

PREM 19/179

Domestic Monetary Policy

ECONOMIC POLICY

Part 5

Part 1 : May 1979

Part 5 : September 19

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
1.10.80							
13.10.80							
14.10.80							
16.10.80							
20.10.80							
23.10.80							
28.10.80							
<p>PREM 19/179</p>							
<p><i>ans</i></p>							

PART 5 ends:-

On Ex to Governor Bukor Eng

28.10.80

PART 6 begins:-

HMT to T

31.10.80

cc: Financial Secretary
Sir D Wass
Mr Ryrie
Mr Middleton
Mr Pirie o/r
Mr Mountfield
Mr Gilbert - DNS
Mr Monck
Mr Ward



OCT 1980

~~PPS PL~~

2

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

Domic

28 October 1980

*You raised
his point
about the
banks selling
granny bonds.*

The Rt. Hon. Gordon Richardson, MBE
Governor,
Bank of England,
LONDON. E.C.2

MS

Gordon

*D...
3/4*

NEW DRIVE FOR PERSONAL SAVINGS: ROLE OF THE CLEARING BANKS

Knowing the importance which you attach to the new drive to increase the flow of personal sector savings into the funding of the PSBR, I would like to ask your help on one aspect of this where the clearing banks are involved.

As you know the banks are an important outlet for sales of National Savings Certificates with something like one-third of sales coming this way. They do not however sell Retirement Issue ("Granny Bonds"). The Department for National Savings have for some time been in discussion with the banks over the fees the banks receive by way of commission on such sales because the banks have expressed themselves very dissatisfied with the rate they receive. This dissatisfaction has led the banks to hint that they might cease selling National Savings altogether, though there was also at one point a hint that the banks might be interested in selling the new 2nd Index Linked Issue, which is to be launched on 17 November.

The banks have recently received an offer from the Department to pay a fee of 25p a £100 of sales, which whilst double the existing rate is still considerably lower than the rate the banks appear to want. (The question of commissions has a very tangled history extending over many years but we felt that as the fees

/are



are ad valorem a doubling of the rate was as far as we could go.) The banks are probably in something of a dilemma here and I think that in such circumstances they might well be prepared to respond to an appeal coming from you to settle on the basis of the recent offer and to participate also in what we all hope will be a high volume of business when the 2nd index linked issue is put on sale.

A handwritten signature, possibly "John", is written in cursive. Above it is a large, stylized scribble consisting of several horizontal and vertical lines.

GEOFFREY HOWE

28 OCT 1980



1. When will you reduce MLR?

pa - monetary policy
file *Econ Pol*

EITHER I dislike high interest rates as much as anybody. But to reduce MLR while borrowing by the public and private sectors is still running at a high level would all too likely add to the money supply. More printing of money would put off the expected fall in inflation, and postpone the economic recovery which all on this side of the House are determined to bring about.

OR I am all too well aware of the heavy burden that the present high level of interest rates is placing on industry. But when borrowing by the public and private sectors continues at a high level - partly to finance pay settlements the country could not afford - there is no real alternative if we are to keep the money supply under control. If Members opposite are saying we should ignore the money supply, they are telling us to ignore inflation and to throw away any prospect of economic recovery.

2. But isn't the money supply out of control anyway?

No. The underlying growth rate of the money supply in recent months has been too high. But we expect a significant falling off in the rate of growth in the second half of the year. We for our part have to ensure that government borrowing remains under control. That is why we intend to do all we can to stick to the planning totals in the last public expenditure White Paper and to get down the cost of public spending. The higher spending advocated by the Opposition would simply add to our borrowing; and this would mean still higher interest rates or more printing of money and more inflation.

3. Why try to reduce the PSBR at a time of recession?

If we fail to keep public sector borrowing under control, interest rates will continue at a high level with all that that means for industry.

4. Why are you cutting public expenditure?

We are not trying to cut public spending in total. What we are doing is trying to adjust certain programmes to pay for the extra money that will be needed for others. Our intention is to stick to the totals in the public expenditure White Paper for this year and next.

5. Why can't you get the money supply down as Mr. Healey did in 1975 with a higher PSBR and lower interest rates?

In 1975, unlike now, bank lending to the private sector was actually negative. Industry was able to keep going - partly because sterling was depreciating so fast - without recourse to the banks. So the total demand for credit in the economy was much lower than it is today.

PRIME MINISTER

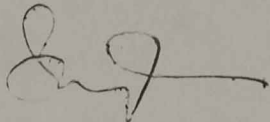
cc. Mr. Wolfson
Mr. Lankester
Mr. Vereker

Dean Pen

12

Monetary Policy

You may care to see the attached leading article from the current issue of the Banker.



B. INGHAM

23 October, 1980

Monetarism is never easy

The budget which Sir Geoffrey Howe introduced in March marked a watershed in the making of monetary and fiscal policy in the United Kingdom. For the first time a government committed itself to a financial and monetary strategy over the medium run. By publishing a series of target ranges for the growth in the money stock for four years ahead, culminating in one centring around 6 per cent in 1983-84, together with projections of government spending and revenue which it thought would be compatible with those objectives, it demonstrated that it was nailing its colours to an over-riding and sustained attack on inflation.

Not only was the government saying that it would deny itself the policy flexibility which governments normally practice, such as the possibility of accommodating inflationary pressures by expanding the money stock or of countering recession by actively increasing public borrowing. It was, above all, trying to make unmistakably clear that it meant to carry out its programme. Because every single one of its predecessors since the 1940s had initiated a programme of restraint only to abandon it after a year or so, the credibility of this new approach has not been easy to establish. Its value as a signal would, however, vanish overnight if it were to be discarded or fudged the first time the going became tough a bare six months later.

The going has suddenly become tougher, certainly. Even after allowing for all the distorting factors—bank re-intermediation following the end of the corset, involuntary borrowing by the corporate sector as the recession bites, the rebuilding of gilt positions by the banks, and the humped pattern of public sector borrowing in the early quarters of the fiscal year—the wider measures of the money supply have all been running uncomfortably high since the spring. Because public sector borrowing is still high, too, the financial squeeze appears to be exclusively concentrated upon the corporate sector, already reeling from the onset of recession at home and abroad, and a challenging export exchange rate.

The contradictory chorus of yelps and yaboos this has generated was perhaps to be expected. It is said, on the one hand, that monetarism has fallen at the first fence. A monetarist government cannot even control the money supply. On the other—and

this is the contradiction—the financial squeeze is gratuitously excessive. Interest rates should be cut before industry is ground into bankruptcy.

This last complaint should not be taken at its face value. Real interest rates in Britain are only moderately positive, far less so than, for example, in Germany. Their contribution to industrial costs cannot be compared with the influence of pay settlements. A reduction, moreover, may have a dramatic effect on the exchange rate only if it destroys foreign confidence in the firmness of the government's counter-inflationary stance.

Ministerial mistakes

On the other hand Ministers have certainly made mistakes. An earlier removal of the corset would have been useful. A deferment of the 1979 cut in direct taxation might have made it easier to reconcile the stance of fiscal and monetary policies. Above all, having abandoned one set of quantitative controls over money supply and thrown open for debate the question of having an alternative, the government then made the big mistake of refusing to let interest rates rise to market clearing levels. Nevertheless, the government should persist. Already the inflation rate is abating palpably more quickly than even sanguine observers had expected. So, too, are pay settlements in the private sector. If the credibility of the government's intentions is to be established, if the signal is to come through, it must hold fast.

This means resisting the political temptation to cut interest rates prematurely. Rather they should be kept up until the measures of the growth of money supply and domestic credit are running clearly within or preferably towards the bottom of this year's 7 to 11 per cent target range. Likewise, the government should eschew base drift that is sweeping aside the present excess in the money supply by re-basing the target when it is rolled forward. It must ensure that pay settlements in its own sector this winter are no higher than in the private sector. And if recession saps public revenue and increases spending it must take corrective action rather than write off a bigger deficit as a stabilisation measure.

A sharp but short recession is a better risk to face than a failure to break inflation psychology.

The hardest
You should see this
contribution by Gordon Clough
PA
24
ho

LORD LEVER - INTERVIEW ON PROFESSOR FRIEDMAN'S CRITICISM OF
TREASURY AND BANK OF ENGLAND

Transcript from BBC Radio 4, World at One, 20 October 1980

INTERVIEWER : In the World this Weekend yesterday Professor Milton Friedman, the high priest of monetarism, attacked the way the British Government's monetary policy is working. More precisely, he said that the Bank of England had got its procedures for controlling the money supply wrong. And it was clear that the people at the Bank, whom he claimed had written the Government's Green Paper on the subject, simply hadn't read enough on monetary control. Professor Friedman may well find a sympathiser on this ~~dx~~ score on Mrs Thatcher, who is rumoured to be displeased with the Bank and Sir Gordon Richards, the Governor, in particular. Professor Friedman told Gordon Clough it was the bureaucracy that was to blame:

FRIEDMAN: The hardest task for any new Government is to get control of the bureaucracy. Every country, whether it be Britain, or Sweden, or the United States, or whatever country you ~~wish~~ name, is really run on a day to day basis by the civil services. They have in their hands the instruments of control, they know all the details. And the execution of policy must be carried out by them. Now if I look at the Green Paper on monetary growth that was issued under the name of the Chancellor of the Exchequer, but actually written by the Bank of England, if that Paper had been handed into me by a student of mine, as a student exercise I would have failed it. it was an incompetent piece of work.

GORDON CLOUGH Failed it, not even ^{given} ~~given~~ it a gamma ~~data~~?

FRIEDMAN : I don't know your system of scoring, I would have sent it back to re~~write~~ it."

INTERVIEWER : (Brian Widlake) ... Well I've been speaking to Lord Lever, better known to you perhaps as Harold Lever who was Financial Secretary to the Treasury in the Wilson Government. And I asked him if he agreed with Professor Friedman's views?

LEVER: I do not agree with that. I think that when the policy is decided the Bank of England and the Treasury will do their best to make it effective. It is inevitable of course that they will have strong ~~fx~~ views about how that may be done, and there'll be much argument about it. Nobody suggests they're perfect. But there's nothing ^{wrong} with the Treasury and the Bank of England in terms of efficiency and the ability to perform its tasks - I mean I'm not saying it's perfect but it's of a very high standard. What's wrong is that the policies are not necessarily policies to produce the results that were hoped for. And it's very ~~not~~ natural, if you set about on a policy decision which has got a basic flaws, that complaints will arise about the enthusiasm in its execution. Milton Friedman's criticisms are based upon the assumptions that 1) monetary policy is the ~~heart~~ ^{heart} of economic management - whereas in my view it's an ancillary matter which has to be carefully managed and looked at; the second assumption (which is faulty) is that there are alternative means of managing the money supply which would produce better more favourable results, which are surer, more erudite, and generally more attractive than the one used by the Bank of England and the Treasury.

INTERVIEWER : But would you agree with ~~xxx~~ him that the Bank of England has made a mess of it?

LEVER: No. If you mean by made a mess of it that the Bank of England has ineffectively operated the right policy, no certainly not. The Bank of England have, within the knowledge of the statistics

we have available, acted efficiently and effectively. But unfortunately the policy (and the instrument), the policy is somewhat amiss with its obsession with monetary growth; and the instruments available for giving effect to that obsession are fragile and not dependable.

INTERVIEWER : Now Professor Friedman ^{criticized} ~~criticized~~ the Bank of England on the grounds that they believe that the only way to control the money supply is through fiscal policy and interest rates. And he said they've got that wrong, what you've got to do is to control the monetary base itself. And then you don't have to worry about interest rates because they will in fact come down if monetary growth is contained?

LEVER: That is a pure speculative assertion by Milton Friedman.

And he's not without the habit of making confident and speculative assertions on inadequate data. . For example, monetary policy is entirely (in part) inspired by the notion that public expenditure is too high and it imposes a burden on private industry. . And if you act unselectively, simply fascinated and obsessed by monetary aggregates, you cannot help private industry in relation to public enterprise. And in the case of the nationalised industries, for example - to oversimplify, two main methods were used. ¹ One was to force them to put up their prices, and the second was to cut down on capital expenditure. And both of these impose enormous burdens on private enterprise. When you tell the Post Office, the gas and electricity industries, they've got to put up their prices the burden is shifted to the private sector. Equally, when you ~~put~~ when you put simplistic unselective cash limits on public enterprise you tend to have capital expenditure cut, and that abruptly disrupts the expectations of those whose business it has been to supply those capital expenditures. .

Apart from the more general ^{question} ~~ques~~-tion, since the great central weakness of our economy is that we're not investing enough, you've got another secondary adverse consequence opposite to that you intend.

INTERVIEWER : Do you believe that if we continue remorselessly on our present course that there will be even more bankruptcies in the private sector and more rising unemployment?

LEVER: Yes. I also ought to tell you that I do not believe that we can continue remorselessly on our present course. One of the things I lament about the public political debate is that the question of modifying the policies has now turned into something that is reprehensible, a contemptible and cowardly U turn. Whereas in fact my whole case is that any sensible application of monetary and other economic policies must be a humble one, always ready to modify, always ready to accept that the lessons of events case you to change or modify your preconceived ideas. And it's lamentable that we're getting to a state of affairs where both parties treat it as axiomatic that if the Government modifies its policy it will represent a defeat for them and a triumph for their critics. Nothing could be more harmful to public debate and to public policy.

HS

~~W. J. 26/10/80~~
you may wish
to note P 26/10

Kevin P. d.

16 October 1980

The Prime Minister has asked me to thank you very much for your letter of 8 October. She was most grateful for the paper which you enclosed with it: she found it extremely helpful.

TIM LANKESTER

Professor Brian Griffiths

HS



10 DOWNING STREET

From the Private Secretary

14 October 1980

Dear Tom,

As you know, the Prime Minister held a meeting yesterday afternoon to discuss domestic monetary policy and control. The following were present: the Chancellor of the Exchequer, Chief Secretary, Financial Secretary, Sir Douglas Wass, Mr. Burns, Mr. Middleton; the Governor and Deputy Governor of the Bank of England, Mr. George and Mr. Goodhart; Sir Robert Armstrong, Mr. Ibbs, Mr. Hoskyns, Mr. Wolfson and Mr. Whitmore. They had before them a series of papers from the Treasury (listed in the Chancellor's minute of 10 October), and a paper from the Bank (which the Governor sent over under cover of his letter of 10 October).

