls~~ ~~operates on a~~ ~~loan-to-deposit~~ ~~ratio~~ ~~where~~ ~~the~~ ~~ratio~~ ~~of~~ ~~loans~~ ~~to~~ ~~deposits~~ is ~~low~~. Thus these developments have left our banking system remarkably free of artificial constraints - a situation that has strengthened London's position as a major financial centre.

Bank lending has been less of a problem in other countries. But they differ from us, too, in putting the main emphasis on narrow measures of money - (M1 in Switzerland), M2 in the United States, and Central Bank money in Germany. With less concern about the growth in liquidity, the use of ^{also} ~~prudential~~ ~~controls~~ in other countries: the normal rule is to set enough debt to fund the USSR, but no more.

20. Given the major changes that have occurred in the UK over the last six years - the abolition of exchange controls in 1979, the corset in 1980, the sharp reduction in inflation and consequent rise in real short-term interest rates,

On the one hand this gives a more certain relationship between bank reserves/narrow measures of money and broader measures, with which they are also concerned. On the other hand, because the reserve requirements in effect constitute a tax on bank intermediation, the system tends to lead to credit being channelled in other ways than through domestic bank lending. In other words, it causes disintermediation: including disintermediation through the uncontrolled offshore markets.

22. We have deliberately set our face against mandatory reserve requirements for banks in the UK that would drive sterling business offshore. Such disintermediation would, we have argued, distort the money figures to little real purpose. But we should, perhaps, not be surprised if against this background the result of the liberalisation since the abolition of exchange controls and the corset in 1979/80 has been a greater degree of intermediation via banks - and a faster growth of bank lending and a faster growth of the broader aggregates in relation to narrow money and the monetary base - than in countries like the US and Germany.

23. Finally, the exchange rate has come to play a larger part in our assessment of monetary conditions. Although on occasion movements in the exchange rate can reflect events that have little direct relevance to domestic monetary conditions, more normally there is an effect on inflationary pressures. In practice, we have found the exchange rate a useful supplementary guide to policy: often a more useful guide than $\text{M}3$.

V Control of $\text{M}3$ and bank lending: overfunding v. short term interest rates

24. Annex II contains an account of the techniques we have used to seek to control monetary growth, and some of the operational problems we have had. If we want to rein back $\text{M}3$ growth, in the short term there is a choice between using funding policy and raising short term interest rates.

Two different approaches. We can either seek to control bank lending directly via short term interest rates, or neutralise

REPLACES THE PARA WITH A SAYS THAT IN ADDITION WE HAVE ENCOURAGED RE-INTERMEDIATION (ABSEN. OF CONTROLS & CORSET), IS ALL IN SURPRISING THAT BANKS GROW FASTER THAN IN US, COMPANY & US. BUT EVEN SO, WOULD THEY NOT HAVE MORE EMPHASIS IN MONETARY CONTROL ON ESSENTIALLY NARROW AGGREGATES (US M1, GERMAN CBM).

effect on.
The liquidity by ~~overfunding~~ overfunding.

~~25. Using funding, that is selling extra gilts, will in effect raise long term interest rates. Some investors -~~
25. ~~Using funding, that is selling extra gilts, will in effect raise long term interest rates. PSBR - is to~~

probably mainly the institutions - will as a result move out of bank deposits and buy gilts instead. But with a given PSBR the effect of this transaction is to contract the monetary base, and it can create money market shortages which, if not relieved, would lead to a sharp rise in short term interest rates as well. Unless such a rise is thought warranted by monetary conditions, the Bank will relieve these shortages by adding ^{to} its holding of commercial bills (the bill mountain).

~~This combination of "overfunding" and money market assistance does not reduce the total of credit extended: what it does is, in effect, to neutralise some of the impact of the rise in private sector borrowing from the banks by financing part of it with less liquid forms of savings - invested in gilts and recycled via the Bank's purchase of commercial bills. We know from experience that ~~overfunding~~ ^{has} does have a reasonably reliable and ~~early~~ impact on £M3, at least in the short run.~~

obscure

26. Changing **short term interest rates**, on the other hand, ~~will have~~ ^{has} at best a delayed effect on £M3 and bank lending. ~~Despite the political importance of the mortgage rate, we have on occasion - as at present - been through periods of very high short term interest rates. But on each occasion there has been little discernible effect on £M3. There is an impact on non interest-bearing forms of money including M0. But on £M3 the short run effect ~~could~~ ^{can}, even, be perverse.~~

has index

27. But if short term interest rates are **uncertain and slow acting in their effect on £M3 and bank lending**, they can be expected to have a **more substantial effect on the real economy** - with a rise adding to the financial pressures on large and small companies, both directly and through the exchange rate. **Overfunding, on the other hand, probably has much less effect on the real economy** - partly because long term interest rates have less effect than short rates.

~~It does, at least in the short term, reduce total liquidity in the economy. But equally it can be argued that the effect on £M3 is mainly cosmetic - like the corset, affecting the~~

High real interest rate may be no reason for the fall in £M3 volume (occasional)

So why fund at all? (on the conventional sense)

It is also arguable,
~~target aggregate, but not inflationary pressures. Another possibility is that, although there is a short run effect, in the longer term, overfunding does not even reduce £M3.~~
 That would be the case, for example, if the extra sales of gilts and higher long rates were crowding potential private ~~sector~~ borrowers out of the long term capital market, and forcing them to borrow from the banks instead.

28. With the persistent tendency of £M3 to overshoot the targets set for it since 1979, we have regularly been faced with the choice of whether to seek to rein it back by raising short term interest rates, or by overfunding. Each time we have reviewed the choice in abstract, as we did in the summer of 1982 and last year, we have concluded that it was preferable to control £M3 without overfunding; and on each occasion in practice we have subsequently concluded that reliance on interest rates alone did not offer a sure enough prospect of reducing £M3 growth, and that ~~gilt~~ sales ^{of gilts} should therefore be increased. The result has been the steady acquisition by the Bank since 1979 of a massive stock of short term paper - in effect short term loans to the banking system. The total has now reached around £17bn, rising from a negligible figure in 1979.

29. The sheer scale of this bill mountain is now creating a range of technical, presentational and other problems. ~~These are discussed more fully in Annex II, but briefly:-~~

Not only 20m,

It looks absurd, but,
 (i) ~~It looks absurd. This in itself does not help the credibility of policy. The Bank of England's holding of commercial bills is now equivalent to about 15% of £M3, and the proportion has been steadily rising by 3-4% a year.~~

(ii) ~~Because the stock of bills matures and has to be turned over every 4-6 weeks, it creates regular huge daily shortages in the money markets that the Bank has to relieve by purchasing new bills. The Bank is thus~~

*claiming -
 + and + and +
 comparison*

intervening more regularly and at longer maturities than originally envisaged under the operational arrangements instituted in 1981, giving the authorities a higher profile in the setting of short term market rates. This is not necessarily a drawback. It was a fallacy to envisage, if it was in 1981, that interest rates could in some way "be left to the market". To achieve monetary control the authorities have to be able to act on interest rates. The only question is whether to achieve that influence on rates by following an automatic quantitative rule for dealing in the money market (as with monetary base control), or through a more discretionary policy.

Handwritten initials

(iii) The scale of daily shortages makes it easier for the authorities to influence rates. But large scale dealing in the bill market can make it hard to avoid opening up opportunities for "round-tripping" arbitrage transactions between bills and bank deposits. Failure here artificially inflates the £M3 numbers and confuses the interpretation of monetary conditions.

IV Is the growth of broad liquidity a problem?

30. We thus come back to the question of whether we should be seeking to restrain rapid growth of £M3, and whether growth of £M3 and other measures of broad liquidity should be of concern. If it is, then - as in the past - we are likely to have to contemplate further overfunding, and a further rise in the bill mountain, as the only reliable means of doing so. If we believe the rapid growth of £M3 is of less concern, or that its effects can be offset by tightening monetary conditions in other respects - eg. by raising short term interest rates - then we have the prospect of breaking out of the cycle of ever increasing additions to the bill mountain and beginning to reduce the problems that it has brought in its train.

Handwritten notes: The rate of growth of £M3 is not shorted in appropriate. It is so but what is the rate for the concern about the growth of £M3, the more.

Handwritten note: Continuity in doing so.

Handwritten note: 24 Persist

Handwritten note: with a policy of high real short-term interest rates

Handwritten note: a strong exchange rate

31. Some argue that a rise in broad liquidity, as measured by £M3, constitutes an actual problem: that it will inevitably lead to faster inflation. Others that it is only a potential problem: a liquidity overhang that could in some circumstances be converted into spending power and hence lead to inflation. Support for both propositions is seen in the history of the early 1970's when, it is argued, it was the growth of £M3 that gave the best warning of coming inflation.

32. Table 1 and Charts 1 and 2 in Annex III show the growth of M0, £M3 and some other indicators against the path of inflation since 1970. They show that both £M3 and M0 gave warning of the inflation of the early 1970s. Conditions in 1972-74 were very different from today's. The exchange rate was weak, fiscal policy was lax, interest rates had for a long time been kept artificially low and an incomes policy was breaking down. Moreover, the international environment was highly inflationary, reflected most dramatically in the oil price rise in late 1973. The conditions today, both domestic and international, are totally different. There is certainly no sign - see Annex III Chart 2 - of asset prices taking off in the way they did in 1972-74 sometime before inflation took off. Had we been operating then as we do today, then the movement in M0, the exchange rate and asset prices would have led us to take action even without a target for £M3.

33. Nevertheless concern on this front - on either thesis - might point to the need to act now to restrain the growth of broad liquidity. On the liquidity overhang theory, this would represent a necessary insurance against not being able to react fast enough if and when the time came. By historical standards the present liquidity overhang is not particularly high. But this is the case for continuing to seek to restrain the growth of £M3, and not changing the target set for it.

34. The alternative approach is to make sure we have adequate defences to ensure that broad liquidity is not converted into spending power. In this respect it is argued that the

From these on was lead to the conclusion
have argued.

MONETARY CONTROLI Introduction and Summary

① ~~There has been recent criticism and misunderstanding about the operation of monetary policy, and we are facing difficulties, both in the interpretation of conditions and the methods of control. The current divergence between broad money and other indicators has drawn attention to other longer standing problems about the operation of policy. These relate to the choice of targets and indicators, and, at a more technical level, the techniques of control, particularly the way the Bank operates in the money markets and the process of "overfunding" with the resulting growth of the bill mountain. It is right to take stock.~~

While we see no requirement for urgent action on the monetary front,

(a number of long-term)

2. The most immediate question is whether monetary conditions are suitably tight to bring us back to a declining path for inflation. The various indicators do not all point in the same direction. Real short-term interest rates are at a historically high level; the monetary base (MO) is growing at a satisfactory rate, *around the M3-point of* well within its target range; the £ is firm, and has risen against all currencies since earlier in the year. On the other hand bank lending and the wider measures of money and liquidity are growing very fast, with £M3 well above the top of its range. Our assessment (paragraphs 4-12 below) is that the recent rise in inflation *(transmitted in particular via the)* reflects conditions ~~that had become too loose last year,~~ and the short run impact of the higher interest rates needed to correct them. We believe that current conditions are tight enough to bring inflation back to a downward trend. There may not be much room for interest rate reductions but neither do we see any need for an increase, *at the present time.*

fall in the exchange rate,

3. The rest of the paper deals with longer standing problems, many of which have been reviewed on several occasions in the past. The fundamental issue, which underlies the others, is the choice of monetary targets and indicators.

3. (ii) Interpreting monetary conditions in a sophisticated financial system like ours is not easy. MO has had a steady velocity trend and proved a useful indicator in recent years. The exchange rate has also proved a useful supplementary guide to policy. But £M3 has persistently exceeded its targets and grown faster than money GDP and inflation. Along with other measures of broad liquidity, it has been greatly affected by structural changes - which are certain to continue in future - and a rise in the demand for liquid assets as a form of savings (paragraphs 13-23).

a. Considerable number of

(and in most years has exceeded its targets)

OK
No targets set for 67.