Referring to the Bank's paper, the Governor first described recent monetary developments as he saw them. Recent developments gave rise to considerable anxiety. The underlying growth of £M3 after allowing for the unwinding of the corset had accelerated in the late spring and summer to well outside the target range. The reasons for this were, firstly, the very high PSBR -- which had been running at an annual rate of about £15 billion in the first half of the financial year. This had proved beyond the authorities' funding capacity, even though gilt sales to domestic non-banks had been very substantial. The Bank had hoped that the high PSBR in the first few months would be offset by lower figures in the second half of the financial year so that the Budget forecast was achieved. But it now seemed likely that, even though there should be lower figures from now on, the PSBR for the year would turn out at about $\text{£10}\frac{1}{2}$ billion. Secondly, external factors had turned positive as the current account had moved into surplus. Thirdly, lending to the private sector had continued on a heavy scale - reflecting the size of the company sector deficit and the absence of alternative sources of finance.

On the other hand, there was some cause for comfort in that there was a reasonable prospect that the growth rate of underlying £M3 over the present target period would come back to around 12 per cent by next April. Furthermore, the markets had accepted the recent high figures relatively calmly. There was also a great deal of evidence that - despite the figures - monetary policy had been and remained very restrictive. This was reflected particularly in the high exchange rate, the improvement in inflation, and the decline in company profits and in output and in employment. Wage increases over the last pay round had not been validated by monetary

/ expansion, and

SECRET

SECRET
file LPO/HRJ/VB
Rien for
bc Mr Hoskyns
Mr Wolfson
Mr Vereker
Mr Ingham
Master set
5

SECRET

- 2 -

expansion, and this was reflected in the large financial imbalances between the corporate and personal sectors. By the same token, one of the reasons why £M3 had over-shot was the intermediation by the banks between the corporate and personal sectors.

The Governor said that he drew the following lessons from this recent experience. First, it threw some doubt on the suitability of £M3 as the appropriate target. While it had advantages conceptually, it was very difficult to control in the short run. Alternative aggregates had their own drawbacks; but it would be desirable in future not to focus too much on the one aggregate. Secondly, attempts to control the money supply in the very short term were not only unlikely to work, but were also not of the essence of successful monetary control. Third, from the recent experience of the corset, he was deeply sceptical of the value of direct controls.

Turning to the immediate situation and prospect and the policy choices facing the Government, the Governor said there seemed to be very little room for manoeuvre. On the one hand, £M3 was likely to rise fairly rapidly up to the end of the calendar year - possibly by 2½ per cent in the final quarter; and the growth of £M3 would only come back to around 12 per cent by April if the PSBR was substantially lower than so far. For 1981/82, the PSBR was forecast at £11¼ billion and this meant that continuing moderate growth of £M3 would depend on a high level of debt sales, continued high interest rates, and lower lending to the private sector. On the other hand, the Bank's forecast for the real economy was extremely pessimistic - and more pessimistic than the Treasury's. The recession was likely to intensify and continue into 1982. Their forecast of unemployment - though inevitably uncertain - showed a rise to nearly 3 million by end 1982. Because of our industry's loss of competitiveness, recovery in the UK looked far less certain than in other countries. The Bank had just completed their latest review of the industrial situation. From this it appeared that the corporate deficit was not as large as it had been in 1974; but in contrast, it was likely to continue at a high level. Profitability was at an appallingly low level: although pre-tax rates of return had fallen in all countries, in the UK it was only about half of what it was elsewhere. The Prime Minister would want to hear the views of the Department of Industry; but in the Bank's view, while collapse was not imminent, there was likely to be a continuing slide. So far industrial closures had largely taken place where, because of inefficiency, they should be happening anyway. But there was now a dangerous over-hang in terms of short-time working, and a serious risk that well-managed capacity would start to close down. Admittedly, in some cases capacity was being taken over by new managers; but in other areas there was a danger that the UK would lose industrial capacity altogether.

All of this posed a difficult policy dilemma. The problem was to preserve the effectiveness of the monetary strategy at a time when there ought to be easing of the disproportionate burden being carried by industry. These countervailing considerations would have to be faced up to in deciding the £M3 roll-over (although an immediate decision was not required). From the standpoint of the anti-inflation strategy, it was clearly important to continue with a low target. At the same time, the target must be credible: there must be a conviction that the target could be achieved without imposing intolerable strains on the system. In his view, for the

SECRET

/sake of the

sake of the corporate sector, there would have to be some reduction in interest rates; but it was questionable whether this could be reconciled with sticking to the figures in the medium-term financial strategy (MTFS). The Bank's fear was that, with the corporate deficit in prospect, the pressure on bank lending would remain high; and in these circumstances, for the existing medium-term targets to be achieved could require even higher interest rates. It was because of continued horrowing pressure up to now that the Bank had felt obliged to ease the clearers' liquidity; otherwise, interest rates would certainly have risen further.

The Governor went on to say that in order to make the MTFS at all feasible while at the same time easing the pressure on the corporate sector, the following actions were desirable. First, the PSBR had to be reduced - though this would need to be done in ways which would not further hurt the private sector. The private sector would benefit especially if public expenditure could be held back by moderate pay settlements in the public sector. Secondly, there needed to be some switching of resources from the personal and financial and oil sectors to the manufacturing sector. For example, greater attempts should be made to encourage long-term company borrowing: in order to re-activate the corporate bond market, the Bank had suggested an interest rate subsidy. Thirdly, further measures should be taken to encourage private savings into Government debt. The recent extension of "Granny Bonds" was a useful start, but this needed to be followed up.

Finally, the Governor summarised very briefly the Bank's views on the monetary base control (MBC) proposals. While there were theoretical attractions in some of the proposals, no one could ignore the practical difficulty that - if MBC or a variant of it were to be introduced now - interest rates would undoubtedly have to rise. This would put further pressure on the exchange rate and add to the pressure on industry. It was hard to see how this would be an appropriate response to the present conjuncture. Indeed, if it was decided on industrial grounds that interest rates should be reduced, this could only be achieved by an administered reduction. The critics of the present system argued that the money supply could not be controlled unless interest rates went up. The Bank's response to them was that, provided the fiscal balance was right, the present system was capable of producing a satisfactory £M3 profile.

The Chancellor said that he agreed with the Governor's basic diagnosis of recent developments and the immediate prospect. He also understood the Governor's concern about the pressures on industry. The question the Government had to face was whether to relax the monetary strategy in order to provide some relief to industry, or whether this would simply increase inflation and postpone long term recovery. He agreed that there would be increasing pressure on the Government to reduce interest rates. But if even the 12 per cent forecast for monetary growth up to April 1981 was to be achieved, it was doubtful whether any

/reduction

SECRET

-4-

reduction could be justified; or at any rate, there would be significant risks. It was also clear that fiscal action would be needed to bring down the PSBR in 1981/82 and to switch funds from the personal to the corporate sector. There would have to be further public expenditure cuts, and it was crucial that the pay element in expenditure should be kept down. On the revenue side, he was reviewing the North Sea tax regime and considering the possibilities for raising money from the personal sector - for example by increasing the employee national insurance contribution and the national health contribution. In addition, he was considering what could be done for the corporate sector - either by way of tax relief or by encouraging the reactivation of the bond market. Keeping to the existing monetary targets could also be eased by encouraging the sale of more debt direct to persons. The Chancellor said that he was also concerned about the effect of the exchange rate on industry. But short of intervention on a major scale, the exchange rate seemed more difficult to influence than any other variable. It was quite possible that a fall in interest rates would not have much effect. Moreover, the further Treasury work on inflow controls persuaded him that they were unlikely to have much effect either - though he would not rule out altogether some inflow control measure if only for presentational reasons.

As for monetary control, the Chancellor said that he would be hesitant about making the major institutional change to MBC at the present time but there were several changes which could, and should, be introduced to improve the present system - and which would be consistent with a move to MBC if it was eventually decided that that was our objective. The following steps were needed:-

- (a) The PSBR needed to be smoother. The Treasury were urgently considering this.
- (b) More debt needed to be sold direct to persons. This meant the extension of "Granny Bonds" and national savings. The Treasury were looking at all the possibilities, though there would be risks to the building societies and staff costs for the Department of National Savings.
- (c) Work on the restricted indexed gilt should be pressed forward.
- (d) New methods of marketing debt needed to be looked at. It was crucial to improve the present system so that the authorities could sell debt when they needed to, and so as to avoid having to make big changes in the price of gilts. It would be helpful if the Bank could produce early proposals for selling the desired quantity of debt as the need arises.

/(e)

SECRET

- (e) The Reserve Asset Ratio (RAR) should be abolished and, if considered desirable, replaced by something more appropriate. This was already an agreed recommendation in the Green Paper on monetary control; it was necessary now for the Bank to carry the recommendation forward. One of the advantages of abolishing the RAR would be that Treasury bills would lose their reserve asset status and this would increase the range of debt instruments available to be sold to the public.
- (f) The Lender of Last Resort (LLR) function of the Bank needed to be modified. The present system did not engage the banks in curtailing the rate of monetary growth: on the contrary, they benefited from seeing their lending expand, and by in effect acting as "Lender of First Resort" the Bank were accommodating this. At least, the Bank ought urgently to consider ways of making the LLR function less as a matter of course.

The discussion which followed focussed on the monetary control issues. The Prime Minister said that the present system was plainly not working adequately and that it had to be improved. She was most concerned about the apparent loss of control of the monetary aggregates over the summer, which could put at risk the Government's anti-inflation strategy. She was keen to pursue each of the six proposals mentioned by the Chancellor. In view of the recent distortions caused by the corset, she also wondered whether our monetary statistics were adequate. The Chief Secretary commented that the fundamental problem was excessive spending and an excessive PSBR: he did not think changes in technique, however desirable, were likely to have much effect.

In response to the statistics point, it was noted the abolition of the corset would itself result in an improvement in the quality of the statistics: it was partly because the corset had so distorted M3 figures that it had been abolished. But there would still remain the problem of Euro-sterling lending: the statistics for this were patchy and delayed. As regards the Chancellor's proposals, the following points were made:

- (a) Smooth the PSBR. Achieving this would be by no means easy, but certain improvements could almost certainly be made. The Treasury Working Party would, if possible, produce a paper within a month.
- (b) Selling more debt to persons. The most hopeful prospect was extending the "Granny Bond" to other age ranges. About £1½ billion was expected from the existing "Granny Bond"; if the further work was to be pushed ahead fast, additional funds could be secured for the current financial year. Commenting on the question of DNS staffing, the Prime Minister said that - if necessary - they would have to be provided with extra staff notwithstanding the Civil Service manpower cuts exercise. She also suggested that the banks should be encouraged to sell "Granny Bonds".

- (c) Restricted Indexed Gilt. The proposal was to restrict this to the pension funds and possibly to the life offices. The Bank were working on a prospectus.
- (d) New methods of marketing debt. The Governor said it was a mistake to believe that debt sales could only be achieved with changes in MLR: huge gilt sales had been achieved over the last year when MLR had only moved down one point. Moreover, if, as the Treasury were arguing, the authorities were to go for debt sales when needed, interest rates would be bound to fluctuate more - and borrowing become more expensive. Sir Douglas Wass commented that this question had been debated over a long period. The problem which they had to address was: how to sell Government debt when there was a "buyers strike" or inadequate sales to meet a particular borrowing requirement. The Treasury had offered various suggestions: one possibility was to market gilts by varying their relative yield, another would be to move towards auctioning on the US pattern. Against this, it was argued that, as long as the PSBR continued to fluctuate, a move to the US system would significantly add to the cost of borrowing. Unless the forecasts of borrowing were improved, an auction system could also lead to inadequate funding. The Prime Minister said that, despite the alleged problems of changing the present methods of marketing, she would like to have some concrete proposals from the Bank of what could be done to enable the authorities to sell debt according to need. This work would have to be associated with work on proposal (e): for the chance of a pre-determined programme of gilt sales under an auction system inflating the money supply would be lessened if Treasury bills lost their reserve asset status and thereby became less attractive to the banks.
- (e) Abolish the Reserve Asset Ratio. One possibility was not to replace the RAR with anything, but to extend the 1½% cash requirement to the whole banking system. The new cash ratio could be defined so that it could be used in an MBC system if it was decided to move in that direction. There was also the related prudential issue on which the Bank were working. The Prime Minister said she would like the Bank to prepare an early paper on this whole subject.
- (f) Modify Lender of Last Resort. It was argued that, although interest rates might rise in the short-term, the lending activities of the banks might be more likely to respond in a helpful way than under the present system; for they would have a positive incentive to hold back lending. The Prime Minister said that she would like the Bank to work up some operational proposals drawing on the Treasury's proposals in their paper on monetary control.

Summing up this part of the discussion, the Prime Minister said she would like the further work on the Chancellor's proposals which she had commissioned from the Bank to be completed in time for a further meeting in about a month's time.

/The discussion then

The discussion then turned to the monetary policy issues. Mr. Burns said that, in his view, a reduction in interest rates in the next few months would not be justifiable as long as the Government was trying to restrict monetary growth to no more than the forecast - i.e. 12 per cent up to next April. But there was no certainty about the forecast, and it was just possible that a fall in interest rates would be compatible if positive expectations allowed the authorities to sell gilts on a large scale. From an industrial standpoint, an interest rate reduction would clearly be desirable: the current squeeze on the corporate sector was indeed very tight. Mr. Middleton added that if MLR was reduced in the next few months, the monetary target might be more or less achieved for 1980/81; but it would restrict the Chancellor's room for manoeuvre in the Budget because lower interest rates certainly meant a more relaxed monetary stance in the longer term. Sir Douglas Wass commented that if - for example - Ministers were to decide to reduce MLR in November the markets might assume that the Government had the money supply under control. But one month's bad figures following could cause great difficulty, and even require an increase in interest rates again. Thus, there were considerable economic and political risks in going down this route. The Chancellor said that he doubted whether an MLR reduction could be justified on monetary grounds. But it might be necessary - on political grounds and in order to persuade colleagues to further cut public expenditure - to take the risk. The Governor said that he did not think that a continuation of the present high level of interest rates, as the Treasury papers seemed to be assuming, would be credible against the current industrial situation.