5. (iii) "Overfunding" has seemed a more reliable way to seek to contain £M3 than raising short term interest rates. The process involves the Government borrowing more than it needs to cover its deficit, with the Bank offsetting the resulting cash shortages by short term lending to the market, mainly in the form of acquisition of commercial bills. But it has led to a £17bn bill mountain, which looks absurd, but represents a large structural distortion in financial markets, and complicates official day-to-day market operations. And £M3 has still exceeded its target range (paragraphs 24-29).

in the short term

Containing

round tripping

Expenditure since late '60s provides a better basis for putting money growth in liquid assets in context with Govt's objectives

4. The question is further complicated by the fact that (iii) There is some dispute over the extent to which growth of broad liquidity constitutes an inflationary danger. The danger of a liquidity overhang is that it might be converted into spending power at some future date. Some argue that it is right to try to restrain liquidity growth as an insurance against the risk of not being able to act quickly enough when the time came. But on the other hand, there are indicators - the exchange rate, MO, asset prices - likely to give early warning

the intended consequences of a build-up of broad liquidity are partial rather than actual: the risk that

It has also led to growth opportunities for

round tripping

The Inflation, therefore, is

of any inflationary pressures from this source, signalling the need for a rise in interest rates to contain them (paragraphs 30-33).

(iv) ^{6.6} The arrangements for the Bank's operations in the money markets have turned out to be less flexible than originally envisaged when the present system was set up in 1981, partly because of the growth of the bill mountain, But interest rates, whether influenced directly or indirectly, are a key mechanism of monetary control. ~~It was mistaken to believe in 1981 - if it was - that rates could be "left to the market".~~ The ^(fundamental) practical question is whether we have adequate techniques for influencing ^{short-term} interest rates, and whether these are sufficiently reliable to react quickly to a sudden move to spend liquid balances and the inflationary threat that would imply. We are satisfied that they are, and that we can and would react quickly in response to adverse movements in the monetary base, the exchange rate and asset prices. (It is not true to suggest the Bank are prepared to supply liquidity to the market without limit) (paragraphs 34-36).

(v) The final section of the paper sets out the main policy options on the central issue: the choice of targets and indicators and the role of £M3 (paragraph 40).

7. [Summary of conclusions of paper]

how clear
that these
mechanisms
of interest &
control are
Bank
control money
handled
operations -

generally

summarise
here

II What are the short term prospects for inflation?

4. The recent inflation increase - as measured by the RPI - from around 5 per cent to 7 per cent largely reflects two factors, both of which we expect to be temporary.

5. The first is the exchange rate fall in the second half of last year which increased import prices and gave companies the opportunity to widen their profit margins. It also meant higher oil prices expressed in terms of sterling; petrol prices are currently 11 per cent higher than a year ago.

6. The second factor has been the effect on mortgage rates of the higher level of interest rates. The timing and extent of the interest rate increase was associated with the exchange rate weakness but a higher level of interest rates was appropriate for domestic reasons as money demand was rising faster than expected; in particular world trade and exports were stronger than anticipated. *has an effect*

7. Both of these influences on prices should unwind in coming months. The increase in mortgage rates last July will fall out of the year on year comparison in August; and the 2 point rise early this year will disappear next Spring. Even if mortgage rates do not fall ^{at all} from today's levels this would have the effect of reducing inflation by 1½ per cent next summer compared with today's rate.

Check
8. In addition the exchange rate has now recovered ^(the whole of) last year's fall and import price growth is already moderating. Firms will find it ~~more difficult~~ ^{less easy} to raise prices and already oil prices in sterling terms are some 10 per cent lower than in January. If the normal relationship of petrol prices to oil prices holds they could be down by nearly as much by next summer.

9. On the basis of the present level of the exchange rate and world oil prices our present expectation is that inflation

will
 would be below 5 per cent by ~~next~~ *a year from now.* summer. This is not contradicted by present information on house price increases. Recently there has been some very modest *and patchy* signs of quickening but average increases *remain* are below 10 per cent on a year earlier, ~~and rising at~~ *of increase* around the same rate as over the last two years. There is nothing to suggest that we face the difficult conditions of the early or late seventies when rapid house price increases anticipated an upturn in the general inflation rate (see Annex III, Chart 2).

III Are conditions tight enough to keep inflation declining in the longer term?

10. Abstracting from these temporary influences we estimate that the underlying rate of inflation has shown only a small increase in recent months. Unit labour costs in manufacturing industry have been rising by less than 5 per cent a year after making allowance for the effect of the Budget which reduced the average rates of National Insurance Contributions. Although this is faster than competitor countries it does not point to higher inflation arising from labour costs. And the lower inflation rate in the autumn should reduce the pressure for larger wage increases, though the settlement rate in the next pay round could well be a little higher than the 5½-6 per cent of the last year or so.

11. In general terms it can be argued that the underlying inflation rate has been on a plateau of around 5 per cent over the past two years; *and more;* for part of the time the recorded rate was helped by special factors, particularly the mortgage rate; and for part of the time the recorded rate has been damaged by those same factors. Although the *monies* actual inflation rate *is likely to* may fall below 5 per cent in 1986-87 the underlying inflation rate *will probably only* is only likely to decline slowly. Maintaining the monetary policy implied by this year's MTF5 may not leave much room for interest rate reductions but we do not, at present, see any need for a further increase.

A significantly tighter monetary stance designed to secure a further fall in inflation would, in the short term, have adverse effects on output & thus employment.

inflation pressure (budget)

*Surely
they can
bear a bit
more
pressure*

12. It is right to be cautious about the speed with which we bring down inflation. A policy stance designed to produce a sharp fall would put pressure on companies and would have adverse effects on output and unemployment. The implication is that we should stick to our strategy and not over-react to the high levels of inflation we are experiencing this summer; levels whose origins lie in monetary conditions that have already been corrected and the influence of the mortgage rate on the RPI.

IV Choice of monetary targets and indicators

13. In a sophisticated and fast changing financial system like ours, it is not easy to decide what monetary indicators to look at and how to interpret them. The difficulties are most obvious when, as at present, the different indicators are giving conflicting signals.

11. 14. Taking narrow money first, in principle the obvious indicator to choose would be a measure of cash and balances held for transactions purposes - perhaps the aggregate of notes, coin and current accounts. But the figures here have been greatly distorted in recent years by the growth and heavy marketing by banks of interest bearing sight deposits. This has lead to funds previously held at longer term, so as to attract interest, being switched into sight deposits; and it also seems to have resulted in a growth of interest bearing sight deposits at the expense of non-interest bearing sight deposits.

Growth of transactions money, 12 months to May 1985 (%)

MO	Non-interest bearing M1	Interest bearing M1	Total M1
5.5	4.1	43.8	15.8

12-15. It was this distortion to the current account figures that ~~lead~~^{led} us to choose a narrower measure still, M0 (the total of notes, coin and bankers' balances at the Bank of England) as our preferred measure of narrow money. This measure has also been affected by structural and technical change, such as the growing use of credit cards and cash dispensers. But these changes seem to have been taking place at a steady pace, giving a fairly ~~steady~~^{predictable} velocity trend for M0 over a long period which we have been able to take into account in setting targets for it.

13-16. Despite these features, many still doubt that an aggregate that consists largely of notes and coin can be an adequate indicator of monetary conditions in a sophisticated financial system. It may be that the Treasury and Bank could have done more to explain with more conviction the merits of M0 as an indicator: it is certainly clear that without some more concerted effort of that kind the market is unlikely to switch its focus from £M3 to M0.

14-17. Turning to the wider measures of money, ~~an~~^a £M3 overshoot is scarcely a new phenomenon. As the following table shows, £M3 has exceeded its target over most of the period since 1979, only coming within it for the 2 years (1982-84) after a deliberate decision to raise the ranges originally announced for those years. Despite this we have brought inflation down.

£M3 performance against target : % growth at annual rate

	Target range	Outturn	Growth of money GDP (financial years)
Jun 1979 - Oct 1980	7-11	16.2	19.8
Feb 1980 - Apr 1981	7-11	19.4	13.8
Feb 1981 - Apr 1982	6-10	12.8	10.1
Feb 1982 - Apr 1983	8-12	11.2	9.4
Feb 1983 - Apr 1984	7-11	9.8	7.9
Feb 1984 - Apr 1985	6-10	11.9	7.0

*Recursive
Cash
Apr - Apr? (p. 14)*

NB

As real share-holders
interest rates have risen
from negative to positive,

15
18. The explanation lies in developments over the period that have affected the nature of M3 and the private sector's demand for liquid assets. Bank deposits have become a ^{much} more attractive way of holding savings, and this combined with other structural changes has diminished the significance of M3 and other broader aggregates as monetary indicators. Much of the increase is in institutional funds held on deposit at banks as part of investment portfolios. The result is that the velocity of M3, which rose sharply between 1974 and 1980, has since 1980 been steadily declining (see Annex III Chart 5).

19. One traditional attraction of the M3 aggregate is the familiar statistical link with the PSBR. But it is clear that in recent years growth of M3 has not been caused by excessive growth of the PSBR. Our performance here in relation to other countries has been good (see Annex III table 2).

16 14. 20. It has been the buoyant demand for private sector credit, leading to a very rapid increase in bank lending - that has been the driving force behind M3 growth. But like the rise in bank deposits that has financed it, this growth of bank lending does not seem in itself to have added to inflationary pressures. In the last three years bank lending has grown at an average rate of 18 per cent, while money GDP has been growing at around 8 per cent.

21. [It is important here to recognise both the similarities and differences between monetary control in the UK and in other countries. Annex 1 describes the operation of monetary policy in the US, Germany and Switzerland.] In all three countries the authorities place emphasis on the control of a narrow aggregate (in Switzerland, M0; in the US, M1; and in Germany, Central Bank Money - CBM). In the US and Germany there is also a concern with broader aggregates. But in those countries policy operates through a system of mandatory ratios between banks' reserves - that is their cash and deposits at the central bank - and their other liabilities.

Handwritten notes in red ink on the left margin, partially obscured.

Handwritten notes in red ink on the left margin, including the phrase "this needs a better lead in - the pound don't seem like (though they could be made to)".

ANNEX 1: MONETARY TARGETS AND CONTROL ARRANGEMENTS IN US, GERMANY AND SWITZERLAND

There is some useful material here, but it is swamped in a mass of country detail.

Summary

1. The United States, Germany and Switzerland have set monetary targets for some years. All three countries place emphasis on narrow measures of money, although the United States also has targets for wider measures and in Germany the Bundesbank monitors M3. The US operates through the level of bank reserves while in Germany the main instruments are short interest rates, repurchase arrangements and alterations to banks minimum reserve requirements. In Switzerland the control problem is exacerbated by the central importance of flows across the exchanges, requiring the authorities to use foreign exchange swaps as well as short term interest rates to control domestic liquidity. Since none of the countries pay all that much attention to broad money they have generally not resorted to overfunding. All three countries have achieved low inflation rates although monetary outturns in Switzerland have often been significantly below target (mainly because of external flows). Excessive interest rate volatility was a problem in the US in the period 1979-81; since then volatility, has been less, in part reflecting changes in control procedures. An examination of the volatility in overnight rates over the last three months suggests that variability (as measured by the standard deviation) in the US, German and Swiss rates is fairly similar, and somewhat below that in the UK (if allowance is made for exceptional movements in the Swiss rate at the end of the month - see para 15).

United States: (a) Targets

2. The US targets the growth of M1, M2, M3 and domestic non-financial debt between the fourth quarter of years. M1 is effectively cash plus current accounts at banks and building societies; M2 is M1 plus retail savings accounts; M3 is effectively cash plus all deposits at banks and building societies; and domestic non financial debt is outstanding credit market debt of the government, local authorities and the private non-financial sector. Of these aggregates M1 is available weekly and the rest monthly. M1 is considered to be the most important aggregate as it has the most stable relationship with nominal GDP.

MONETARY TARGETS AND OUTTURNS

Table 1(a): United States: 1979-84

		Target	Outturn*
1979/80	MIA	3½ - 6	5
	MIB	4 - 6½	7.3
1980/81	MIB	3½ - 6	2.3
1981/82	M1	2½ - 5½	8.8
1982/83	M1	4 - 8	10.4
1983/84	M1	4 - 8	5.2

* % Q4 on Q4

Table 1(b): Germany: 1975-84

	Target for Central Bank Money (CBM)*	CBM growth	Nominal GNP growth
1975	8 ¹	10 ¹	4.4
1976	8 ²	9 ²	9.1
1977	8 ²	9 ²	6.5
1978	8 ²	11 ²	7.8
1979	6-9	6	8.2
1980	5-8	5	6.5
1981	4-7	4	3.9
1982	4-7	6	3.6
1983	4-7	7	4.6
1984	4-6	5	4.6

* Fourth quarter on fourth quarter

¹ December 1975 on December 1974

² Year on year

Source: Deutsche Bundesbank

Table 1(c): Switzerland: 1980-84

		Target	Outturn
			% calendar year
1980	Central bank money	4	-7.0
1981	CBM	4	-0.5
1982	CBM	3	2.6
1983	CBM	3	3.6
1984	CBM	3	

(b) Control Procedures

3. The Federal Reserve Board and the Federal Open Market Committee (FOMC) in Washington sets out the short and medium term targets for monetary policy. More-or-less every month the FOMC meets to decide short term policy. The result is a directive to the New York Fed, which is in charge of day to day operations in the money market. Until 1979 the open market desk mainly acted on interest rates to control money supply but since then it has operated on bank reserves in order to achieve monetary targets. The main aggregate M1 is thought to have a reliable relationship with bank reserves and so the New York Fed, adds or drains reserves through repurchase agreements etc to control M1. From 1979 to 1982 the FOMC set a target for non-borrowed reserves but by 1982 it was realised that targetting this alone allowed a 'leakage' through discount window borrowing, which meant that the Fed's control over M1 was not as tight as it might have been. Thus from 1982 the target for non-borrowed reserves has been altered more often to offset changes in discount window borrowing. This means that now total reserves are targetted. Another perceived fault in the 1979-82 procedure was the system of lagged reserved accounting. The latter meant that banks reserve requirements were known before an accounting period began. Therefore the Fed had to supply a certain level of reserves or allow interest rates to be highly volatile as banks scrambled to meet their reserve requirements needs, once again weakening Fed control over M1. In early 1984 a system of contemporaneous reserve accounting was introduced to allow the Fed to control reserve growth and hence M1 more tightly. This system covers a two week period with the banks required reserves at the Fed calculated from the level of the banks current accounts.

(c) Target and Outturns

4. The comparison between targets and outturns for M1 is set out in table 1(a). It can be seen that in 1982 and 1983 the M1 target was overshoot, due mainly to the introduction of new interest bearing current accounts. The Fed decided in mid-1982 that for various reasons the targets were too tight and that money could grow above target without harmful consequences on inflation. On the other hand they have overshoot their M3 target for each of the last few years by margins ranging from $\frac{1}{2}\%$ to 3%. In other years the Fed have a reasonable record on M1. Since October 1979 the annual rate of price inflation has fallen from $12\frac{1}{4}\%$ to 4%. Meanwhile, the real economy has grown by almost 3% per annum over the period.

5. In the early part of the period interest rates were highly volatile, as was money supply. Indeed prime rates moved from 12.9% in September 1979 to 19.8% in April 1980 then down to 11.1% in August 1980 back to 20.2% in January 1981. The average level of 3 month rates in 1979-81 was almost 8% higher than in 1971-79. Since 1981 and the introduction of a modified form of reserve targetting, volatility has been less pronounced. Although slightly greater than 1971-79 it is nevertheless considerably less than in 1979-81. Indeed since the beginning of 1982 the prime rate has fallen from 17% to 10% at present, with the rate in 1983 and 1984 varying only between 10½ and 13%. Nevertheless nominal rates have remained high. Three month rates even in 1984 were close on 4% higher than in the 1970's despite a 3% lower inflation rate.

6. As the Fed operates on the reserve requirements of the banks and concentrates mainly on a narrow aggregate, it does not use overfunding as an instrument of monetary policy. To ensure that government finance has as little impact as possible on the liquidity of the system the authorities deposit excess income from government operations in accounts at commercial banks, drawing them down only when they are needed.

Germany: (a) Targets

7. In August 1973 the Bundesbank changed its policy from influencing bank reserves to controlling the growth of 'central bank money' (CBM) defined as currency plus required minimum reserves on banks domestic liabilities at the reserve ratios prevailing in January 1974. CBM is a weighted average of the assets comprising M3¹ but it has the advantage of being available before data on M1, M2 and M3. Targets for CBM have been set annually since December 1974 on the basis of the growth of potential production plus the rate of "unavoidable" price rises. The hope is that this procedure avoids the need to adjust the targets as a result of transitory effects on prices or output. Since 1978 the Bundesbank have expressed the target in terms of a range for the Q4 on Q4 growth rate. The stated objective is to aim for the lower or upper half of the range depending upon the outturn of other non-monetary indicators during the target period, such as the exchange rate. Although only CBM is targetted the Bundesbank also monitors M3 and presents its counterparts. Indeed there is thought to be a reasonably strong link between CBM and M3 because the former includes reserve requirements based on the latter's deposits.

(1) CBM comprises all currency in circulation (less banks till money since March 1978) plus 16.6% of residents' sight deposits plus 12.4% of residents' time deposits plus 8.1% of residents' savings deposits held within German banks. These percentages are the required minimum reserves on those deposits as at January 1974.

(b) Control procedures

— can't see how word for the fees

8. It is useful to distinguish between the methods used for control over the medium term and those used to manage day to day operations. In the former category the main instruments are changes in banks' reserve requirements - which are far more frequent than in the US or the UK - and changes in the amount of, and the rates at which, bills are discounted. The Bundesbank sets rediscount quotas which are varied according to its view of market conditions. The reserve requirements are governed by the Anweisung der Deutschen Bundesbank uber Mindestreserven (AMR). The AMR specifies what reserve ratios are to be applied to the monthly average of reserve liabilities from the 16th of one month to the 15th of the next. For simplicity, the Bundesbank allows banks to calculate their liabilities from those outstanding on the 23rd of the previous month and the 7th and 15th of the current month. (It can order a bank to calculate the full monthly average if it suspects it of "window-dressing" the figures.) This procedure means that by the 15th of the month a bank should know what its reserve requirement is, and can therefore alter its reserves over the rest of the month to satisfy the requirement. Undoubtedly the setting of reserve ratios has encouraged the growth of the offshore EuroDeutschemark market.

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(A - no)

9. The Lombard facility is a loan by the Bundesbank secured on eligible collateral granted at the official Lombard rate, which is usually 1% to 1½% above the official discount rate. From February 1981 to May 1982 this system was replaced by the Special Lombard facility which effectively allowed the Bundesbank to decide whether or not to lend and at what rate, thus allowing the authorities to have penal rates for banks short on reserves without raising general interest rates. However, the introduction of the scheme pushed overnight rates up to around 20% to 30%.

10. Day to day control is operated through repurchase agreements, foreign exchange swaps and the Lombard [and Special Lombard] facility. The use of repurchase agreements appears to be on the increase. They are usually for bonds (not bills) for periods of between 25 and 45 days. (The vast bulk of government borrowing is through medium term paper which is not very marketable on a day to day basis as transferability is restricted. Open market operations are therefore carried out using Treasury bills or Treasury discount bonds (ie. zeros) issued by the government to the Bundesbank on request.)

11. Recently the Bundesbank has tried to reduce changes in the politically sensitive Lombard rates and has made increasing use of securities repurchase agreements (repos). To increase the impact of changes in the amount and rates of such agreements, the Bundesbank has gradually increased the size of its holdings of these securities from around DM12bn at the end of 1979 to about DM47bn by the end of 1983. The German 'bill mountain' is therefore mainly a result of a change in the Bundesbank's tactics. Decisions concerning whether or not to roll over the repos are taken in the light of pressure on the DM and the rate of monetary growth. For example, in January and February of this year the Bundesbank kept liquidity tight in the face of pressure on the DM.

12. This combination of altering interest rates and reserve requirements has allowed the Bundesbank to control CBM quite successfully (see Table 1(b)). The overshoot in the period 1975-78 was largely due to exchange market intervention to dampen the appreciation of the DM. The reversal of these exchange rate pressures in the light of the second oil crisis made monetary control easier. This is brought out in table 2 which compares the volatility in interest rates in the period up to 1979Q4, when the German effective rate was generally appreciating, with the period since then when the rate has fallen back a little. During the latter period the Bundesbank has managed to keep monetary growth broadly within the target ranges and interest rate volatility has been reduced. Inflation, which was creeping up to around 8% in Autumn 1973, just prior to the introduction of monetary targets, has been kept firmly under control averaging well under 5% from 1974 to 1985.

Table 2: German inflation, monetary growth, interest rates and exchange rates: 1970-85

	Pre-monetary targets 1970Q1-1973Q3	Monetary targets & appreciating DM 1973Q4-1979Q4	Monetary targets & depreciating DM 1980Q1-1985Q2
Inflation	5.4	4.8	4.3
CBM growth	10.4	8.1	5.3
Effective exchange rate at start and end of period	77.7 - 100.2	97.0 - 132.0	131.7 - 121.5
3 month interest rate	8.2	6.0	8.2
Volatility* of interest rates	0.3	0.5	0.3

* As measured by the coefficient of variation

13. Since less attention is attached to broad monetary growth, there has been no temptation to overfund and debt sales have generally matched government deficits quite closely.

Switzerland: (a) Targets

14. From the introduction of targets in 1975 until 1978 the Swiss concentrated on M1, which effectively is cash plus current accounts at banks and post offices. However in view of the instability of the demand for M1 the Swiss switched in 1979 to central bank money, or monetary base, as the target variable. The target for the monetary base is set annually to last a calendar year and relates to the average of the 12-month percentage changes for each month of the year. This is an extremely slow moving indicator and is clearly of little use in guiding day to day or even month to month policies. In the last few years a 3% target has been set, which is thought to be compatible with 2% real growth and 0-1% increase in prices. Besides the monetary base there have been periods particularly in the late 70's and early 1980 when the central bank has found it necessary to intervene in the exchange markets to resist large short term swings in the exchange rate, and hence relegate the monetary target to a secondary role.

(b) Control Procedures

15. The primary method of monetary control is through foreign exchange swaps with the most active period being at the end of each month when the banks have to meet the liquidity ratios set by the Central Bank. The need for liquidity, which causes a large jump in overnight rates, is relieved by the central bank through foreign exchange swaps which unwind during the following month. Although foreign exchange swaps are the most important instrument the Swiss also set discount and Lombard rates, and occasionally use bond repurchase agreements. However, except at end month, overnight rates are very stable and the central bank operations are very light.