In further discussion, it was argued that the Government must do everything possible to ease interest rates while sticking to the monetary strategy by reducing public expenditure and the PSBR. It would be easier to justify an MLR cut if the Government were to take a tough line on public sector pay; anything that could be done to reduce the nationalised industries' call on funds would also help.

As regards the exchange rate, Mr. Ibbs argued that the extent of the damage being caused by it was still not being fully appreciated in industry. The risks of taking action to push the rate down needed to be set against the industrial risks of allowing it to stay at its present level. The Chancellor said that industry had unrealistic expectations of the possibility of getting interest rates down; for without a very substantial fall, the exchange rate was unlikely to be affected. Apart from considering the possibility of inflow controls, the Treasury had also considered "talking the rate down". On the whole, he was reluctant to adopt this approach - because it would probably either have no effect at all (in which case it would look futile) or it might result in an unacceptable fall in the rate. Rather than trying to help industry by pushing down the exchange rate, fiscal measures and a fall in interest rates was likely to be a more practicable approach.

In conclusion, the Prime Minister said that - notwithstanding the worries about industry - the Government should stick to the existing monetary strategy. The priority was to take whatever measures were needed to achieve this while taking the pressure off industry and providing the opportunity for a fall in interest rates.

/Accordingly,

SECRET

- 8 -

Accordingly, the Chancellor should re-assert the Government's commitment to the MTFs in his Mansion House speech. At the same time, the Bank and the Government would need to keep the position of the corporate sector under close review; and it would be necessary to think further about the possibility of pushing the exchange rate down.

I am sending a copy of this letter to Tim Allen (Governor's Office, Bank of England) and David Wright (Cabinet Office).

Tim Allen

Tim Lambert
L.

A. J. Wiggins, Esq.,
H.M. Treasury.

SECRET

CONFIDENTIAL



Domestic Monetary Policy

H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-233 3000

Direct Dialling 01-233 5627

P E Middleton
~~Deputy~~
Under Secretary

13 October 1980

T Lankester Esq
10 Downing Street

Dear Sir,

Meeting of Ministers

13/10. 1430 hrs.

I attach the agenda which the Prime Minister requested for this afternoon's meeting.

I am sending a copy to Sir Robert Armstrong.

Yours ever,

Peter

P E MIDDLETON

Circulation List:

Chancellor of the Exchequer
Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr Burns
Mr Ridley

CONFIDENTIAL

AGENDA FOR THIS AFTERNOON'S MEETING

1. The Governor to be invited to speak first to his paper
2. The Chancellor to follow bringing out the monetary control issues
3. It is then desirable to take separately issues of:
 - a. monetary policy
 - b. monetary control

Monetary Control Issues

Timing is important because consultations on the Green Paper are now complete. The outcome is expected in the next few weeks. The Chancellor will wish to discuss this further with us. But the immediate objective is to get the Bank engaged urgently in producing a workable set of proposals to improve the present system - and which would be consistent with and, if need be, a step towards Monetary Base Control. The need for a change is to introduce a more quantitative element into methods of control and to reduce the risk that monetary growth accelerates so much in the short run that it prevents us controlling it in the longer run.

The steps which need to be taken are:

- a. Smooth the PSBR - reduce the present skew profile if we can. Treasury is urgently considering. But it will be impossible to produce a completely smooth profile.
- b. Sell more Debt Direct to Persons - more granny bonds and National Savings. No disagreement. But risks to Building Societies and staff costs for DNS. For the Treasury.
- c. Press on with Restricted Indexed Gilt - Bank working on a prospectus. Need to press ahead urgently. An attractive bond which will make debt easier to sell in difficult times. Supervised by Financial Secretary.
- d. New Methods of Marketing Debt. Essential to improve present system, regardless of other changes:
 - i. so we can sell debt when PSBR/monetary growth accelerates rather than on the expectation of falling interest rates (the Grand Old Duke of York) when it is coming under control.

- ii. in order to avoid having to make big changes in MLR to engineer small changes in price of gilts.

Bank to produce proposals for selling desired quantity of debt as need arises.

The above (together with the first stage in abolishing the Reserve Asset Ratio set out below) are all necessary in any event to improve the present system. But they do nothing about freeing MLR and short rates. Two other changes where action must be with the Bank are needed:

e. Abolish the Reserve Asset Ratio. An agreed recommendation in the Green Paper. Plays no part in monetary control. Abolition would immediately increase the range of debt instruments we can sell to the public because Treasury bills lose their reserve asset status:

- i. If replaced by nothing we can still use existing methods of determining interest because the $1\frac{1}{2}\%$ cash requirement for clearing banks is still in place.

- ii. But it is also agreed that the cash ratio has to be revised and extended to a wider range of banks. The new cash ratio should be defined so that it could be used in a mandatory system of monetary base control if it was decided to move in that direction. It need not however be used as such.

- iii. The Bank will in any case wish to sort out the prudential implications. They are in the midst of consultations. These are necessary but distinct. They must follow rather than determine monetary control requirements.

f. Modify Lender of Last Resort. Essential if wish to move to MBC and control supply of base to the banks. The Bank can pitch the rate to penalise the banks but avoid undue swings in interest rates. Critical Step towards a more flexible regime for short term interest rates which still maintains some control by the authorities. Banks less certain of being able to match advances with deposits if lender of last resort at Bank's discretion.

Treasury proposals are contained in the papers. Debt sales (para 69-76)

RAR and lender of last resort (illustrative scheme (Annex 1) para 3, 16-42). We now need the Bank to work up operational proposals preferably based on our work.

Monetary Policy Issues

a. The Prospect. Analysis

i. No real disagreement. But essential to sort out the nature of the squeeze. Is the recession the result of a tight monetary squeeze as suggested by the Bank? We disagree. If the Bank's analysis is accepted it has serious implications for our ability to restrain inflation when activity picks up. Ask Burns to speak on this.

ii. Prospects for the monetary aggregates, interest rates and the exchange rate on the outlook shown by the Treasury and Bank forecasts.

iii. Prospects for the manufacturing sector and imbalance with personal sector.

b. Decisions Needed

i. Can anything be done about the exchange rate: inflow controls come at this point?

ii. Is a reduction in interest rates essential for psychological reasons - and to secure a successful outcome on public expenditure; what are the risks for the current target and the MTFS?

iii. Is the imbalance between persons and companies best dealt with in the Budget - as suggested in the Chancellor's covering minute?

c. Thursday's Speeches

i. Do we reassert the MTFS?

ii. Do we say anything about monetary control?

This list does not include a specific request for a decision on the roll forward of this year's target which need not be discussed at today's meeting; there is little disagreement about this between the Treasury and the Bank. The roll forward does not need to be announced this week and the Chancellor can make recommendations when he has discussed it with the Governor.

CONFIDENTIAL

covering SECRET



Prime Minister

4

I suggest you read
this paper first and then
the others as suggested
in my note on the next
one below.

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

TZ
11/10

..... I attach a series of papers for our meeting on 13 October:

- (a) monetary control
- (b) the economic prospect
- (c) the underlying monetary position
- (d) the roll forward of the £M3 target
- (e) the exchange rate

2. You have already had a preliminary note on:

- (f) money supply, interest rates, the PSBR and the exchange rate

and the first of the regular series of notes on:

- (g) the CGBR, and the path of the PSBR for the rest of this year.

3. I have also sent you today a minute about public spending and pay. They form part of the background but I do not suggest that we consider them at Monday's meeting.

The Background

4. Since we came into office we have made great strides in removing distortions from the economy. These have included:

- the abolition of pay and price controls
- getting Clegg comparability out of the system

/ - abolishing

CONFIDENTIAL



- abolishing exchange controls
- switching some of the burden from personal tax to VAT

5. Just as we were setting out on our programme we had to cope with a further substantial increase in the oil price in 1979. One result is that the whole world is moving into recession. It is not surprising therefore that there have been some difficulties. In particular

- ① the exchange rate has been higher than we - or anyone -
- ② thought; the company sector, especially the part engaged
- ③ in international trade, has been hit harder than we hoped;
- and the money supply has grown faster than the target.

The Prospect

6. The prospect, based on the latest (though still preliminary) forecasts, is described in the note 1(b) above. The main points are:

(a) Inflation will continue to decline in the early months of 1981, but may get stuck before reaching single figures.

(b) Output is expected to fall in 1980 by 2½-3 per cent and may not start to recover until as late as autumn of 1981.

(c) The PSBR forecast has risen to £10¼ bn this year (the path is included in note 2(g) above) and £11¼ bn in 1981-82.

(d) Bringing the growth of the money supply back within the medium term strategy will be difficult and probably require continuing high interest rates.

/7. The most



7. The most pressing problem now is to sort out the monetary situation so that we can be confident that we can maintain our strategy. If we do not there is little or no prospect that we shall emerge from this recession without a further surger in inflation. So we must now bend all our energies to this end, and above all ensure that we make our policy actions consistent with it.

8. Our meeting on Monday must consider two key issues:

(a) Is the system of monetary control adequate to reduce monetary growth?

(b) Irrespective of the control system what measures do we need to take in order to get back on the track of the medium term strategy?

Monetary Control

9. The paper on monetary control by the Treasury is designed to help us answer the first question. It raises a lot of fundamental questions. They concern our attitude to fluctuations in monetary growth, the techniques to reduce monetary growth and the role which we are willing to give to interest rates and the market in controlling it.

10. This is not just an issue which has arisen since the corset. The present methods of control are plainly inadequate. We must make changes in order to have greater confidence that we can achieve our stated objective; but all changes have institutional implications and implications for sectors of the economy other than the banks. We must guard against forcing the pace so quickly that we create more problems than we solve. We need to discuss not only short term interest rates and the banking system, but also methods of funding and the possibilities for smoothing the path of public sector borrowing.

/Getting Back on Track



Getting Back on Track

11. If we are to get back to the path of the medium term strategy, we have to face up to the implications for interest rates and the exchange rate.

(a) If we stick to our monetary strategy there is no sure or easy way of doing anything about the exchange rate. As long as we are determined to reduce inflation the exchange rate, given by the market, is likely to be a high one. Moreover, if the exchange rate did fall substantially interest rates would probably have to rise, unless we were prepared to relax our monetary objectives.

(b) Interest rates will have to fluctuate more; they will almost certainly stay high for a considerable time and may even have to rise. If we are going to pursue an effective monetary policy, interest rates, like the exchange rate have to be determined more by market forces.

12. I remain convinced that if we are to both tackle industry's problem while sticking to the monetary strategy, it is essential to control the PSBR, and do what we can to adjust the fiscal balance in favour of industry. This route means tackling the two major imbalances in the economy, between the public and private sectors and within the private sector, between financial companies on the one hand and non-oil companies facing international competition on the other. The note on the economic prospect draws attention to these issues in para 4-7. Anything which we can do here will also ease the monetary situation.

/13. But tackling



13. But tackling the level and structure of the PSBT to achieve this objective will involve painful decisions:

(a) My minute on public expenditure shows that tough decisions will be needed if expenditure is to be held back to conform with our published plans. These decisions concern both the volume of expenditure and no less important, the pay element. Getting back to the July target would reduce the PSBR by something over £½ bn compared with the forecast. We must do better than that.

(b) Tax policy will have a crucial role:

(i) I am reviewing the North Sea tax regime to see whether more revenues can be raised, especially in the vital next few years.

(ii) In one way or another we shall have to raise some of the money we need from persons. Officials are urgently looking at actual possibilities including increasing the employees NIC and the National Health contribution as a step along this road.

(iii) I am investigating the scope for both obtaining a contribution from the banks to the cost of fixed rate export credit at times of high interest rates and of transferring more fixed rate export credit paper to the banking system.

/They will



They will thus help finance the public sector. This seems a more attractive route than taxation - although this could raise more revenue and I have still not ruled it out.

(c) Although public sector prices will certainly need to rise we shall have to be very careful about future Government measures which add to the RPI until the money supply is more closely under control. This applies to both public expenditure and tax.

14. Extra revenue will clearly have to be directed in the first instance towards reducing the PSBR in order to relieve the pressure on interest rates. But it would be desirable to have something in hand to help the company sector directly, e.g. through the revised arrangements for stock relief which we shall in any case need to bring in as a first step in adjusting the corporation tax for inflation accounting.

15. The balance between the sectors can also be helped through our funding policy where greater reliance on National Savings will relieve pressure on the capital markets though at some risk to mortgage rates.

16. By this approach we should be able to mitigate some of the effects of a high exchange rate without removing the incentive to companies to control their own costs. Cost increases are responsible for most of the loss of competitiveness which has taken place. I shall not miss any opportunities to move in this direction in the run up to the Budget, but there are limits to what can be done in advance of that.

Rolling Over the Monetary Target

17. Perhaps the single most immediate question is whether to roll over the £M3 target. We face the continuing

/uncertainties



uncertainties following the removal of the corset - brought out in the note on the underlying situation. There is also uncertainty about this year's PSBR though we are still confident that it will fall sharply in the first quarter of next year, as is brought out in the note on this subject. As the note on the roll forward itself says, one obvious option is to stick with the existing target to the Budget. We can then reassess the whole position in relation to the medium term financial strategy at Budget time.

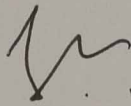
18. There is a lot to get through, at our meeting on Monday. Though we shall not be able to take final decisions I hope that we shall emerge with a clearer view about the way forward in 2 respects:

(a) on questions of monetary control where the consultations following the Green Paper are now complete and an indication of Government policy is awaited.

(b) On the immediate issue of rolling forward the monetary target.

19. The Governor and I will both have to make major speeches at the Mansion House on 16 October in which we shall need to say something about monetary policy.

20. I am sending copies to Sir Robert Armstrong and Robin Ibbs.

(G.H.) 