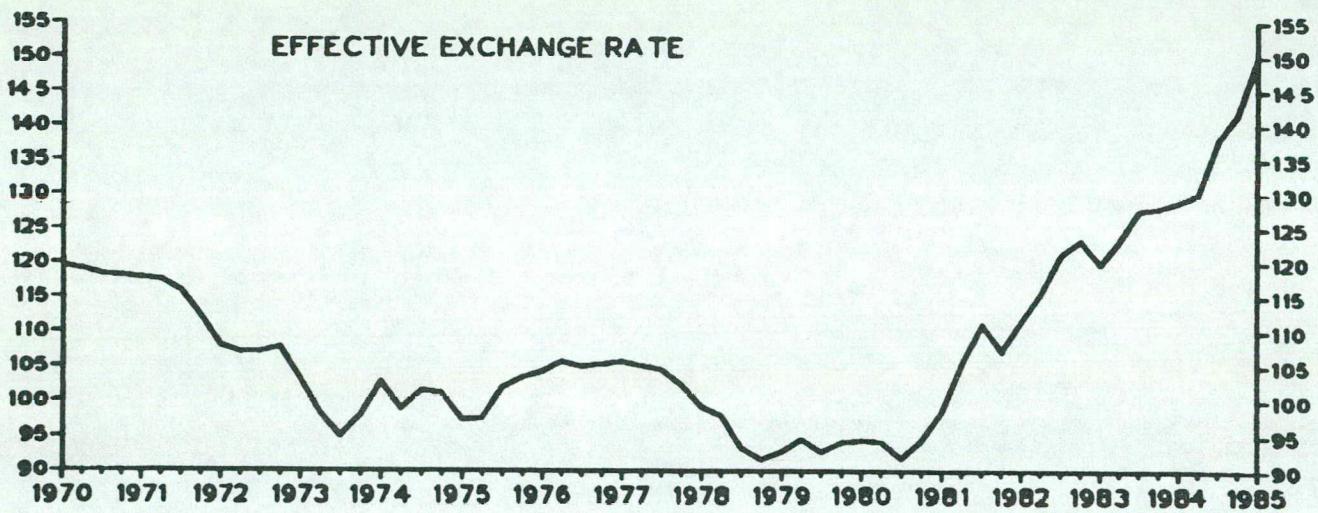
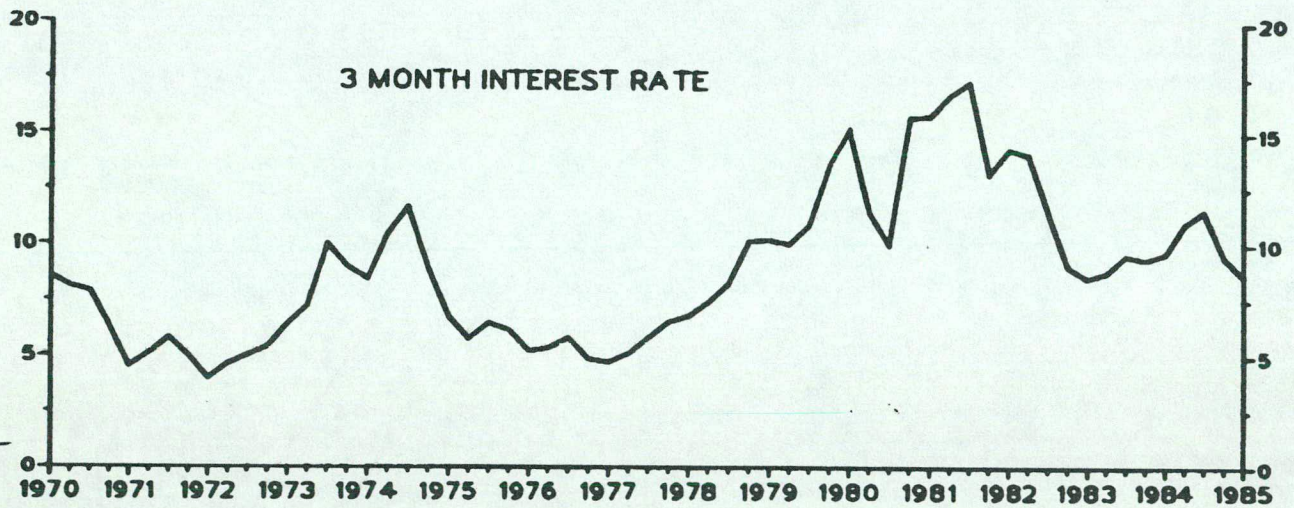
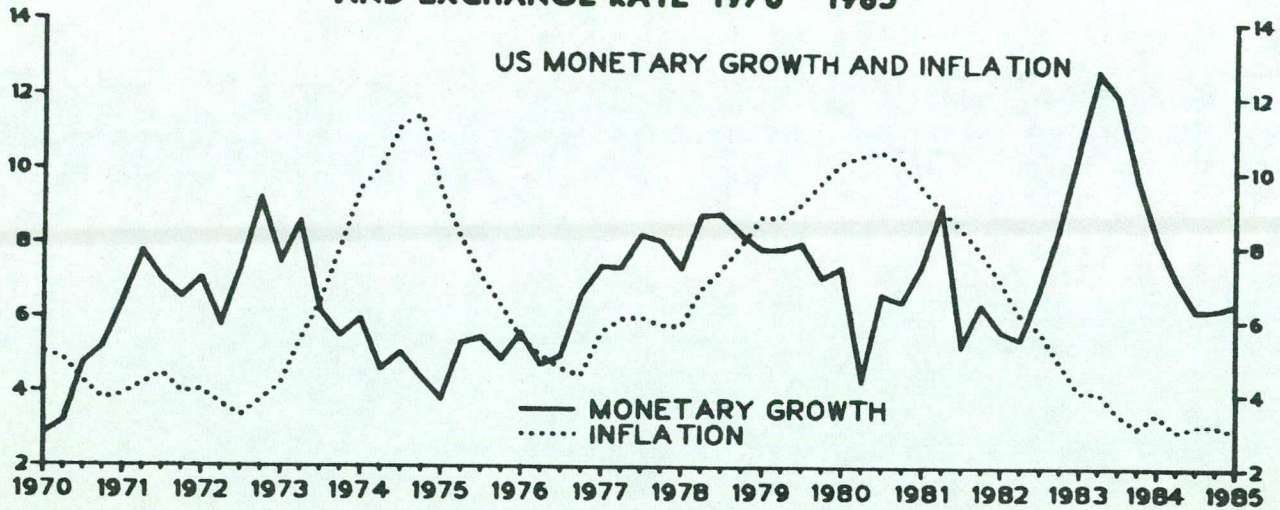
(c) Target and Outturns

16. The comparison of targets and outturns is set out in table 1(c). In 1980 and 1981 there was a large undershoot of the central bank money target

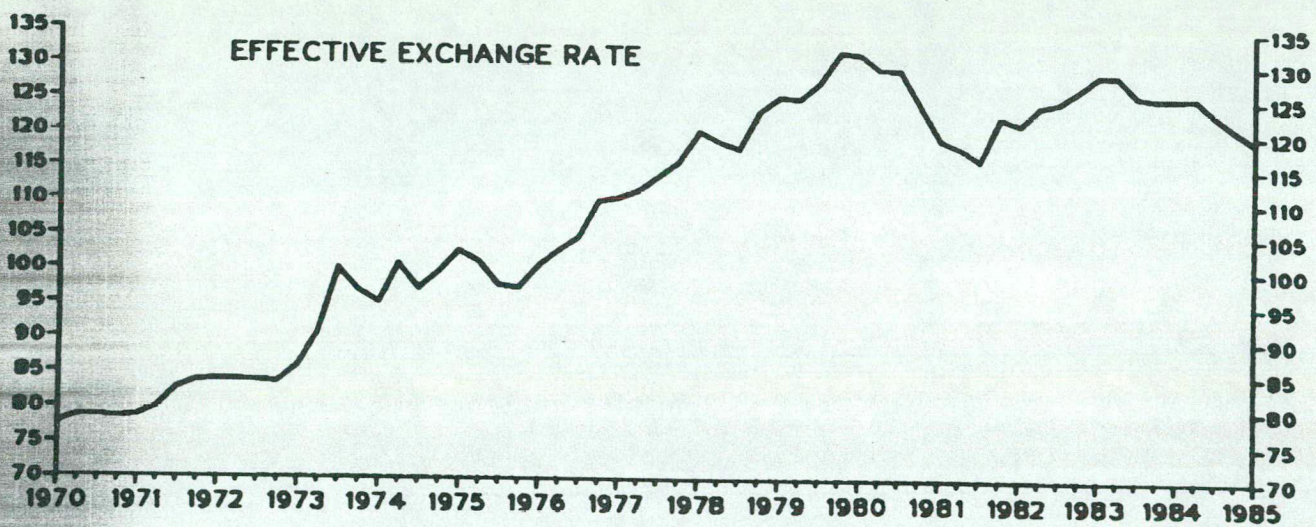
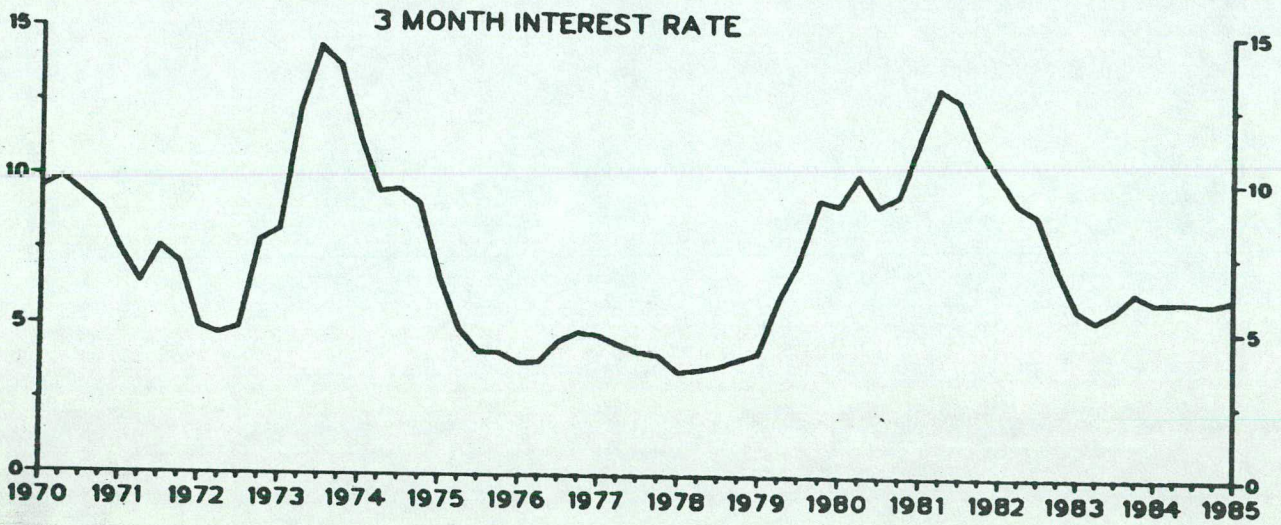
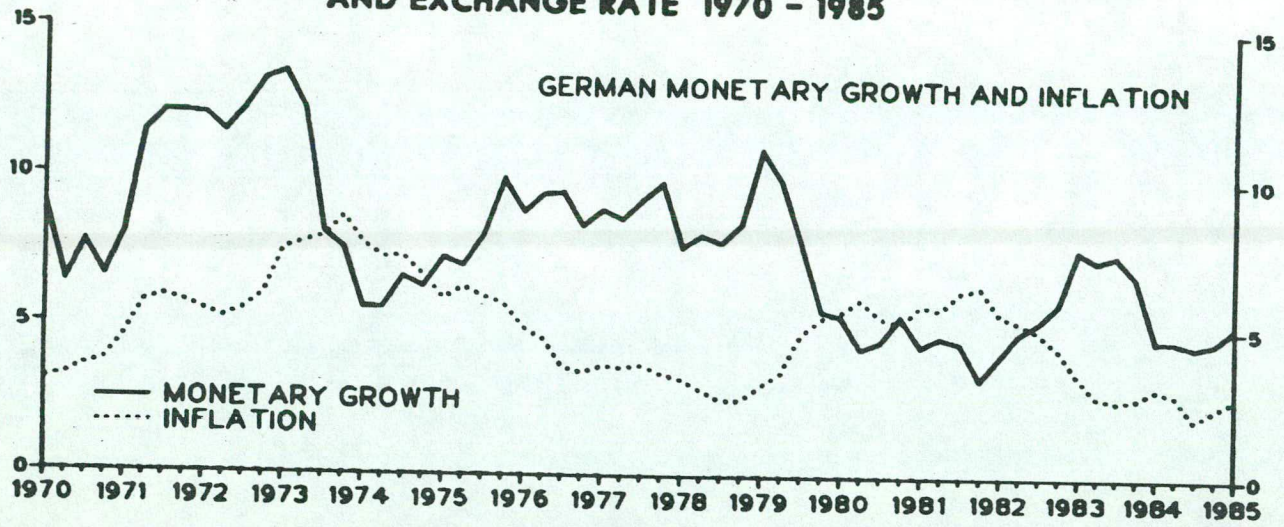
as the authorities absorbed large quantities of liquidity created in 1978-79. Since then the Swiss have been close to their target. Although the growth of the monetary base is stable the growth of the wider aggregates can be volatile, as individuals switch between different types of accounts. The effect of the sharp slowdown in monetary growth in 1980 and 1981 led to a recession in 1982, which co-incident with a peak inflation rate of around 7½%. Since then there has been a slow recovery while inflation moderated to 3% by end 1984. Like most other countries interest rates rose to a peak in 1981 before declining in 1982, since when they have been little changed. Nevertheless three month interest rates in Switzerland only briefly touched double figures in 1981 and soon fell sharply, back to around 3% by end 1982.