10 October, 1980

PM

MONETARY CONTROL

SUMMARY AND CONCLUSIONS

The paper discusses alternative techniques of monetary control on the assumption that the authorities target the money supply, and allow the exchange rate to be determined by market forces.

2. Under the present system, the main monetary policy instrument is the power to administer MLR. There are a number of problems:

(i) it is difficult for the authorities to know what path of MLR is consistent with the target growth in the money supply. Underlying monetary trends are often hard to discern, and relevant economic relationships are only imperfectly understood;

(ii) the highly political nature of discretionary changes in MLR gives the system a bias towards delay, especially when interest rates need to rise;

(iii) if short term interest rates are changed only infrequently unexpected changes in incomes and prices will lead to fluctuations in the money supply. This may increase the risk that inflationary shocks will unwittingly be accommodated;

(iv) the authorities have no direct control over long term interest rates. Present methods of selling gilts rely on changes in short term rates (and hence the general level of interest rates) to influence expectations of future interest rates, and hence the expected capital gains from holding gilt edged stock. In principle, this technique is both inefficient and highly uncertain, though in practice it has proved consistent with very large scale funding of the PSBR in recent years;

(v) The central Government has no short term debt instrument with enough appeal to non-banks to be used to mop up the monetary effects of short term swings in the public sector's accounts;

(vi) the banks are not actively involved on the side of the authorities in controlling the growth of their deposits. Their behaviour may sometimes be positively unhelpful to monetary control eg. the use of windfall profits due to high interest rates to underprice advances.

With present techniques, the prospects of meeting the monetary targets depend critically on getting fiscal policy right. The contribution of monetary policy instruments is unreliable. And while in the long run fiscal policy must be consistent with the target for monetary growth, excessive reliance on fiscal policy for short to medium term control is a serious weakness. In consequence there can be no assurance that the targets for M_3 or the MTFs targets will be met with any precision.

3. Monetary Base Control, in one form or another, has the important advantage of allowing interest rates to be determined by the market in a way which is consistent with policy objectives for a relatively narrow monetary aggregate. Interest rates are more likely to move promptly and in the right direction than under the present system.

4. All short term interest rates would be more volatile under MBC; if some interest rates remained sticky, financial flows could be seriously distorted. This would have far reaching implications for building societies as well as banks. At the same time, of course, Ministers would have to give up effective control of interest rates, including mortgage rates.

Monetary Control.

- ① Smooth PSBR
- ② Selling more to persons.
- ③ Increased fall to U.K. institutions: - minus life.
- ④ More flexible marketing of long term debt.
- ⑤ Redefine bank deposit rules - improve
- ⑥ Modify def. of Reserve Assets to exclude Treasury Bills.

5. We do not think that it is possible to devise a system of MBC which, on its own will offer effective monetary control over the broader aggregates including £M3 , without causing disintermediation on a scale which would impair the authorities' ability to interpret and control underlying monetary conditions.

6. If more flexible techniques for selling public sector debt could be developed however it might be possible to combine targets for £M3 or even PSL1 with some form of monetary base control.

7. A switch to MBC would necessarily involve a major institutional upheaval affecting the role of the discount market, the gilts market, the terms on which banks and building societies would lend, and the instruments available to finance central and local Government. Some of these changes might be welcome, some are in any event necessary for better monetary control. But a major change inevitably has unpredictable side effects, as the earlier experience of Competition and Credit Control testifies. Some shifts in the demand for money and other financial assets can be expected, which will temporarily complicate the task of monetary management, perhaps seriously.

8. There would therefore need to be a period of transition to minimise the risk of a breakdown in control. This implies that MBC cannot help with the problem of monetary control over the next year. We cannot even be at all confident that it would significantly improve the Government's chances of meeting the targets set out in the MTFs.

9. Ministers may like to consider three broad options. The objective of achieving a steady reduction in the growth rates of the monetary aggregates is taken as given.

preferably excluding

Option A: A gradual move towards targeting the monetary base
(~~broadly defined to include notes and coins~~). In this option there are no compulsory reserve requirements. The essential role of MBC is to generate short term interest rates. The main parallel is with present Swiss arrangements.

Option B: A gradual move to a flexible mandatory system of monetary base control, targeted on M2 (a new aggregate broadly equal to £M3 less wholesale deposits ie. large deposits bearing money market interest rates). This would be closer in spirit to the system recently introduced in the US. Annex 1 contains an illustrative blueprint for such a scheme.

Option C: Improving the flexibility of present methods of control, principally by reforms designed to achieve more precision in the timing of debt sales. Measures to smooth the seasonal pattern of the PSBR would also be relevant, as, conceivably, might an attempt to use the existing reserve asset system more aggressively.

10. Many of the measures which might be taken within the present framework of control would of course be equally relevant in the event of a switch to MBC; this applies particularly to changes in debt selling techniques.

11. The attached table summarises the key features of the present system, and of the main monetary base options identified above.

MONETARY CONTROL: SUMMARY

Control System	MAIN FEATURES:-					Comments
	Short term Interest Rates	Monetary Targets	Monetary Base/ Reserve Assets	Reserve Requirement	Lender of last resort facilities	
<u>Present System</u>	Discretionary control of MLR	£M3	Call money, Treasury bills, gilts (with less than 1 year to maturity) LA bills, commercial bills (up to 2% EL's)	12½% eligible liabilities 1½% cash ratio (London Clearing Banks only)	Unlimited, at given MLR	Unreliable; not capable of delivering short term control. Could be improved by more flexible techniques for selling public sector debt
<u>Monetary Base Control</u>			<u>either</u>			
A. <u>Non-Mandatory</u>	Market determined (possibly subject to ceiling)	Monetary base, £M3 (or? PSL1)	Notes and coins, plus bankers' balances <u>or</u> (preferably) bankers' balances	No mandatory requirement	only available i. in financial crisis or (possibly) ii. on penal terms	May not contribute much to control of money supply. No incentive to disintermediation cf. Swiss approach. Improved debt selling methods needed to control wider aggregates (£M3, PSL1)
B. <u>Mandatory</u> (as in illustrative scheme, see Annex I and table III)	Market determined subject to ceiling set by authorities	M2, £M3 (or? PSL1)	Bankers' balances	Mandatory requirement to hold base assets equal to x% retail deposits	only available i. in financial crisis or ii. at penal rates	Short term control over M2; but some incentive to disintermediation. cf. US arrangements. Improved debt selling methods needed (as above)

MONETARY CONTROL

Introduction

This report is concerned with possible changes to the present system of monetary control, rather than with the current monetary situation, which is discussed in detail in a companion paper. The two cannot be completely divorced of course. The Government's commitment to the medium term financial strategy (MTFS) and to targeting the monetary aggregates sets the context within which possible changes must be considered. The report also takes as given the present policy of allowing the exchange rate to be determined by market forces.

2. The plan of the paper is as follows:

Part I discusses the objectives of monetary control, and the various policy instruments which the authorities can use to control the money supply.

Part II considers the adequacy of the present system of control.

Part III analyses the failure of the reserve asset requirement (RAR) and the Supplementary Special Deposits (SSD) scheme (the 'corset'), as means of control.

Part IV discusses Monetary Base Control (MBC) in general terms, and assesses what we have learnt from the Consultations following the Green Paper on Monetary Control.

Part V discusses some practical possibilities; a gradual transition to a non-mandatory system rather on Swiss lines, or a flexible mandatory MBC, fairly similar to present US arrangements.

Part VI considers other proposals for reform, including using the present system of control to squeeze bank liquidity, and a move to a more flexible system for selling gilts.

The mandatory scheme outlined in Part V is described in detail in Annex 1. Annexes 2 and 3 discuss US and Swiss experience with MBC. Annex 4 (by the Bank of England) summarises the debate on monetary control arising from the Green Paper.

I Objectives of Monetary Control

(a) Final and Intermediate Objectives

3. The final objective of monetary policy is to control the price level. The choice of the money supply* as an intermediate target rather than interest rates, bank lending, total liquidity or some other financial variable, reflects a view that the quantity of money is more systematically related to nominal incomes (and hence prices) than those other variables. The rationale is that money is a strategic asset in modern economies. Restricting monetary growth will therefore have pervasive effects on economic behaviour, affecting spending decisions, asset prices (including the exchange rate) and consequently nominal incomes. In the short run, the main burden of equating the demand and supply of money will fall on interest rates and the exchange rate. In the longer term, however, nominal incomes and prices will adjust so that at the new price level, people are just willing to hold the stock of money outstanding.**

* If the final objective of policy was the exchange rate rather than the price level, monetary policy would be most appropriately directed to Domestic Credit Expansion (DCE) rather than the total money supply; with a floating exchange rate, however, it is clearly money, not DCE that is relevant.

** A detailed account of the transmission mechanism from money to prices was given in the July edition of the Treasury's Economic Progress Report.

4. The link between money and prices presupposes a stable underlying demand for money, in real terms. This is only likely to be the case if the assets that constitute money are significantly different from other financial assets. If not, controlling the money supply will simply lead to the growth of near money substitutes. The widespread effects on economic behaviour which are a necessary part of controlling inflation will not occur. That said, however, it is by no means easy to identify those assets which in the real world constitute "money".

5. The adoption of monetary targets may have favourable effects on expectations which speed up the response of prices to changes in the money supply, and help to reduce the output loss associated with a reduction in inflation. Monetary targets - and the market's assessment of how far the authorities will keep to them - do seem to affect expectations in financial markets. This may significantly affect the ease with which the authorities can meet their targets. But the evidence for other markets, especially the labour market, is still weak. The public's perception of the stance of monetary policy may become increasingly important. But it is no substitute for effective control of monetary conditions in the terms discussed above.

6. The role of expectations may shorten the time period over which the authorities need to exercise control over the money supply. Visible success in meeting targets is an important element in their credibility. On other grounds, however, there are no compelling reasons for the authorities to aim at control over periods of less than about a year, much less under six months. The underlying relationships between prices and money are not that precise or mechanical. Some (typically non-monetarist) economists argue that very short term control is harmful since it prevents money from filling a necessary role as a shock absorber. Less controversial is the view that fine-tuning which destabilises the longer term trend is positively undesirable.

(b) Definition of Target Aggregate

7. A review of control techniques naturally raises questions about what is being controlled. Clearly a target must relate to something the authorities can in fact control. Equally, to be worth controlling it should be well related to final objectives - the price level and nominal incomes. Beyond this, theory offers few pointers. The choice of monetary aggregate must be made on empirical and pragmatic grounds. Narrow aggregates, like notes and coins, M1 or the old M2 are in principle easier to control than broader ones like M3 or PSL1.** Certainly, one of the great attractions of targeting the monetary base, in preference to some wider aggregate, is that it alone is under the direct control of the authorities. Wider aggregates on the other hand are generally thought to convey more information about the overall thrust of the Government's policies and therefore to be more reliably related to ultimate objectives; against this, proponents of base targeting suggest that wide aggregates are as much the consequence as the cause of changes in nominal incomes.

8. The evidence for the UK is inconclusive. Over a long run of years, no one aggregate has been a consistently better predictor of the price level than the others. (See Chart 4). One episode however shows a striking contrast. The inflationary surge in 1974/5 was preceded by a sharp upswing in M3 but not in the narrower definitions of money, (including the base); on the other hand it is at least arguable that the triumph of M3 was, in this case, partly due to coincidence.* Whatever the evidence, however, it would be dangerous to rely too exclusively on any one definition of money, for policy purposes, since the strain of attempting to control behaviour by exploiting past relationships almost inevitably tends to weaken them.

*between roundtripping following Competition and Credit Control (see para 25) in 72/3 and the inflationary shock of the oil price hike in 73/4.

** See table II for definitions of these aggregates.

9. The principal justification for £M3 as a target is as an indicator of the overall stance of policy, and, as such, it is well understood by financial markets. It also has some institutional rationale since it includes most, though not all, of the liabilities of the banking sector (see tables I and II). In terms of the theoretical considerations outlined in the preceding sections, however, it is in many respects a curious hybrid. It includes interest and non-interest bearing deposits: wholesale money * and CD's as well as retail deposits; public sector deposits as well as personal and corporate sector accounts. It covers a wider span of liquidity than PSL1, from notes and coins to term deposits of over two years. As recent experience has illustrated, many of the assets in £M3 have close substitutes which are excluded - for example personal time deposits (in £M3) and building society deposits (not in £M3), CD's (in £M3) and Treasury bills and commercial bills (not in £M3). Since the abolition of exchange controls, euro sterling and covered foreign currency deposits have become virtually indistinguishable from domestic wholesale bank deposits.

10. Euro sterling is probably the most intractable aspect of the problem of close substitutes. The definition of £M3 could reasonably be extended to include domestic near monies, such as bank accepted commercial bills. We could also include some euro deposits as the US have started to do (their M2 for example, includes overnight euro dollars held by US non-banks at Caribbean branches of US banks). But there is a severe limit to how far this can be taken in the case of offshore banking; even euro sterling business need not be confined to the branches of UK banks.

11. However, whether in practice euro markets create serious problems for domestic monetary management depends on the control techniques used. In the absence of exchange controls, arbitrage ensures ^{that} euro sterling interest rates move very closely in line

*There is no statistically accepted definition of wholesale and retail deposits. Broadly 'wholesale money' covers large scale deposits (say over £50,000) lodged mainly by financial institutions and large corporations, which bear money market rate of interest. They include deposits taken at branches, interbank or raised on money markets. Retail deposits include current accounts as well as more traditional time deposits (often at 7 days).

with domestic sterling rates. Changes in domestic interest rates will therefore influence the total volume of sterling deposits, including those held offshore. On the other hand unless the links between domestic and offshore banking systems are cut, direct controls applied only to domestic deposits are likely to lead simply to a diversion of business, without imposing effective control on the total sterling money supply. This distinction has important implications for the design of a workable system of monetary base control in the UK, which are developed in Part IV and V below.

(c) Monetary Policy Instruments

12. The size of the money stock - as distinct from the base - is determined partly by the actions of the monetary authorities and partly by the portfolio decisions of the bank and non-bank private sector. In the absence of direct controls, therefore, the authorities can only regulate the growth of the money supply if they can find some reliable means of influencing private sector behaviour. In practice this means exploiting stable and predictable relationships between variables they do exercise some control over, and the target aggregate. The debate about monetary control techniques largely centres on which relationships the authorities should choose.