17. In Switzerland government finance is not normally a major influence on changes in the liquidity of the banking system.

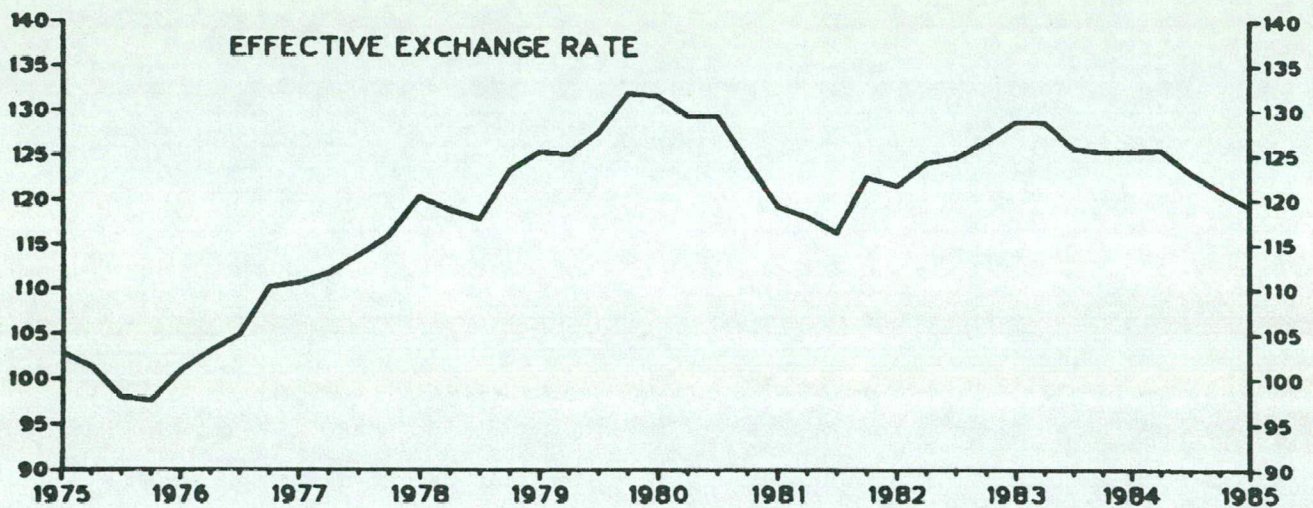
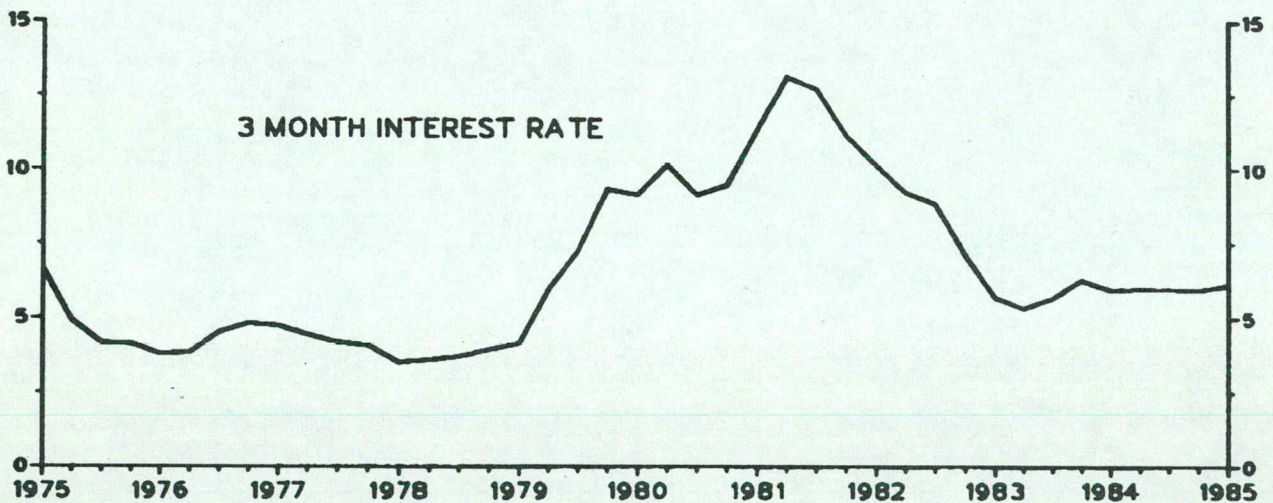
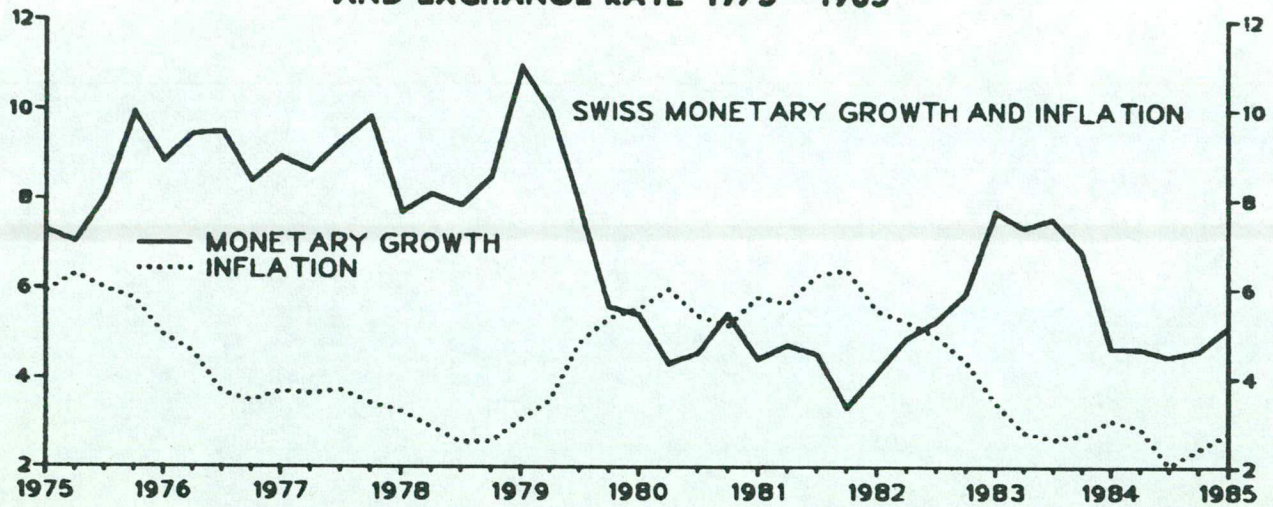
US MONETARY GROWTH, INFLATION, INTEREST RATES AND EXCHANGE RATE 1970 - 1985



GERMAN MONETARY GROWTH, INFLATION, INTEREST RATES AND EXCHANGE RATE 1970 - 1985



SWISS MONETARY GROWTH, INFLATION, INTEREST RATES AND EXCHANGE RATE 1975 - 1985



ANNEX II - TECHNIQUES OF MONETARY CONTROL

1. We have relied on three main instruments for controlling monetary growth: fiscal policy, funding and short-term interest rates. The first two are particularly relevant for controlling broad money. A tighter fiscal policy (ie lower PSBR) or extra funding will, other things remaining equal, reduce the growth of £M3. Over the medium to long term, higher short term interest rates are also likely to have a contractionary impact through their effect on the demand for credit. But in the short-term their effect is very uncertain: higher short rates may result in an increase in interest-bearing bank deposits and hence lead to an increase in £M3. There is no such ambiguity in regard to narrow money. Thus, higher short rates reduce the demand for M0. While the market has often expected an increase in short rates to counter excessive growth in broad money, we have tended to regard short rates as the more relevant for controlling narrow money.

2. Fiscal policy cannot normally be changed in the short-term, and in any case is beyond the scope of this paper. Suffice it to say that, unless fiscal policy is reasonably tight, too much of the burden for controlling monetary growth has to fall on funding and interest rates. Successive MTFS's have recognised this, though - because of PSBR over-runs - actual experience has not matched up to our intentions.

Funding

3. Over the six years 1979/80-1984/85, the PSBR totalled £61 billion and debt sales to NBPS totalled £65 billion. Because of redemptions and sales to the monetary and external sectors, gross sales of debt were of course very much higher - at £96 billion.

4. In one sense, this has been a major achievement. The Bank have sold large amounts of gilts. Improved selling techniques, notably the use of tranchettes, and the introduction of IG's (and their derestriction in 1982) have made a major

contribution. National savings, having been allowed to languish in the 1970's, have also played a major role.

5. One question is whether, for a given level of funding, we are minimising our **funding costs**. Clearly, we have to pay whatever the market requires for any particular instrument. On the whole, we are likely to do better if we offer the market a range of instruments. The issue of convertibles, low coupons and IG's have helped in this way, as have the introduction of new National Savings instruments. Further options are kept fairly continuously under review.

6. An important aspect from a cost point of view is the choice of maturities. Over the three years 1979/80 to 1981/82, about one-third of the new conventional high coupon stocks issued were of maturity up to 10 years. In the last 3 years these shares have been reversed, with just under a third of new issues having a maturity greater than 10 years. (This is partly the result of issuing convertible stocks which at prevailing prices are unlikely to be converted into longs.)

7. **So we have succeeded, to some extent, our policy of keeping out of the long end of the conventional market.** The argument for concentrating on shorts is mainly one of **cost**. Paying double-digit interest rates into the next century is expensive; for assuming over the medium term interest rates fall, it is cheaper to issue short and medium debt and then refinance it. We have also wanted to leave the long-end of the market to the corporate sector.

8. But these factors have had to be balanced by other considerations:

(i) we face exceptionally heavy redemptions in the late 1980's and 1990's. In theory, the redemption monies can be reinvested in gilts; in practice, they often are not - at least in the short term. It has seemed sensible, therefore, to try to avoid too great a bunching of maturities by stretching out the redemption profile to some extent.

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(ii) at times when the gilts programme has been running into difficulty or when we have wanted a big increase in sales, it has been helpful to issue some longs - though normally this has been as part of a tranchette package.

(iii) partly because of our heavy sales in the shorter maturities, the yield curve has more recently exhibited a pronounced downward slope towards the longer end; consequently, the cost argument is now less compelling.

(iv) it is more effective for the control of £M3 to sell gilts to the non-bank private sector rather than to banks or foreigners, who are more interested in the shorter end.