13. Taking fiscal policy as given, there are two broad possibilities:-

(1) the authorities may seek to influence the behaviour of the non-bank private sector by acting on the price of financial assets; for example they may use discretionary changes in interest rates backed up by open market operations in public sector debt, to influence the demand for money, or the demand for the credit counterparts of the money supply (PSBR less gilt sales, bank lending etc.)

(2) alternatively the authorities may try to influence the behaviour of the banks, in the first instance, by official action on the quantity of reserve assets; for example, they may use control of the total liabilities of the monetary authorities (base money) to influence the growth in the liabilities of the commercial banking system (deposits).

14. The choice between prices (eg. interest rates) and quantities (eg. base money) as operating targets does not really turn on theoretical issues about how in principle the economic system works. The problems are practical. Both the authorities (and the markets) are operating in conditions of uncertainty, with imperfect knowledge of the true relationships involved. Given the Government's wider objectives, the best operating target is the one which minimises the risk that the authorities will react to unexpected developments either inappropriately, ineffectually, or too late. The market's perception of how the authorities are likely to respond may be an important ingredient in the credibility of announced targets.

15. Proponents of monetary base control argue that attempts to stabilise interest rates increase the probability of inflationary policy errors. Under base control, interest rates and the market will absorb the shock of unexpected changes, rather than the money supply. This does not necessarily mean that interest rates will be very different, on average, for any given rate of monetary growth, though they may be more volatile, especially at the short end. Arguably they might even be lower, if the use of MBC helped to reduce inflationary expectations. However, control techniques may well affect the probability that a given monetary target will actually be achieved.

16. The balance of these arguments turns largely on whether base money or the relevant interest rates are most securely under the control of the authorities; and which bears the most reliable and best understood relationship to the target aggregate.

In the absence of sufficiently reliable relationships arising from natural self interest, the authorities may have to resort to compulsion, by imposing minimum reserve ratios, interest rate ceilings, or direct controls over bank lending or total liabilities. But if they are making any significant contribution to monetary control, legal requirements of this sort inevitably create an incentive for avoidance, just because they are inflexible, and compel banks to behave in a certain way. This will tend to distort the message conveyed by all monetary statistics.

II The Present System

17. For given fiscal policy and on the basis of present techniques of marketing gilt-edged stock, the current system of monetary control relies above all on discretionary changes in MLR made effective by money market operations conducted through the discount market. London Clearing Banks are obliged to hold bankers balances with the Bank of England equal to at least $1\frac{1}{2}\%$ of eligible liabilities, but the purpose of this requirement is to give the Bank greater leverage over the cost of short term funds, not to ration the supply of cash to the banking system. The $12\frac{1}{2}\%$ minimum reserve asset requirement is nowadays used neither as a means of influencing short term rates nor of deliberately squeezing banks' liquidity.

18. A major difficulty with the present system is that the relationship between the variable which the authorities control directly, short term rates, and the target aggregate, £M3 , is at best complex, and at worst very unreliable. A rise in short rates has opposing effects on the demand for £M3 . The demand for notes and coins and non-interest bearing deposits will be reduced: but interest bearing bank deposits will usually become more attractive relative to longer term assets. In practice, the authorities ability to engineer a significant and reasonably rapid response of £M3 to changes in MLR depends on the ability to influence expectations

in the gilt edged market. A rise in short rates will typically lead to a rise in the general level of interest rates which will move the yield gap in the wrong direction. But if the authorities can successfully convince investors that future movements in rates are more likely to be down than up, the prospect of making capital gains may stimulate speculative purchases. Since the process by which expectations are formed is very imperfectly understood and may well change in an unpredictable way, this technique is extremely uncertain; nonetheless it has, on occasions, been very successful.

19. In the longer term, the response of £M3 to short term rates depends largely on bank lending. But the evidence, such as it is, suggests that the response to changes in short term rates is slow, weak and uncertain. It may even be perverse in the short run. These results are not implausible. Since the demise of the debenture market, companies have few suitable alternative sources of funds; floating rate loans mean companies are not locked into high interest rates and the tax system has the effect of reducing the real cost of borrowing, as long as a company has sufficient taxable profits. Interest rate expectations may sometimes play an unhelpful role, since if companies expect interest rates to fall they are likely to postpone raising longer term non-bank finance. If this is so, a debt management policy which relies on inducing expectations of falling interest rates may have a counter productive effect on bank lending.

20. It is often argued that the present system has a 'bias towards delay' at least so far as increases in interest rates are concerned. Part of the problem is that because changes in interest rates are discretionary they are inevitably highly political. There is naturally a tendency to ensure that rises are really essential before taking action. The result of waiting may be that larger rises in rates are then needed to restore confidence and re-establish monetary control. The amplitude of interest rates fluctuations may be increased.

21. Equally serious, from a control point of view, is the difficulty of deciding what changes in interest rates are appropriate. Movements in £M3 are most unlikely to provide a timely and accurate guide if, as argued above, £M3 reacts slowly, uncertainly and sometimes weakly to changes in interest rates. If there is a policy error, considerable time is likely to elapse before £M3 shows the consequences, and even when policy is adjusted, it will be some time before £M3 is brought back on track. The authorities can try to allow for these lags in taking their decisions, but their knowledge of how the system works is not sufficiently precise to allow them to do so with much accuracy.

22. A further, more general, criticism is that the system does not enlist the active support of the institutions whose liabilities are being controlled. At present the authorities use one instrument, interest rates, to influence the behaviour of the banks customers, rather than the banks themselves. A system which enlisted the active participation of the banks, by exploiting their self interest on the side of monetary control, might, it is argued, be both quicker to produce results, and more effective in the longer run, since there are a range of methods which banks can use to influence the growth of their balance sheets. The criticism has some force. The difficult issue is, however, whether the banks can be induced to react to pressure in ways which are helpful rather than damaging to effective monetary control. This is discussed in more detail in Parts IV and V below.

23. The Green Paper argued that "using the basic weapons of fiscal policy gilt edged funding and short term interest rates, the monetary authorities can achieve the first requirement of control of the money supply - control say over a year or more." The discussion above

suggests that the validity of this judgement may depend, to an undesirable extent, on the authorities ability to set fiscal policy correctly. The specific contribution of monetary policy instruments looks distinctly unreliable, depending as it does so heavily on the authorities ability to use discretionary changes in MLR to alter expectations in financial markets and to influence the demand for bank advances. Important as fiscal policy is for long term control of the money supply, an excessive reliance on fiscal policy for short to medium term monetary control is a serious weakness. The PSBR is extremely hard to forecast. Its relationship with the money supply is complex at least in the short run. Equally important, fiscal policy is notoriously inflexible; not only is it difficult and time consuming to change, it is often slow to take effect. As a result, fiscal policy is no substitute for effective monetary policy instruments.

III Reserve Asset Requirement and the SSD Scheme

24. Present arrangements, with their emphasis on short term interest rates as operating targets, are a survival of the system introduced during the early 1970's, which did include two control techniques which, at least potentially, were more quantitative. Yet neither the corset nor, still less, the reserve asset ratio (RAR) worked well as techniques of monetary control. Before considering changes to the present system, it is worth briefly reviewing the lessons that can be drawn from these comparative failures.

(a) Reserve Asset Ratio (RAR)

25. The Bank always intended to use the RAR to influence short term interest rates rather than to control the supply of assets to the banking system. Yet it was thought that, in conjunction with Special Deposits, the RAR might be used to squeeze bank liquidity with a view to inducing the banks to dispose of non

reserve assets. In the event, attempts to operate the system in this way led to severe problems. Banks responded to reserve asset pressure by bidding for reserve assets and for deposits in the inter bank market, rather than selling assets. While interbank rates rose sharply, yields on Treasury bills fell, encouraging the non-bank private sector to shift into money. The failure of banks to raise lending rates in line with deposit rates created profitable opportunities for arbitrage ('roundtripping'). The net result was that liquidity pressures caused the bank's balance sheets to expand rather than contract.

26. In view of the obvious affinities between the RAR/Special Deposits system, and some forms of mandatory monetary base control, it is instructive to ask why. There are four points worth noting:-

(i) the definition of reserve assets was a positive inducement to liability side management. It included claims on the public sector which could be held by non-banks as well as banks (eg. Treasury Bills, gilts with less than one year to maturity, all local authority bills) and even some claims on the private sector (commercial bills, up to a maximum of 2% of eligible liabilities). The authorities were not in a position to control the supply of reserve assets to banks, even had they wanted to. Under these circumstances, bidding for deposits was a feasible way to relieve reserve asset pressure for the banking system as a whole, as well as for an individual bank.

(ii) bank behaviour in the early '70's reflected the pent-up pressures released by the abolition of earlier controls over bank lending. Banks wanted to increase their stock of lending: this may have been one reason why they chose to respond to reserve asset pressure by adding to their liabilities rather than contracting their asset portfolios.

(iii) flexibility in some short term interest rates, but not others, can rapidly create major distortions. Banks failed to raise base rates enough to prevent roundtripping, partly to preserve the good will of their customers, partly because they may have thought that short term profit maximising behaviour would attract penal taxation. How long this behaviour would have continued, had the RAR experiment not been abandoned, is a more open question.

(iv) The authorities failed to recognise that asset management in the short run is difficult for many banks, unless they happen to hold significant amounts of marketable non-reserve assets or can rapidly call in some advances. The tactic of intensifying the squeeze to discourage banks from bidding for deposits may have given a further twist to the spiral in interbank rates.

27. These difficulties do not necessary mean that the reserve asset requirement is intrinsically unworkable. The scope for using it more aggressively in present circumstances is briefly discussed in Section VI.

(b) The SSD Scheme

28 The 'corset' was introduced to prevent round tripping and to encourage banks to restrict their lending or at least their total assets. Increasingly however it had the effect of forcing credit into forms outside the scope of the control, at least during the periods when it was a binding constraint on banking liabilities. Two points are worth noting:-

(i) experience with the corset underlines the proposition (familiar from exchange controls) that any system of direct controls needs continuously extending as loopholes appear if it is to retain effectiveness.

(ii) the existence of exchange controls was an important element in the earlier success of direct controls. Moral suasion is only a very limited substitute; contrary to explicit guidance from the Bank of England, disintermediation through Euro markets seems to have amounted to several hundred million pounds in the last six months of the corset. It is worth noting however that Euro deposits are not a substitute for conventional retail banking business (current accounts etc).

29. There are lessons here for the design of any future scheme with a mandatory element. One approach would be to exclude wholesale deposits from the total controlled. Another would be to supplement control of wholesale deposits with restrictions on Euro currency operations. These would have to include, as a minimum, a ban on resident holdings of Euro sterling deposits, and probably also a ban on resident holdings of foreign currency deposits outside the UK. We could also follow the Americans in attempting to extend some control over Euro markets. This would mean co-operating closely with the US, since euro markets have, so far at least, been dominated by the overseas branches of American banks.

IV Monetary Base Control

30. The essential feature of all versions of MBC is that the authorities attempt to control the growth of some, or all, of their own monetary liabilities. To this end, the central bank must lend only as a last resort, and not to defend any particular level of interest rates. Some proponents of monetary base control would argue that a Government which announces a target for the base has no need of further intermediate targets, for M1 or M3. In the UK context, however, the Government's prior commitment to targets for £M3 in the medium term financial strategy has focussed the

debate on the role of MBC as a technique for controlling one or other of the wider monetary aggregates.

31. As a method of influencing monetary conditions, monetary base control works by exploiting the relationship which is assumed to hold between the supply of cash to the banking system and the total volume of bank deposits. Since the monetary base (cash) is equal to some or all of the liabilities of the Central Bank, (see tables I and II) the authorities should both know what it is from day to day, and be able to control its growth with a high degree of accuracy. Since, it is argued, banks need cash (base) in order to create deposits, control over the base gives the authorities a direct and reliable means of controlling monetary growth.

32. Interest rates will be determined by the interaction of supply and demand. Market determined rates will respond speedily to shocks, rather than with a lag once monetary growth has visibly got out of control. Unanticipated changes, such as overshoots in the borrowing requirement, will as a rule be reflected in fluctuations in short rates, rather than unplanned changes in the money supply. This will provide reassurance for market expectations and may actually help to reduce inflation more rapidly. A further advantage over the present system, it is claimed, is that the authorities will be directly influencing the banks' behaviour, rather than attempting, at one remove, to influence their customers. Banks will have to choose how to rearrange their portfolios on profit maximising grounds; and if raising interest rates fails to restrain the demand for credit, they will be compelled to find something else that does produce the desired results.

33. That, in broad terms, is the case for monetary base control. The Green Paper on Monetary Control raised three issues:

(i) can the base be controlled over a useful time horizon without an unacceptable degree of interest rate volatility?

(ii) is there likely to be a stable relationship between cash and deposits in a banking system as sophisticated as the UK's, particularly given the availability of a wide range of other highly liquid money market instruments? Even if one exists, is it sufficiently reliable and well understood to deliver effective monetary control?

(iii) would a mandatory system of MBC (in which any behavioural relationship is overridden by legal cash ratio requirements) run into exactly the same problems of disintermediation experienced with the corset?

34. As well as inviting opinions on the practicability of the various MBC schemes discussed in the Green Paper, opinions were also invited on the desirability of some form of monetary indicator system, which was advanced as a more modest move towards automatic interest rate flexibility. The essence of indicator systems is that they would replace discretion by rules of some sort; interest rate changes on a given scale might, for example, be triggered by deviations in either the growth of M_3 or the monetary base from the target path. The advantage claimed for such a system is that it might produce more timely adjustments in interest rates (though not necessarily more appropriate ones).

(a) Control of the Base

35. The most comprehensive definition of the monetary base includes all the liabilities of the monetary authorities. In the UK, as tables 1 and 2 show, this consists of all notes and coins in circulation plus bankers balances with the Bank of England. Advocates of non-mandatory MBC (or pure base targeting) sometimes envisage controlling this broad measure of the base on the grounds that it is an important determinant of inflation in its own right. Chart 1 shows the composition of the base, under current UK institutional arrangements. Notes and coins held by the non-bank public account for more than 80% of the total, vault cash (or "till Money") held by banks for a further 15%, while bankers balances represent only about 5%. Not surprisingly, since notes and coins are used for transactions and are supplied on demand, there is a fairly close relationship between the base and nominal incomes and prices (see charts 3 and 5), and the growth in the base has been broadly in line with other monetary aggregates (especially M1, one-third of which is notes and coins). The causal significance of these relationships is however more open to question, and still more, whether they would survive an attempt to ration the supply of base.

36. Under a mandatory system, the banks are compelled to hold base assets equal to a certain proportion of their qualifying liabilities. The wider economic significance of the assets making up the base is therefore of relatively little moment; what matters is the supply of base to the banks. Controlling notes and coins held by the non-bank private sector would create unnecessary complications. Whether a narrower definition should include till money as well as bankers balances can be decided on control grounds, and written into the design of the scheme. Recent debate in the UK has tended to assume that in a mandatory system the authorities would only directly seek to control bankers balances.

37. The Bank of England know the total of bankers balances on a day-to-day basis. They can influence the size of these balances by operating on the asset side of the balance sheet shown in table I. This balance sheet reflects transactions arising from

the normal course of operating Exchequer Accounts (including the Exchange Equalisation Account) whose size is determined by the Central Government Borrowing Requirement and net intervention in the foreign exchange market. Given these transactions, the authorities try to meet a given target for the base by varying their sales of public sector debt (including Treasury bills) to the private sector (including the banks). Yields on public sector debt vary according to the amount sold. The effect of open market operations may sometimes be to leave the banking system short of cash. To the extent that the authorities meet this deficiency by providing lender of last resort facilities, the base will be expanded. Effective control of the base therefore means that the authorities must be able to regulate the amount of base provided in this way. One way to achieve this is through the price mechanism - by only providing last resort facilities on penal terms.

38. The scope for errors in day to day control is considerable. Daily fluctuations in Exchequer Accounts can amount to \pm £500m. This is enormous in relation to the sort of growth in the base the authorities are likely to be aiming at, even over a period as long as a month; even if bankers balances were as much as 10% of the money stock (as compared with 1% now), an annual target growth of 5% a year might only permit about £20-30m growth in the base each month. These problems would still be present over periods as long as a week, and perhaps even a month, though they would be less acute.

39. Practical versions of MBC therefore need to leave a margin for error in short term control of the base, if unnecessary fluctuations in short term rates are to be avoided. In this context it is interesting that the Swiss, who are publicly committed to a target for the base, only aim to hit it over a period of about six months. The Americans have not published any targets for the base at all - and indeed seem to take decisions about the desirable growth in bank reserves practically on a week by week basis, in the light of short term developments.

(b) Non Mandatory Monetary Base

40. MBC systems are classified as mandatory or non-mandatory according to whether or not banks are bound by legal minimum reserve requirements. In a non-mandatory system the authorities exercise control by exploiting the banks' need for cash, for operating and prudential purposes. The argument is that cash is an essential input into the provision of liquidity services. This is equally true whatever the legal status of the financial intermediary providing these services, and regardless of whether its liabilities are included in the target aggregate. Problems of avoidance and disintermediation simply do not arise. The corollary, however, is that controlling the supply of cash would not affect the supply of assets against which it was not essential to hold cash reserves. The main doubt about non-mandatory MBC, therefore, is whether it would offer a sufficiently powerful lever over monetary conditions in an economy where there are many close substitutes for cash.

41. The Swiss system is run on these lines, without the aid of legally imposed minimum reserve requirements. It is true that in recent years the Swiss have substantially overshot their monetary targets, and that there is growing instability in the cash/deposits relationship. The official response has been to switch to a base target alone. Whatever the problems however the authorities have clearly felt the approach was worth persevering with; the Swiss inflation performance remains enviable. (See Annex 3).

42. Even relative to Switzerland, cash does not play a large part in the UK banking system. While the total liabilities of the Bank of England are equal to roughly one-fifth of total bank deposits, base money held by banks is only equal to about 3% of total deposits, and bankers balances with the Bank of England are very small indeed - less than 1% of total deposits. This figure is only as high as it is because London Clearing Banks are required to hold bankers balances equal to 1½% of eligible liabilities with the Bank, which, they claim, is considerably in excess of what they would choose to hold on prudential and operating grounds. By comparison Swiss banks voluntarily hold balances with the Swiss National Bank equal to 13% of deposits (M2).

43. While cash plays a limited role in facilitating transactions between clearing banks, it has virtually no role as a source of liquidity. An important element in the relationship between cash and money, on which the Swiss version of MBC rests, is therefore missing under present UK institutional arrangements. Unlike Swiss banks, UK banks hold a wide range of short term money market instruments for liquidity purposes - notably Treasury Bills, but broadly all those included in the present definition of reserve assets. The status of these instruments owes something to the fact that the Bank is prepared to accept them under all circumstances as eligible for lender of last resort facilities. If these arrangements were modified they might no longer be effectively as good as cash; it is also possible that if short term interest rates became more volatile, the liquidity of these assets might be somewhat impaired. More generally the banks demand for liquidity probably reflects the terms on which lender of last resort facilities are available; if these were more restricted it might be higher.

44. It is possible, therefore, that if present institutional arrangements were changed, a stable demand for cash, as a source of prime liquidity, might emerge. On the other hand, it is likely that the non-clearers at least would continue to have a negligible demand for cash. The inescapable problem is that there is no means of knowing whether this would happen before the changes were made. Equally serious, the authorities would have no information about the nature of the relationship even if it existed. It is most improbable, for example, that the ratio between cash and deposits would be a constant: it would almost certainly be significantly affected by changes in interest rates. But if the authorities were to operate the system effectively, it would be essential for them to have some idea of the size of these inter-relationships.

45. The major doubt about this form of MBC therefore is whether it would provide effective control; this question cannot be answered until the experiment has been tried. A switch to non-mandatory MBC would therefore be a major gamble. Moreover not even the most ardent advocates of non-mandatory MBC suggest that it could be counted on to control an aggregate as wide as £M3. Indeed there are good reasons for supposing that it would never do this. While banks have some motives for holding cash against retail deposits, and, with enough time, the authorities might hope to observe a stable relationship, it is improbable that a reliable and significant demand for cash to hold against wholesale deposits would ever emerge. The behaviour of the banks engaged in the Euro markets offers some support for this view - the deposits they choose to hold with their head offices, which are 'cash' in their terms, appear to be extremely small. On its own, therefore, non-mandatory MBC can only be regarded as an instrument for controlling a somewhat narrower aggregate than £M3 (say M2)*.

(c) Mandatory MBC

46. The problem of effectiveness would be partly solved by imposing minimum reserve requirements. Even then the relationship between changes in base and changes in the money supply would not be mechanical if the penalties for reserve shortage were very high since banks would probably hold excess reserves, (unless this too were penalised.) And in principle there will always be some scope for banks to relieve cash pressures by bidding notes and coins away from the non-bank public (for example, by offering interest on current accounts). These elements of flexibility would not necessarily be undesirable, given the problems involved in short term control of the base outlined above.

* See table II for definitions

47. The principal problem in mandatory systems is the risk of substantial disintermediation. This is in part because a legal reserve requirement amounts to a form of tax on the banking system. The size of the implicit tax depends on the interest foregone on the banks holdings of required reserves. The effect of the tax is to raise margins on UK banking business: the result is likely to be a once for all loss of business depending in part on the size of the tax. Changes in the size of the required ratio will alter the size of the tax; so will alterations in the rate of interest (if any) paid by the Bank, relative to market rates. If the bank were to pay interest, at market rates, on all required reserves, the tax would be zero. The risk of a loss of business, probably to offshore banks, would be correspondingly reduced.

48. However there is no avoiding some incentive to disintermediation if the scheme is to offer any effective control. The fact that during times of base asset shortage the banks face the prospect of having to raise marginal funds at penal rates, raises the marginal cost of bank intermediation relative to that by other institutions not subject to the control. Rather than lose business outright, the banks have every incentive to find ways round the controls, by routing flows through Euro markets. To the extent they do this, MBC will not generate the across the board change in interest rates needed to control the demand for credit in the longer term; what will happen instead is that relative yields will change, and control will be largely cosmetic.

49. The effort devoted to avoidance will reflect profit maximising decisions by banks and customers. This will turn on:

(i) the degree of pressure exerted by the authorities - the scale of penalty and the certainty of having to pay it (as perceived by the individual bank);

(ii) the costs involved in avoidance rather than compliance.

If the authorities are to make the system work they may have to invest resources themselves in making avoidance expensive. The resources required will almost certainly rise the longer the controls persist.

50. A more promising alternative is to use mandatory MBC to control a target aggregate which, at least initially, is comprised of assets which have no obvious close substitutes. That probably means excluding wholesale deposits since, in the absence of exchange controls, Euro deposits provide a nearly perfect substitute for domestic wholesale deposits. It may be that retail deposits would come to have close substitutes in time as well, but if, as implied in the previous section, it is more probable that banks have a 'natural' demand for cash to hold against retail deposits, then controlling the base will exercise some control over all the other institutions whose deposits are a close substitute for retail bank deposits, whether or not they are subject to reserve requirements themselves.

d) Multiple Targets

51. If, therefore, it were decided to move to some form of MBC, it would be desirable to reconsider the case for multiple targets. There are two broad possibilities:

(i) the authorities could set a target for the monetary base (defined broadly). Short term interest rates would be generated as a by-product of the operations needed to control the base. There would be no compulsory reserve requirements, and control over wider monetary aggregates would depend on other instruments eg. fiscal policy, or debt management.

(ii) the authorities could use a mandatory form of MBC to meet a target for an aggregate like M2*: ie. the deposits against which banks were required to hold cash would be those included in M2 (broadly, retail deposits only). Growth in the base would be set to achieve the target for M2. Short term rates would be determined as a by-product of controlling M2, rather than £M3 (or M_0).

52. Neither of these options could, on their own, be relied upon to deliver control of £M3 on, say, an annual basis. Indeed, if the second options led to disintermediation out of M2 it might make the problem of controlling £M3 worse. But they would provide market determination of short term rates which could well be an improvement over the existing discretionary control. However this would not necessarily be the case. Under option (i), if the demand for cash in a non-mandatory system turned out to be weak or unstable, interest rates would be determined by the market, but they would not necessarily be conducive to control of any of the wider aggregates.

53. The authorities would need to use fiscal policy and debt management to control the wider aggregates (£M3 and PSL1**) While fiscal policy sets some bounds on the growth of total financial wealth, it would not be enough on its own, since there would still be the possibility of sharp changes in the composition of private sector portfolios in response to changes in relative yields, which could lead to a rapid rise in PSL1 or PSL2 even when narrower aggregates like M1 and M2 were well on track.

54. The authorities would therefore need to structure the composition of public sector debt sales between long and short dated instruments to prevent unhelpful changes in relative rates from appearing. A policy of simply aiming at a smooth flow of

* Reviving M2 might not be entirely simple. There are difficulties in devising a definition of wholesale deposits which would be robust enough for control purposes. It would involve collecting new data. But so far the problems do not look insuperable.

** If MBC^{were} used to control a relatively narrow aggregate, it might be appropriate to pay more attention to PSL1 at the same time. This would also help to reassure some sections of the market.

gilts sales, month by month and allowing Treasury bills to take the strain as the residual source of finance would probably produce an erratic path for PSL1 - certainly so long as the PSBR continues on its present bumpy path through the financial year.

55. A move to a system of MBC would thus inevitably raise issues of debt marketing techniques and not only because relinquishing short term control over short term rates would make it difficult, if not impossible, for the authorities to deliberately stimulate speculative purchases of gilts by operating on short rates. (This question is discussed in more detail in section VI below.)

(e) The Monetary Control Consultations

56. A detailed account of the main points to emerge from the consultations which followed publication of the Green Paper is given in Annex 4 by the Bank of England.

While UK respondents generally agreed on the importance of medium term control, there was a widespread disposition to dismiss 'short term' control as not being of fundamental importance - subject to the important proviso that the credibility of the Government's commitment to its monetary targets should be well established. No consensus emerged on the key issue of whether it was desirable to move away from discretionary interest rates towards more market determined short rates. But the monetary indicator system found few friends (though there was muted welcome for the idea of an indicator with override). Most people appeared to regard it as insignificantly different from the present system, with little to contribute to the problem of the appropriate scale of interest rates changes.

57. Monetary base systems found few new converts, though some of the early proponents, (Griffiths and Pepper) shifted their ground a little and became more explicit on the practicabilities of their schemes. There was widespread agreement that any kind of MBC would require important institutional changes if it were to stand any chance of working in the UK. There was considerable concern at the transitional problems that might be involved, and in particular at the risk that a major upheaval in the method of control would have unforeseeable consequences for the demand for money which would jeopardise the success of the MTFs.

58. There was no enthusiasm for non-mandatory MBC from the financial institutions. (eg. the Clearing Banks, Accepting Houses Committees, Discount Market), though a number of UK academics favoured this form of MBC. The relevance of the Swiss experience was widely questioned, principally on grounds of institutional differences; the fact that the Swiss use MBC to control M1 rather than M3 (and latterly as a target in its own right) was also noted. Few City experts could see non-clearing banks developing a significant and stable demand for cash in the absence of legal reserve requirements. There was little positive enthusiasm for mandatory MBC among the institutions either, though there was greater willingness to concede that some flexible forms of MBC might be workable. But many people, especially those closely connected with banking, argued that it would give rise to significant disintermediation especially if targeted on £M3. There was a widespread view that it would amount to "the corset in disguise".

59. One largely unresolved issue centred on the behaviour of the banks. Many practitioners stressed that banks were principally in business to lend to customers; that they were not short term profit maximisers and could afford not to be: that they would go to considerable lengths to accommodate their customers; and that lending decisions were not sufficiently centralised for reserve asset considerations to have major bearing on loan policy. The most likely responses to a cash squeeze were liability side management and disintermediation. Against this, it was argued that bank behaviour was a product of the monetary control environment. It would change if there were a change in that environment. British banks had shown themselves well able to adapt to the fiercely competitive conditions of international banking.