(v) we have come to doubt whether the corporate sector will ever issue long stock on any significant scale again. It now seems that, if the corporate bond market is to revive, it is more likely to do so in the short and medium maturities.

9. Another important question concerns **overfunding** (which is usually defined as the extent to which debt sales to the non-bank private sector exceed the PSBR). On this definition, in three of the past six years we have underfunded. But taking the 6 years together we have overfunded by £3.6 billion, and in each of the past two years overfunding has amounted to £2.5 billion. There is an alternative definition. That is the extent to which the Government finances the PSBR other than by borrowing from the monetary sector - ie. overseas borrowing is also counted as funding. On this definition overfunding over the last 6 years has totalled almost £11bn and has been around £4bn in each of the last 2 years. The chart attached shows that overfunding also has a much longer history.

10. Overfunding has not been part of the Strategy. On the contrary, the Chancellor said in his 1983 Mansion House speech that over the medium term there should be no systematic tendency to over or underfund. On each occasion when we

have looked at it (as for example we did in some depth in the summer of 1982, and again last summer) we have concluded that it would be preferable to keep £M3 on track by other means; and that ideally, over a period, we should be looking to fully fund the PSBR, and no more. But when faced in practice with the choice between overfunding, putting up short-term interest rates or allowing £M3 to grow even faster, we have often chosen the first. In the past six months, we have veered to a policy of keeping short-term interest rates high, but this has not yet done much to curb bank lending.

11. Since the abolition of the corset in 1980, bank lending has grown very rapidly indeed - roughly twice as fast as our targets for £M3. This expansion shows little sign of abating. It is partly explained by the liberalisation and increased competition which followed the removal of the corset. Despite high real interest rates, borrowers have been happy to take on extra debt.

12. The growth of lending to the corporate sector has been particularly puzzling. The company sector's financial position has greatly improved and there has been a strong revival of equity issues in the past few years (and particularly in the past few months). But neither have prevented a continuing fast rise in bank borrowing. We have taken steps to improve the prospects for corporate bonds - for example, the deep discount tax regime announced in 1984 and the new arrangements to allow shorter maturity bonds announced in this year's budget. But although there have been a few bond issues, this has not yet been on a scale to take the pressure off bank borrowing.

13. We have looked at other ways of restraining bank lending. One option - considered in the run-up to the last two budgets - was a modest consumer credit duty, but it would have been ineffective to bring in such a duty without applying it to mortgages as well. Now that we no longer have exchange controls, the reimposition of something like the corset would simply drive business offshore.

14. In the absence of other restraints on bank lending, we have felt obliged to overfund. But several criticisms have been voiced against this policy. These include:

(i) Much of the money lent by the banks - eg that to financial institutions - is not going to be spent on goods and services, but held as a financial asset. It makes little difference to the economy whether a pension fund holds an extra bank deposit or buys some more gilts.

(ii) Funding is no answer to excessive growth of bank lending to the private sector, because credit has an independent influence on the economy. Instead, we should constrain credit.

(iii) Aggressive funding is self-defeating. It raises long rates relative to short rates, further crowding private sector borrowers out of the long term capital market and stimulating the growth of bank borrowing - and thus does not reduce fM3 .

(iv) Overfunding adds to the bill mountain, is costly and complicates monetary management in ways that could inflate fM3 .

15. There may be some truth in all of these. But as regards (i), some part of any extra funding, particularly if it is provided by the personal sector, is likely to be at the expense of spending; and institutions, instead of holding extra bank deposits rather than gilts, may purchase property or foreign assets - both of which could have adverse inflationary consequences. And as regards (ii), it is hard to argue that reducing private sector liquidity has no effect on spending. Both of these arguments in effect question the relevance of fM3 as a target aggregate.

16. There is perhaps more force in argument (iii). By tilting the yield curve in favour of short rates, overfunding may have had some effect in adding to bank lending - rather than "sterilising" a given amount of it. But again

the argument can easily be overstated, and the attraction of overfunding is that, unless this effect were one for one, it will have enabled us to restrain £M3 at lower short term rates than would otherwise have been needed.

17. As regards (iv), it is certainly the case that overfunding has contributed to the need for money market assistance (MMA) and hence to the bill mountain. But it has only been one factor. Thus, between 1979/80 and 1984/85, whereas overfunding totalled $\text{£}3\frac{1}{2}$ billion, MMA increased by $\text{£}16$ billion. In 1984/85 MMA rose by $\text{£}6$ billion, against overfunding of $\text{£}2\frac{1}{2}$ billion. Other main factors have been borrowing by the local authorities and nationalised industries from the banks, increases in notes and coins with the public, and debt sales to the banks. All of these drain liquidity from the system, and the resulting shortages have had to be relieved in order to prevent short-term rates from rising to much higher levels. It is sometimes argued that a "neutral" funding policy would in fact be directed at avoiding any increase in MMA. Over recent years this would have involved consistent underfunding.

18. Although overfunding has not been its only cause, the growing bill mountain raises several issues:

or not as long as they can be

(i) since the public sector is lending short and borrowing long, it may turn out to be costly in terms of debt interest.

(ii) the daily shortages in the money markets are now very large simply on account of bills maturing. This has made the Bank a large purchaser of bills almost every day. At times this has tended to put downward pressure on bill rates, opening up opportunities for "round-tripping". Some "round-tripping" has at times almost certainly been a factor in the growth of bank lending;

do we care?

(iii) the size of the daily shortages, as explained further below, has interfered with the operation of the 1981 arrangements for daily monetary management.

19. Measures being considered for reducing the bill mountain include further encouraging nationalised industries and local authorities to borrow more from central government and less from the banks; and providing part of MMA in other forms, eg through the purchase of export paper from the banks or by making deposits with them. This switch would reduce the quantity of bills held by the Bank and hence also the size of daily shortages.

Short-term interest rates

20. The essence of the money market arrangements introduced in 1981 was that market forces should be given greater scope in determining the level and structure of short-term rates. This was to be achieved by the Bank confining their money market operations as far as possible to buying and selling bills of 0-14 day maturity (bands 1 and 2). The Bank would set the rate at this very short end and it would move within an unpublished 2 per cent band; all other rates would be left to find their own level. There was to be a continued but limited role for discount window lending at published penalty rates. The options, which include the temporary reinstatement of MLR and the so-called 2.30 arrangement, were to be used rarely if and when the authorities wanted to have a decisive effect on rates - resisting or encouraging a rate change as the case might be.

21. In practice, the 1981 arrangements have not been fully implemented for two reasons:

(i) technical - Because of the growing bill mountain the Bank have been buyers of bills almost every day and on a big scale. To take out the large shortages, they have not been able to confine their dealing to the shortest bands; and their dealing rates over the whole range up to three months have been clear to all. This has made changes in dealing rates far less frequent than originally envisaged. Any change in rates has come to be seen as

a signal of a change in the authorities' attitude (and partly for that reason has come to require Ministerial agreement).

(ii) policy - We have been reluctant to accept fully the degree of interest rate flexibility and market influence over base rates which had been envisaged.

22. Nonetheless, the objectives of 1981 have to some extent been achieved.

(i) The official hand in short-term interest rate changes has over the period as a whole been less obvious than it was previously. Market forces have played a bigger role, even though less than envisaged.

(ii) Consequently, interest rate changes have generally had a somewhat lower political profile than previously.

(iii) There has probably been less "bias to delay".

(iv) Interest rates, including base rates, have become more flexible.

23. But even had conditions been as originally envisaged it is doubtful if the arrangements could ever have operated in the way intended. There seems to have been a design fault in the arrangements. As noted earlier, the intention was to confine official operations in the bill market to bands 1 and 2, with these very short term rates acting as a "dragging anchor" on longer term money market rates. But what typically happens when the market is signalling a rise in rates is that the term structure steepens, with longer rates rising, and very short rates (out to 1 month) actually falling. So upward pressure on rates is not always felt at the maturities where the Bank was originally intending to operate. In these circumstances, dealing at unchanged rates would add to, rather than counteract, the upward pressures on longer term rates. So even if we could confine the Bank's dealings to bands 1 and 2, that would probably not be sensible.

24. Any operations by the Bank in the bill market designed to influence the crucial interbank rate are likely to open up differentials between the bill and interbank rates. Take the case when we are trying to push rates down. As long as the differential is not excessive, this leads to a shift from bank finance to bill finance, which takes the pressure off the interbank rate. But if the differential gets too large, there is an incentive to issue bills and redeposit in the interbank market. It is important to avoid this latter "round-tripping", but it should not be assumed that this is always easy when we are trying to influence rates. Even when we are not positively trying to push rates down, the sheer scale of the Bank's daily bill purchases may open up a sizeable differential. In practice there have been many occasions when we believe such round tripping will have been profitable.

25. It is sometimes argued that, because the structure of its rates changes so infrequently, the Bank inhibits moves in the structure of short term market rates; and that this process can lead to arbitrage transactions that inflate £M3. But it is mistaken to suppose that the Bank can, or does, administer the term structure of short-term market rates. Even within the bill market, where the Bank operates directly and on large scale, the structure of rates can often differ very considerably from the structure of rates at which the Bank is prepared to deal. The same is true of the structure in the more important interbank market. The structure of rates at which the Bank is prepared to deal is changed infrequently, and gets out of line with the market structure, for the reason described at the end of paragraph 21(i): any change, even in the structure of dealing rates, has come to have a high profile and to be taken by a "signal" of the authorities' wishes. This rigidity on occasion limits the Bank's ability to deal in bills of some maturities. But it does not "fix" the structure of market rates.

26. It has been suggested by some that we should get back to the pure intentions of 1981. Certainly, it is desirable

to reduce one of the technical impediments - namely, the size of the bill mountain. But on two grounds at least a return to pure 1981 seems questionable:

(i) Short-term interest rates are commonly stated to be one of our main instruments of policy; yet the extent to which we have the technical means of influencing interest rates is not all that great even now. To return to pure 1981 would reduce our influence on interest rates. Certainly operating at longer maturities has given us a much better handle on the 1-3 month rates that have the largest influence in base rate decisions.

(ii) The 1981 papers assumed that the market was likely to produce interest rates that were consistent with the Government's broader objectives. Without denying that market pressures do have some informational content, there was little justification in logic for this assumption. The market can and does at times produce the "wrong" level of interest rates.

27. Nevertheless, there are arguments for permitting short rates to vary more from day to day, as was the original intention in 1981. Two particular points have been made:-

(a) If there were less certainty about the level of short term rates borrowers might be less attracted by bank borrowing, and more by longer term forms of finance. And banks might be less willing to extend loans if they were less sure of their ability to finance them - or at least to do so at an acceptable cost - by bidding for market funds (or by selling commercial bills to the market and ultimately to the Bank).

(b) An arrangement of this kind would provide reassurance that the authorities would not permit the recent growth of broad money aggregates at some point in the future to be converted into cash and spent.

28. Whether any additional reassurance of the kind suggested under (b) is needed is arguable. We already target MO. It is not true to suggest that the Bank are prepared to supply unlimited liquidity to the market at a fixed price. They limit their daily purchases of commercial bills to the quantity calculated as required to prevent an unwarranted contraction in the monetary base or rise in short term rates. If there were signs of the rise in the wider aggregates being converted into an undue increase in MO - or into other forms of narrow money which we also watch - then we would take offsetting action, allowing interest rates to rise. In any event liquidity can be turned into spending without that necessarily requiring a rise in MO or M1. If the concern were about the apparent lack of an automatic mechanism, then arguably the exchange rate is likely to provide one. For any sudden encashment or spending of £M3 balances would almost certainly be reflected also in sharp movements across the exchanges, and a sharp fall in the £ - which would tend of itself quickly to bring about a rise in short term interest rates.

29. There are certainly some arguments for allowing greater variability in - and thereby injecting greater uncertainty about - short term interest rates. But some of the argument in (a) seems overstated. Since banks lend at variable rates they are (unless the maturities of their assets and liabilities are unmatched) protected against a general rise in market rates. In addition to the points in (a), there is also the argument that more uncertainty and variability in overnight rates could make short term currency speculation a more risky operation, and increase the range of weapons available to the authorities to discourage such speculation. Against that, greater variability in short rates would almost certainly mean more frequent movements in base rates. And we would have to accept less influence over their size and timing.

30. The extreme form of arrangement likely to involve greater interest rate flexibility would be a move to some form of monetary base control (mbc), with the Bank following a wholly quantitative operational rule. We have always seen such a move as likely to give rise to considerable transitional

problems. Banks would certainly require greater operational cash balances than they do now, so - unless the aim were to tighten policy - the change would require some increase in the monetary base. But there is no way of telling in advance how large that increase would be. Nor is there any reason to think there would be fixed relationship between that base and the broader measures of money. We have seen simple forms of mbc as likely to lead to sharp fluctuations at least in very short (overnight) interest rates, which would bring institutional changes in their train. Although some of these, such as an end to the overdraft system, might be positively welcome, there would be difficult transitional problems, significantly distorting the monetary indicators. We have always seen such transitional difficulties as ruling out a rapid move to mbc.

31. That leaves the question, if it were desired to make a move in that direction, are there any possibilities short of fully fledged mbc? Could the Bank, for example, simply on occasion operate so as to require the market to borrow from it at penal rates? This would involve operating initially during a day so as to relieve less than the predicted money market shortage (under-assisting), thereby forcing up short term rates and forcing the market to borrow from the Bank at the end of the day.

32. It is perhaps important to emphasise that this would not, or should not, involve regularly under-assisting, by only meeting part of the daily shortage and lending some tranche of daily assistance at a penal rate. That would only be appropriate when - perhaps because MO had been growing fast, or sterling had fallen sharply - we felt that short term rates should rise and that market conditions should be tightened. It is indeed possible that on occasions we would want to over-assist, and seek to push rates down or prevent a rise - though our experience is that trying to prevent a strong upward market move in rates by such tactics is likely to be counter-productive.

33. Like a move to fully fledged mbc, but to a lesser degree, we could face transitional problems with such a change of

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tactics. Banks might wish to increase their reserves of cash somewhat, changing the significance of MO. More generally, more frequent base rate moves might be unsettling to industry. But arguably these effects should not be too sharp if we were to make what at first might be only fairly minor changes in the Bank's operating techniques.

34. While it is not difficult to envisage money market operating techniques being changed in this way, it is perhaps harder to see what operating rule the Bank would follow. With a fully fledged mbc system it is simply a question of operating so as to keep the growth of the monetary base on a predetermined track. Even then there is a question - as is clear from the description of other countries' arrangements in Annex I - of how far to operate on a day-to-day basis, or how far (for example like the Swiss) to try to keep the base on track over a longer period, permitting short-term variations. The latter would not necessarily lead to any great increase in short-term fluctuations in interest rates. In Switzerland the normal variability of very short term interest rates appears little different from in the UK. Had we operated such a rule over the last year, in relation to MO, it is indeed not clear that the Bank would or should have operated in any different way than in fact they did: on this criterion the amount of assistance given to the market has proved about right.

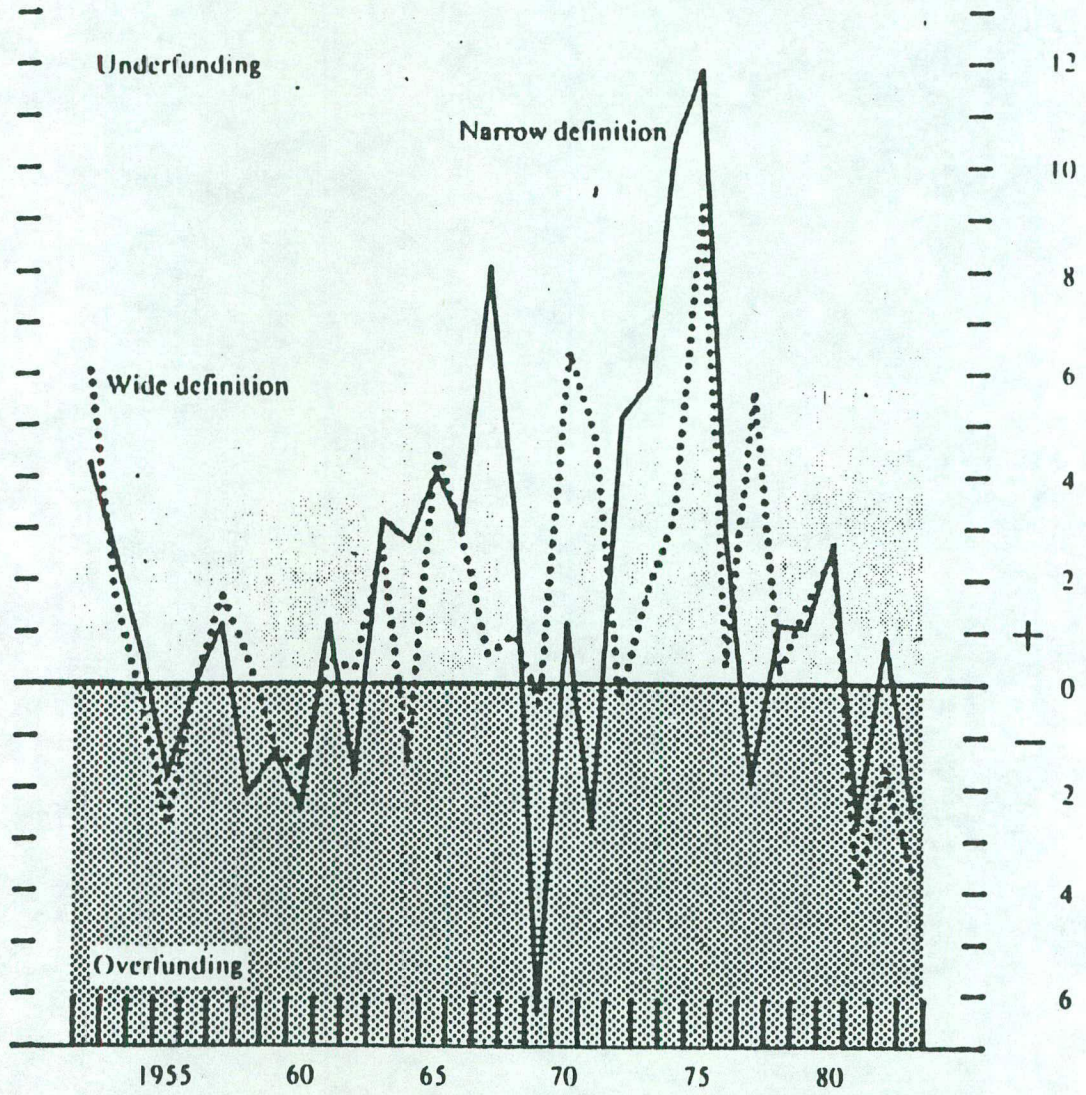
35. The conclusion is that we could, if we wished, bring about more variation in short-term interest rates than hitherto. It would be possible for the Bank to over or under assist the market day by day and lend at penal rates, on occasion, at the end of the day. Before introducing such a change in the Bank's operations it would be desirable to reduce the size of the daily market shortages by measures of the kind described in paragraph 19. There could be some benefits, but against those we might have to accept greater variability in base rates, and less control over their extent and timing than we have exercised recently. No doubt an operational rule for deciding when to under (and when to over) assist could be devised. But

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if the focus were on the trend growth of M0 it is not clear that an operational rule related to that would in fact have caused any greater movement in short-term rates than we have actually seen over the last year or so.

Chart Funding of the PSBR

£ billions, 1982 prices



CHANCELLOR

Rhamax
p-p

There was no problem when we were targetting sterling M3 and using funding to control sterling M3; we chose a definition of funding that was most closely related to sterling M3 (though in practice we stuck with the so-called 'conventional' definition, which in my view, has more to do with DCE - but let that pass).

2. The question is what the no overfunding rule implied. Was it a self-denying ordinance ie we were still interested in the effect of funding on sterling M3, but only up to a point. We took overfunding as a sign that reliance on funding to control sterling M3 had become excessive.

3. Alternatively - and this was certainly in our minds in the presentation to the PM - was no overfunding an attempt to put the lid on, and preferably reduce, the stock of money market assistance? If that was our concern we should - as Terry often points out - have chosen a different definition of funding altogether - actually one that relates to M0. (ie. it derives from the counterparts to M0 as the present rule derives from the £M3 counterparts)

5. We shrank from this because it has the counter-intuitive implication that funding includes all sales of central Government interest bearing debt to the monetary sector (among other things).

5. The first way of looking at things is the most straightforward. If we adopted a target for an aggregate wider than sterling M3 it would make sense to adopt the definition of funding that went with it. That would mean defining funding more narrowly than we do at present with the implication that the no overfunding rule would be (typically) consistent with rather higher gross sales. In practice too it should increase the scope for divergence from what would be required to prevent a rise in the stock of money market assistance - at least in principle. In other words, we now think that the no overfunding rule, on our present definition, is probably consistent with some small trend rise in the stock of money market

assistance; with a definition of funding based on a broader liquidity aggregate, I think there is some presumption that this trend rise would be slightly greater. (I am sure we don't expect G.S. to be as sensitive as I guess nobody has)

6. There are also the presentational issues you raise - the light that a new definition of funding would throw on our past behaviour. These are part and parcel of the presentational difficulty of switching target aggregates at this stage. But I wonder how many people understand the link between the definition of funding and the choice of target aggregate. *Those who do, however, may suspect*

that we are trying to revise them on good resolutions or overlooking
if we move to a definition associated with broader liquidity -
in effect saying that even more gilt sales "don't" count!

RACHEL LOMAX

P.S. By way of clarification, I attach a note which gives a definition of funding. (It is all my hand work on the margin, but it happens to be kept round in my cupboard. It has a few pages of figures, includes some general points.

DEFINITIONS: OVERFUNDING AND MONEY MARKET INFLUENCES**Overfunding**

One way or another, the PSBR is always exactly financed; the attached table (a simplified version of FS table 2.6) shows the range of transactions through which this is achieved. Financing transactions include some changes in financial assets (principally fc. reserves, Bank of England holdings of commercial bills), as well as changes in public sector liabilities. It is sometimes convenient to think of the PSBR as an approximate measure of the change in the National Debt; but the correspondence is not very close in practice, partly because the Debt excludes financial assets, and partly because it is affected by changes in the valuation of fc. debt and the capital uplift on IG's (see BEQB December 1983 for a detailed reconciliation of the CGBR and the change in outstanding debt).

2. Definitions of overfunding focus on some sub-set of financing transactions that are thought to be of special significance. "Funding" is an old term which has acquired new meanings. The Radcliffe Report defined it in the following terms:-

"Throughout the post-war period the dominant motive of the authorities in their management of the debt has been the desire to "fund", ie to lengthen the average life of the securities outstanding. The policy of funding has its roots in earlier ideas about debt management; it was, for instance, designed to protect the Treasury from maturing claims at inconvenient or expensive moments. In recent years, these motives have continued to be present, but the obvious relevance of the structure of the debt to the abnormal liquidity of the economy has led to a more explicit emphasis on funding 'as an aid to monetary control'."

By the time of the Wilson Committee, however, funding had acquired a more precise meaning, as a measure of the finance raised in non-monetary form.