60. The discussions with foreign MBC experts dwelt far less on the institutional and practical implications and more on the broad theoretical advantages of a move to MBC. The central point to emerge was the importance of controlling the base, both because it was the only aggregate which the authorities could control directly, and because, it was argued, it has a reliable

bearing on the rate of inflation. The distinction between mandatory and non-mandatory systems was not thought to be crucial. While the importance of honouring the inflation objectives implicit in the MTFs was accepted, £M3 was not thought to have an intrinsic value as a target. While the transition to MBC would probably be difficult the Government's chances of achieving a deceleration in monetary growth by present methods of monetary control were generally held to be poor.

V. Monetary Base Control: Practical Possibilities

61. Control of the base would, by itself, require important institutional changes. This is true whether or not the banks are subject to compulsory reserve requirements. The terms on which the Bank provides lender of last resort facilities would have to change. It is unlikely that the discount market could survive in its present form. Call money would probably disappear, and a market in base money, like the federal funds market, would probably grow up. Techniques of selling gilt edged securities would need to change. The implications for medium to longer term interest rates are not clear, but short rates up to three months would certainly become more flexible. If major distortions in financial flows were to be avoided this flexibility would have to extend to all short rates, especially banks base rates but also mortgage rates as well as MLR. This would in turn have far reaching implications for the terms on which both the banks and building societies could lend to their customers; some changes in the overdraft system, for example, seem inevitable.

62. These changes are not necessarily undesirable, indeed some (eg. changes to the overdraft system) may be a necessary pre-condition to improved monetary control. But they would constitute a major upheaval in the UK financial system, comparable to that which followed Competition and Credit Control. The portfolio preferences of both the banks and non-banks would certainly change. There might be a surge in bank lending and the money supply, for example, as companies replaced overdraft facilities by term loans, and deposited the proceeds in their accounts. Changes in/character of short term assets, like Treasury bills,

which are currently fairly close substitutes for money, could be expected to affect the demand for money. The net effect of these changes is almost impossible to predict; but, even more so than the ending of exchange controls and the corset, a switch to MBC would have widespread repercussions on financial markets and asset prices.

63. To minimise the risks of a breakdown in control, there would have to be a reasonably long transitional period, in which the authorities gradually switched the focus of their operations from interest rates to the monetary base. In practice this might mean allowing the market an increasing role in the determination of MLR, (within a gradually widened band for example), while narrowing the target range for the growth in the monetary base.

64. It is impossible to judge in advance whether a purely non-mandatory system of MBC would prove practical in the longer term. The problems of transition might be even more acute than in moving to a mandatory scheme, since the authorities would have to guess the appropriate level of the base, as well as find out, by trial and error, the correct rate of growth. And in the final analysis, there is absolutely no guarantee that the interest rates generated by control of the base alone would keep the wider aggregates on an acceptable year to year path, even with the help of fiscal policy and debt management. If the demand for base by the banks was, in the event, weak and unstable, the chances are that control of the base would not give the authorities much effective influence on monetary conditions.

65. Annex 1 describes a mandatory version of MBC which might prove workable. The main features of the scheme are summarised in table III. It is designed to minimise the possible distortionary effects of imposing legal reserve requirements, while offering

more certain control over the wider aggregates than a purely non-mandatory scheme. While it might eventually be possible to dispense with legal reserve requirements there can be no assurance of this. The scheme must therefore be judged in its own right as something which might well become permanent, and not just as a half-way house.

66. It has some clear advantages over the corset; it does not impede competition between banks for example, and it is targeted at an aggregate (M2) with fewer obvious close substitutes than £M3 . Nonetheless it is a mandatory scheme; and as such it would need to be operated fairly lightly, if it were not in turn to give rise to some of the same problems of disintermediation and distortions that were experienced under the corset.

VI. Other Possibilities for Reform

(a) Using the existing reserve asset system more aggressively

67. It has been suggested that it might be possible to move in the direction of MBC, without major institutional upheaval, by using the present reserve asset requirement more aggressively. In practice this might mean that the authorities would have an eye to reserve asset growth in determining the movement of short term interest rates. The authorities would estimate the growth in reserves which would be consistent with the target for £M3 , taking account of the probable relationship between £M3 and eligible liabilities. If the demand for reserves was stronger than allowed for in this calculation, reserve assets would be created only in ways which would involve significantly higher short term rates.

68. This would represent a step towards controlling quantities rather than prices. Compared with a move to a mandatory MBC, however there would be a number of important differences. First,

the authorities cannot control the supply of reserve assets in the present system with any precision (though they can squeeze bank liquidity by calling for Special Deposits). Second, Treasury bills, which under an MBC would be the residual asset which the authorities would use to control the base, are reserve assets in the present system. The authorities therefore have less flexibility in the assets they can use to influence bank liquidity than they would have under MBC (though in principle this gap might be filled, as suggested in (b) below). There is also a risk of perverse changes in relative yields which, as in 71/72, might cause the non-bank private sector to shift into bank deposits, thus inflating the money supply. Thirdly, the denominator of the current RAR, eligible liabilities, is unsatisfactory as a control total, as experience with the SSD scheme has amply demonstrated. Using the present system more aggressively would leave the discount houses intact, though it would not avoid those institutional changes arising from greater volatility in short term interest rates. There is a risk that such a move might combine the worst features of the 71/72 experience and the corset, without achieving a credible move to interest rate flexibility or more effective control of underlying monetary conditions.

(b) Debt Sales

69. Under any system of monetary control, a crucial role must be played by sales of public sector debt. The more certain the authorities can be of selling a desired quantity, then, other things being equal, the better their control of the money supply will be. Whether Ministers decide to move to monetary base control or not, therefore, we shall have to persevere with efforts to improve the techniques and instruments at the authorities' disposal. This would, however, become more urgent with a move to monetary base control, because that would reduce the authorities' ability to use one of the present instruments - discretionary changes in MLR.

70. This is a minefield, and it would be wrong to suggest that it will be at all easy to pick a way through it. Present methods of selling debt can be criticised, but they have enabled the Bank to sell vast quantities of gilts at a real cost which has not obviously been excessive. The Bank surveyed a large number of alternatives in the Quarterly Bulletin for June 1979, but found problems with all of them. Nonetheless, it may be helpful in this paper to outline the areas in which we think it would be most profitable to concentrate further work.

71. One is the possibility of indexing at least a certain volume of gilts, in the hope of reducing their capital uncertainty and hence making them easier to sell at will. Work is already under way to design an indexed gilt which could be restricted to the UK investing institutions.

72. The second is the possibility of marketing gilts by varying their relative yield rather than by varying one general level of interest rate. With existing techniques the Bank find that they can only sell gilts on a rising market: that is, when interest rates are expected to fall, and gilts are expected to offer capital gains. On occasion, therefore, the authorities have to engineer the necessary expectations. Under present arrangements, they do so when necessary by raising MLR and hence the general level of interest rates to such an extent that investors expect the next move to be downwards.

73. This has several undesirable features. Firstly, it is inefficient: it is like reducing the price of all drinks to persuade people to buy more coffee. Secondly, it is uncertain: the authorities have no way of knowing how far to raise interest rates to convince investors that the peak has been reached. Thirdly, it is extraordinarily painful: changes in MLR are highly political and there is therefore a bias towards delay, in which there can be hiatuses in gilts sales.

TABLES AND CHARTS

Tables

- I Balance Sheets of "the Monetary Authorities" and Commercial Banks
- II The Monetary Aggregates: definitions
- III Illustrative MBC Scheme: main features

Charts

- 1. Monetary Base
- 2. Ratio of Money to Base (M1 and £M3)
- 3. Prices and Monetary Base
- 4. Prices and Money (M1 and £M3)
- 5. Monetary Base: Velocity
- 6. Money Velocity (M1 and £M3)

Table I: Balance Sheets

A. Consolidated Accounts of "the Monetary Authorities" (ie. relevant parts of the balance sheets of the Bank of England, the Royal Mint and the Exchange Equalisation Account)

Assets	Liabilities
1. Foreign exchange reserves (net)	1. Notes and coins held by banks and non-banks
2. Lending to central Government [note: changes in lending=CGBR less <u>all</u> sales of public sector debt to banks and non-banks]	2. Bankers balances
3. Lending to bank and non-bank private sector (including lending at last resort)	

B. Commercial Banks

Assets	Liabilities
1. Lending to public sector: ie bankers balances, notes and coins, public sector debt. [note: changes in lending equal PSBR less sales of public sector debt to non-banks, <u>less</u> non-bank holdings of notes and coins]	1. Residents' £ deposits
2. Lending in £ to private and overseas sectors	2. Overseas £ deposits
3. Lending in foreign currency	3. Foreign currency deposits
	4. Non-deposit liabilities

Table II: The Monetary Aggregates: definitions

MONETARY BASE

Defined as some or all of the liabilities of the monetary authorities.

Widest definition

M^1_0 = notes and coins held by banks and non-banks + bankers balances with the Bank of England.

Counterparts:-

changes in M^1_0 = CGBR less sales of public sector debt to banks and non-banks plus net official intervention in the foreign exchange market.

Narrow definition

M^3_0 = bankers balances with Bank of England.

Counterparts:-

changes in M^3_0 = CGBR less sales of P.S. debt to banks and non-banks less notes and coins plus net official intervention in foreign exchange markets.

MONEY SUPPLY

M_1 = notes and coins + £ sight deposits.

\bar{M}_2 = M_1 + 7 day time deposits of retail banks: defunct since 1972.
New definition would comprise all retail deposits eg. deposits under £50,000.7

£M3 = M_1 + private sector £ time deposits + public sector £ sight and time deposits.

Counterparts:-

changes in £M3 = PSBR less sales of public sector debt to non-banks plus bank lending less external finance of public and banking sectors less non deposit liabilities.

M_3 = £M3 + residents foreign current deposits.

PSL1 = Notes and coins plus £ bank deposits with original maturity under 2 years, CD's, plus money market instruments (ie. Treasury bills, bank bills, local authority deposits, deposits with finance houses) plus CTD's.

PSL2 = PSL1 plus savings deposits and securities (ie. shares and deposits with building societies, deposits with TSB's, deposits with National Savings Bank, Premium Bonds, British Savings Bonds, National Savings Stamps and gift tokens).

M_1 , PSL1 and PSL2 relate to non-bank private sector holdings; public sector deposits are excluded.

TABLE III

ILLUSTRATIVE SCHEME: MAIN FEATURES

Feature	Purpose
1. <u>Mandatory</u> : Banks must hold a specified proportion (eg. 8%) of their qualifying liabilities in base assets.	To ensure : changes in the base affect growth of wider monetary aggregates.
2. <u>Base assets</u> : consist of bankers balances at the Bank of England.	Bankers balances entirely under the control of the authorities. Supply of base to banks insulated from swings in non-bank private sector's demand for notes and coins.
3. <u>Qualifying liabilities</u> : consist of banks' retail sterling deposits.	The control total is M2 (total retail deposits), not £M3, to minimise scope for disintermediation through euro markets.
4. <u>Interest</u> : to be paid on required reserves at market rates.	To minimise incentive for disintermediation.
5. <u>Lagged accounting</u> : ratio computed from qualifying liabilities at each make up day and base assets averaged over the next 4 weeks.	To smooth out erratic fluctuations; to minimise incentive to disintermediation.
6. <u>Financial penalties</u> : breaches of the required ratio carry prohibitive penalties.	To enforce minimum reserve requirements; to encourage holding of excess reserves (for greater flexibility)
7. <u>Lender of last resort</u> : Bank of England to cease acting as day-to-day lender of last resort. <u>BUT</u> it will lend to the market without limit:-	To allow the authorities to control the base.
(i) to prevent financial crisis. (ii) to cap excessive rises in short term rates.	To guarantee the stability of the financial system. To provide a safety valve in the case of unintended base asset shortage.
8. <u>Transition</u> : Bank of England to increase gradually the amount by which interest rates have to rise before lender of last resort facilities are made available to relieve base asset shortages.	To allow the financial system time to adjust.