3. The definition of "monetary" financing depends on what is meant by money. The most familiar definitions of funding (and overfunding) implicitly assume that money is the sum of cash in circulation, plus the sterling monetary liabilities of the monetary sector. Any way of financing the PSBR that changes the monetary sector's assets is therefore excluded, (as well as notes and coin issued directly by central Government). In principle, therefore, funding might be defined as below the line financing transactions except the following (which score as "monetary financing"):-

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TABLE A1: FINANCING THE PSBR, 1982-83

£ millions

Liability/held by:	Non-Bank Private Sector	Monetary Sector	Overseas Sector	Total
Notes and coin	1419	-227	14	1206
Bills etc				
- Treasury bills	192	-142	143	193
- Issue Department transactions in commercial bills	787	-	-	787
- export credit paper	-	-	-440	-440
Direct borrowing by central government from overseas	-	-	1699	1699
Other CG debt sales				
- gilts	4455	-136	813	5132
- National Savings	3034	-	-	3034
- tax instruments	837	-16	-	821
- other non-marketable debt	36	-195	-	-159
- net indebtedness to Banking Department	-	-69	-	-69
Local authority debt	-284	-2091	101	-2274
Public corporation debt	20	-520	-266	-766
Total	10496	-3396	2064	9164

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- (i) notes and coin in circulation with the public;
- (ii) monetary sector holdings of public sector debt (including notes and coin);
- (iii) Issue Department transactions in commercial bills. These score as public sector transactions with the non-bank private sector in the attached table. But, to the extent that the monetary sector acts as intermediary, its balance sheet is affected. In this case changes should be treated in the same way as the monetary sector's take-up of Treasury bills. (However, any direct public sector transactions in commercial bills with the non-bank sector would count as "funding", like sales of TB's to non-banks).
- (iv) Issue Department transactions in export credit paper. These score as public sector transactions with the overseas sector but, to the extent that the monetary sector acts as intermediary, they too count as monetary financing.

4. This approach yields the "alternative" definition of overfunding used in the paper. In accounting terms:-

<p>Monetary financing</p> <p style="padding-left: 40px;"><u>equals</u></p> <p>cash in circulation with public</p> <p style="padding-left: 40px;"><u>plus</u></p> <p>monetary sector lending to public sector (ie sector's holdings of cash and public sector debt)</p> <p style="padding-left: 40px;"><u>less</u></p> <p>Issue Department purchases of commercial bills etc from monetary sector.</p>	<p><u>equals</u></p>	<p>Under/over funding</p> <p style="padding-left: 40px;"><u>equals</u></p> <p>PSBR</p> <p style="padding-left: 40px;"><u>less</u></p> <p>sales of public sector debt to UK non-banks</p> <p style="padding-left: 40px;"><u>less</u></p> <p>external finance of the public sector (ie all financing transactions with overseas sector, including changes in reserves, net of fc. borrowing plus overseas take-up of public sector debt and cash).</p>
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These definitions can be seen as a measure of the public sector's contribution to £M3. This is an accounting identity rather than a behavioural relationship. Changes in any of the items can be expected to affect other factors bearing on £M3, and different changes will have different second round effects.

5. On this definition, it makes no difference whether transactions in assets with the non-bank and overseas sectors score as adding to the PSBR, or as financing items. Overfunding would be unaffected by treating sales of BT shares like gilts; or by

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TABLE A2: OVERFUNDING: PUBLIC SECTOR CONTRIBUTION TO PSL2

Financial Years	Over(-)/Underfunding(+) (PSBR <u>less</u> sales of ps debt to non banks less external finance of public sector)	Building Societies' transactions in gilts and LA debt* <u>plus</u> non bank take up of public sector debt included in PSL2(-)	Over(-)/Underfunding(+) (excluding public sector debt in PSL2) col 1 <u>less</u> col 2
1963-64	+ 0.4	+ 0.1	+ 0.3
1964-65	- 0.3	+ 0.2	- 0.5
1965-66	+ 0.8	- 0.1	+ 0.9
1966-67	+ 0.5	- 0.1	+ 0.6
1967-68	+ 0.1	- 0.1	+ 0.2
1968-69	+ 0.2	-	+ 0.2
1969-70	- 0.1	- 0.2	+ 0.1
1970-71	+ 1.5	- 0.3	+ 1.8
1971-72	+ 1.2	- 0.8	+ 2.0
1972-73	-	-0.3	+ 0.3
1973-74	+ 1.6	- 0.6	+ 2.2
1974-75	+ 2.3	- 1.3	+ 3.6
1975-76	+ 4.1	- 2.1	+ 6.2
1976-77	+ 0.2	-	+ 0.2
1977-78	+ 3.2	- 2.8	+ 6.0
1978-79	+ 0.1	- 1.1	+ 1.2
1979-80	+ 1.1	- 0.7	+ 1.8
1980-81	+ 2.1	- 1.8	+ 3.9
1981-82	- 3.6	- 2.2	- 1.4
1982-83	- 1.6	- 2.0	+ 0.4

*Gilts only before 1966-67.

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redefining the PSBR to include changes in fc. reserves. But the definitions are sensitive to the classification of the Issue Department's holdings of the commercial bills. If they appeared above the line (ie. within the PSBR), both underfunding and monetary financing would be higher (though nothing would have changed in the real world).

6. The "conventional" definition of overfunding treats monetary and external finance in the same way: overfunding is the difference between the PSBR and sales of debt to domestic non-banks. It measures the public sector's contribution to DCE, rather than £M3. With a fixed exchange rate and a DCE target, the objective was to influence the external balance (the change in the reserves) rather than the domestic money supply. So it was helpful to focus on the stance of policy before taking account of (endogenous) external flows. This definition is still the most widely used, but it has little relevance under monetary targets and floating exchange rates. (Of course the behavioural consequences of selling debt to non-banks and overseas may be different; but so too are different ways of changing the PSBR and, maybe, of selling different debt instruments to the private sector).

7. This definition of overfunding is clearly sensitive to whether changes in the fc. reserves are included within the PSBR, as well as to the classification of Issue Department purchases of commercial bills.

8. Other definitions of overfunding are relevant to other measures of money. The broader the definition of "money", the narrower the appropriate definition of "funding", and the less chance that a given PSBR will be overfunded. For example, if "money" is widely defined to include all the assets that fall within PSL2, the definition of monetary financing in para 3 has to be enlarged to include:-

- (i) all those public sector liabilities that fall within PSL2 - CTD's, certain DNS instruments, LA temporary debt; (regardless who holds them);
- (ii) sales of public sector debt to other institutions whose liabilities are included in PSL2 - ie building societies.

Table A2 provides a historical series for this measure of overfunding (the public sector's contribution to PSL2). Note that this definition, like the alternative definition, includes external public sector finance in "funding".

Definition of the PSBR

9. As already noted, the behavioural significance of any measure of overfunding depends on its relationship with other factors affecting money. For example, changes in

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overfunding that are largely offset by opposite changes in monetary sector lending to other sectors are of statistical rather than economic interest. This is a general problem. Changes in the PSBR and debt sales will usually have some effect on bank lending. However, changes in the PSBR that reflect changes in public sector net lending to other sectors are particularly likely to lead to an offsetting change in monetary sector lending to other sectors - except in so far as the public sector is prepared to lend on different terms from the monetary sector. An extreme example is the change in the arrangements governing the refinance of fixed rate export credit, which simply shifted the responsibility for financing a given total of credit from the public sector to the banks; this has no effect on banks' balance sheets, but produced equal and opposite changes in overfunding and bank lending to the overseas sectors. (This is discussed further in the main text). Reductions in lending for industrial support could have had similar effects - though there are "real" effects here, since public sector lending is often to bad credit risks.

10. Table A3 abstracts from this hazy area by excluding net lending from the PSBR. On this measure the contrast with the net funding position in the mid 1970's is less pronounced (but still apparent).

TABLE A3: PSBR AND OVER FUNDING, EXCLUDING PUBLIC SECTOR NET LENDING

£ billions

	Overfunding Conventional definition (1)	Public sector Net lending (2)	Overfunding PSBR less net lending* less sales of debt to non-banks (1) less (2)
1971/72	-0.7	+0.5	-1.2
1972/73	+1.4	+0.7	+0.7
1973/74	+1.7	+0.9	+0.8
1974/75	+3.8	+1.9	+1.9
1975/76	+5.3	+1.8	+3.5
1976/77	+1.3	+1.2	+0.1
1977/78	-1.1	-0.3	-0.8
1978/79	+0.7	+0.8	-0.1
1979/80	+0.7	+0.2	+0.5
1980/81	+2.3	+0.4	+1.9
1981/82	-2.5	+1.0	-3.5
1982/83	+0.9	+0.9	-
estimate 1983/84	-2.9	-	-2.9
forecast 1984/85	-1.2	+0.6	-1.8
1985/86	-1.0	+0.4	-1.4
1986/87	-	+0.4	-0.4
1987/88	-	+0.3	-0.3
1988/89	-0.9	+0.3	-1.2

*Net lending is shown in F.S table 2.3, and defined on p 33 of the F.S Explanatory handbook.

Money market influences

11. At the end of the day, the surpluses and deficits of all sectors must be exactly financed. Every sector has a means of meeting its residual financing needs. The banking system is typically the residual source of finance for the non-bank private sector; immediate borrowing needs that have not been met in other ways are financed by running down bank deposits, or drawing on overdraft facilities. These options are open to L A's and PC's too; or they can use central Government facilities (eg NLF deposits). The Bank of England acts as the residual source of finance for the monetary sector; and the monetary sector performs the same function for central Government. The Bank's day to

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day operations in the money markets are therefore the point at which the system is closed, and imbalances in the supply and demand for funds are finally resolved.

12. While CG and the monetary sector are the "front line" agents, it is important to recognise that their need for residual finance reflects their transactions with other sectors. In particular, the money market position will be affected by the extent to which CG and the monetary sector act as intermediaries for other sectors. Money market influences are usually analysed in terms of the financing of the CGBR; but at the cost of some additional complexity, it is equally possible to relate them to the financing of the PSBR.

13. The ultimate residual is the banking system's deposits with the Bank of England. Under present arrangements, however, they only perform this function in the very short term. The Bank normally aims to reconcile the ex ante supply of cash resulting from all CG transactions with the private sector's demand for cash, by buying and selling bills (and from time to time other instruments).

14. The analysis of money market influences in this paper is intended to explain the factors determining the size of these residual financing transactions. These fall into three broad categories:-

- (i) the CG's need for funds - this includes the CGBR and the change in the fc. reserves;
- (ii) the supply of funds to CG resulting from more discretionary debt management operations, ie total sales of CG debt to all sectors, excluding transactions in bills with the monetary sector;
- (iii) the private sector's demand for cash. This is dominated by the public's demand for notes and coin. But changes in the target level of operational balances, or the desired level of till money, should also be taken into account.

15. In practice, it is difficult to draw hard and fast lines on the basis of actual transactions. Not all monetary sector transactions in TB's may reflect liquidity operations; and residual financing may sometimes be achieved by transactions in other public sector paper. The definitions underlying table 2 of the main paper ignore this complication; monetary sector purchases of gilts are treated as a money market influence, while all transactions in bills score below the line as operations. Equally, it is difficult to distinguish between changes in bankers' balances that reflect a change in the banks demand for cash, and those that are "financing" transactions. On the definitions

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used here, bankers' balances are treated as a financing item, rather than a money market influence (which is why they do not appear in table 2); this is certainly an over simplification, but given the scale of the annual changes involved, not one that is likely to seriously distort the main message of the table.

16. These definitions are relevant to changes in the net stock of assistance. This may bear little relation to the volume of transactions needed to relieve money market shortages from day to day, which also reflect the need to refinance maturing bills. If most of the commercial bills in the system are held by the Bank, maturities will create a persistent bias towards money market shortages. Equally, however, if the banking system held large volumes of Treasury bills, maturities would tend to produce surpluses, and the Bank would have to deal heavily from day to day simply to mop them up. The scale of the Bank's dealing activities, therefore, reflects the size of the existing stock of bills, and its distribution between the authorities and the monetary sector, as well as the influences that determine the change in the outstanding stock.