UNITED KINGDOM

CHART 1

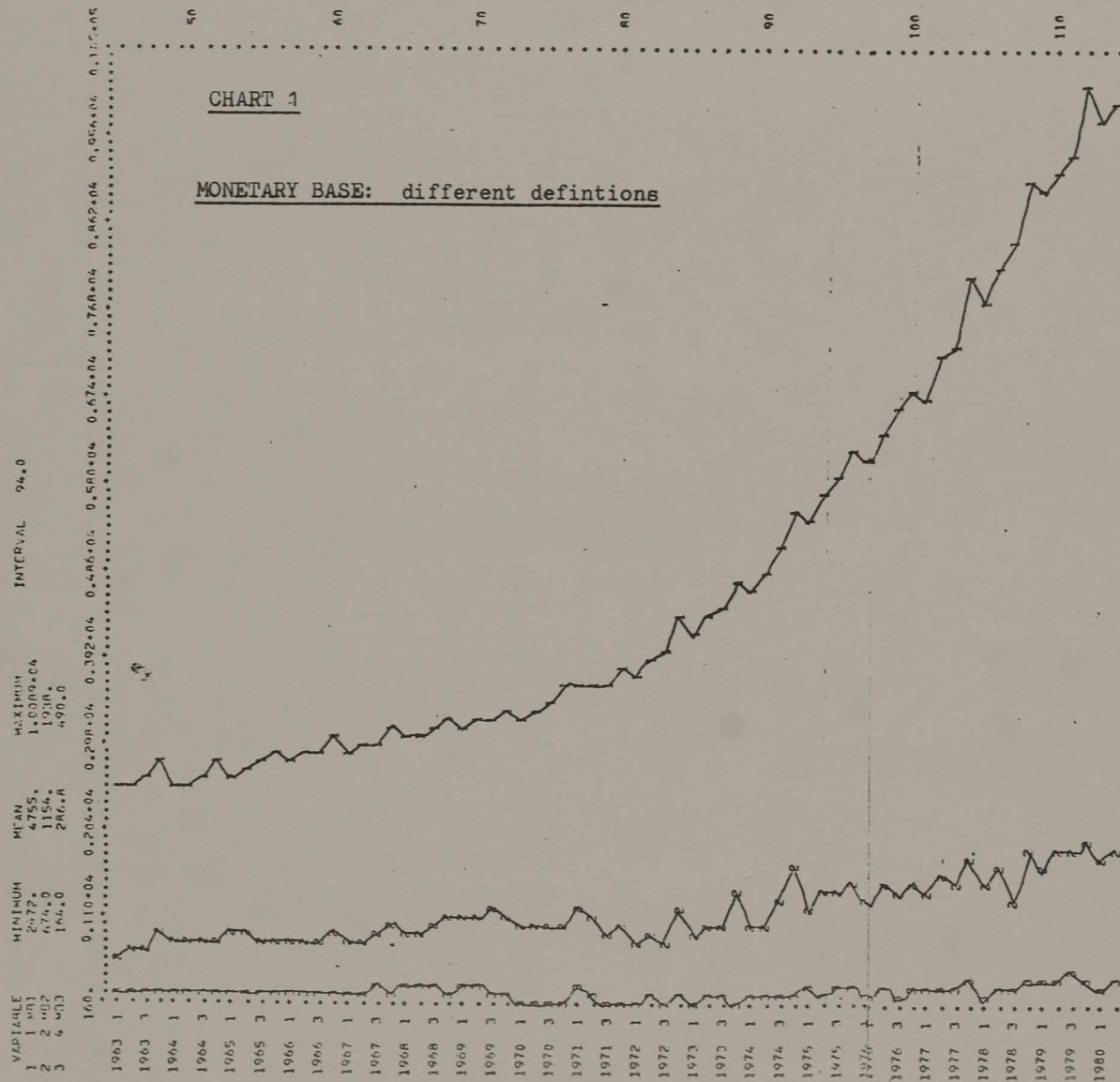
MONETARY BASE: different defintions

MB1 = Bankers' balances + total cash

MB2 = Bankers' balances + till money

MB3 = Bankers' balances

115552 071060



INTERVAL 94.0

MAXIMUM
1.0000+04
1900.
490.0

MEAN
4755.
1156.
286.8

MINIMUM
2.72.
674.0
164.0

VARIABLE
1 1 M01
2 2 M02
3 4 M03

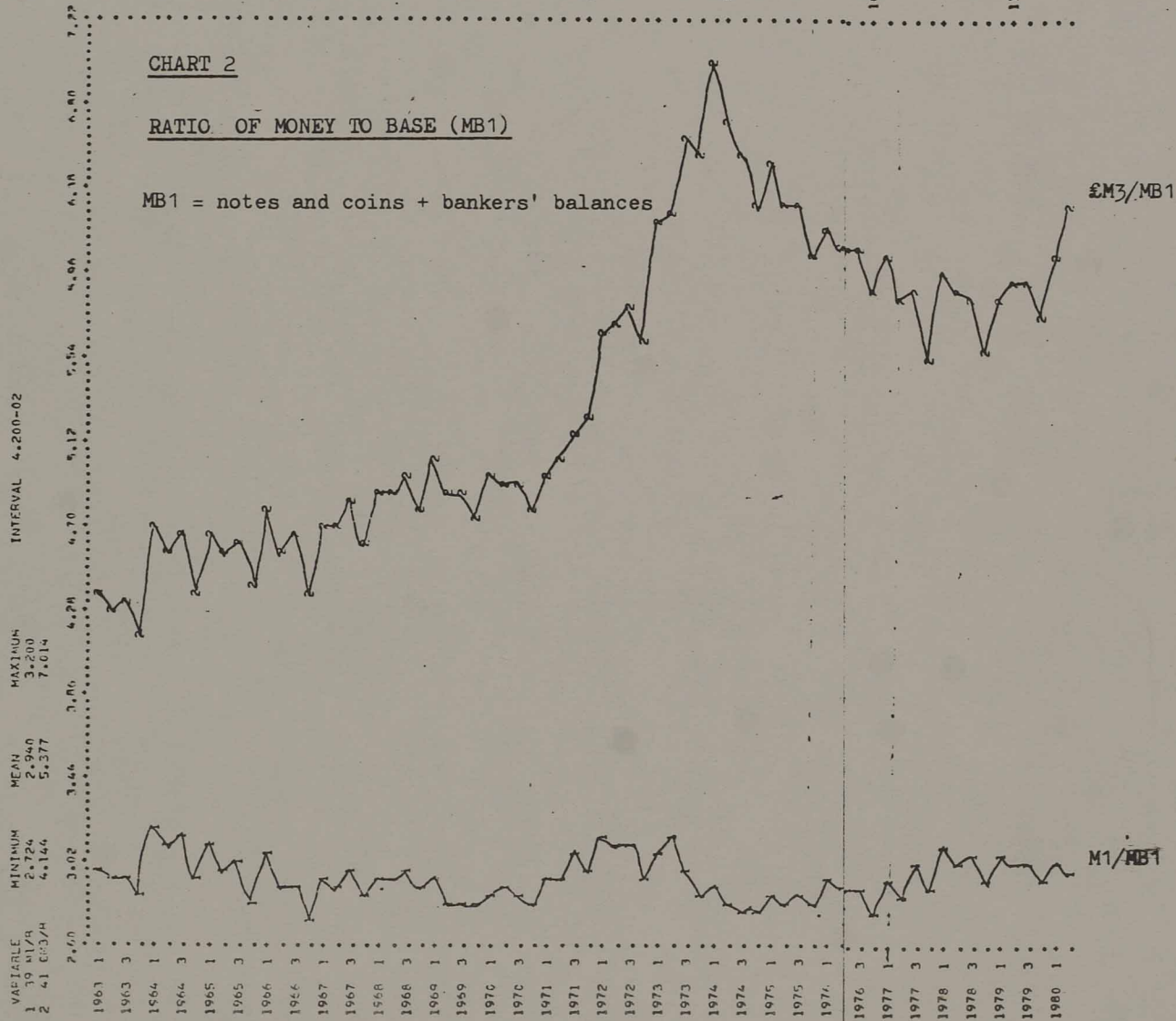
0.110+04 0.206+04 0.202+04 0.486+04 0.580+04 0.674+04 0.768+04 0.862+04 0.956+04 0.117+05

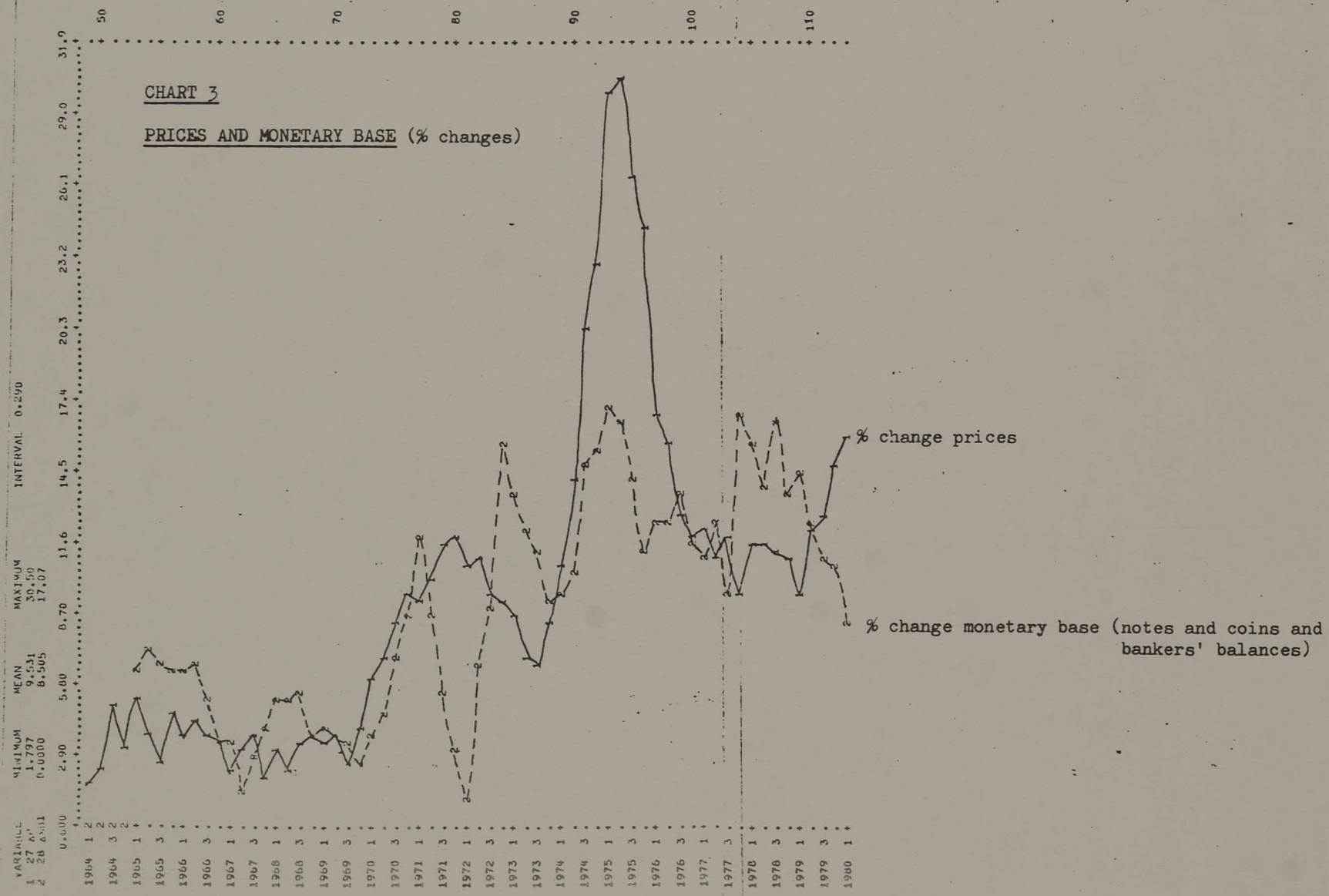
115552 071000

CHART 2

RATIO OF MONEY TO BASE (MB1)

MB1 = notes and coins + bankers' balances





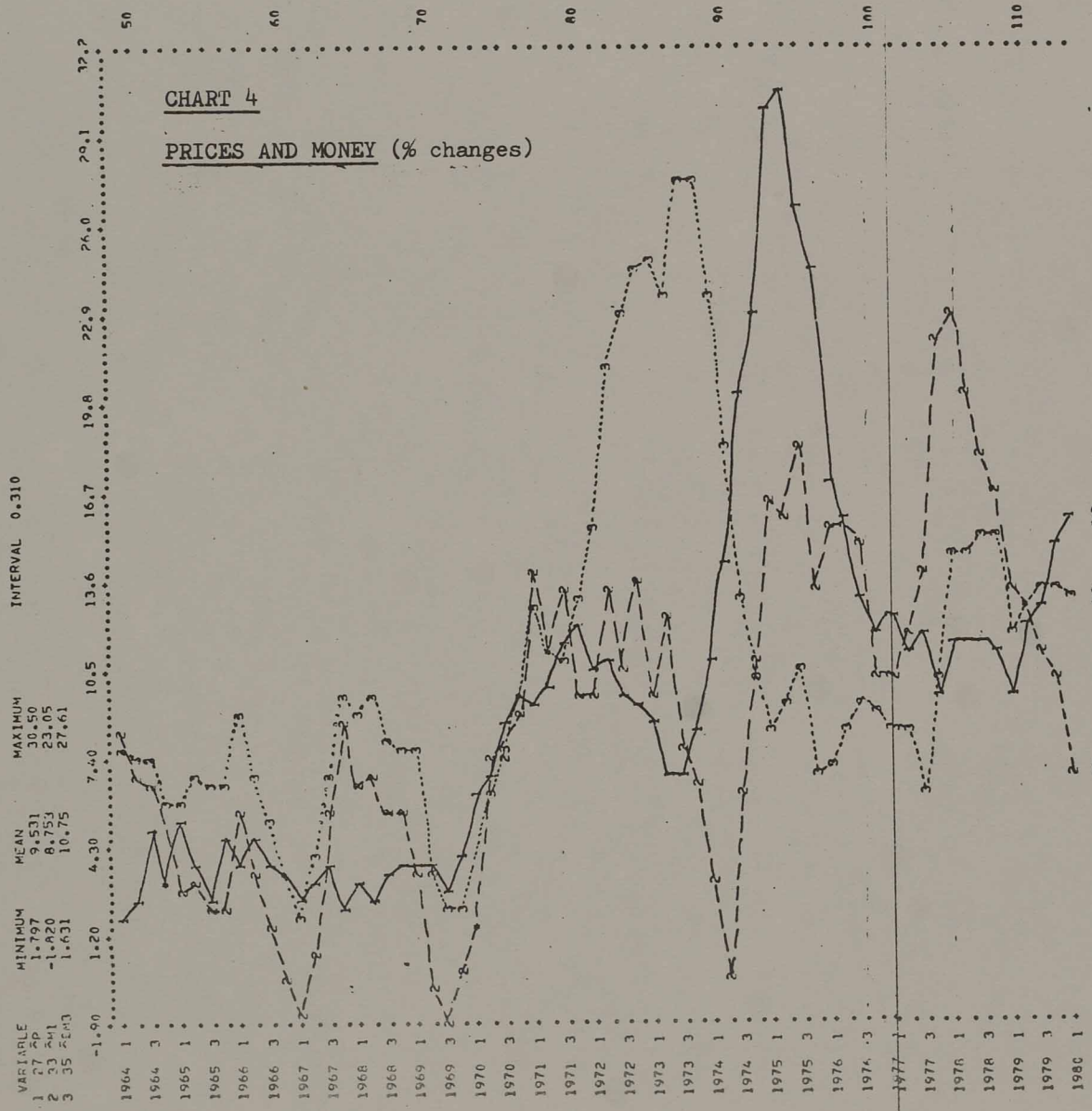
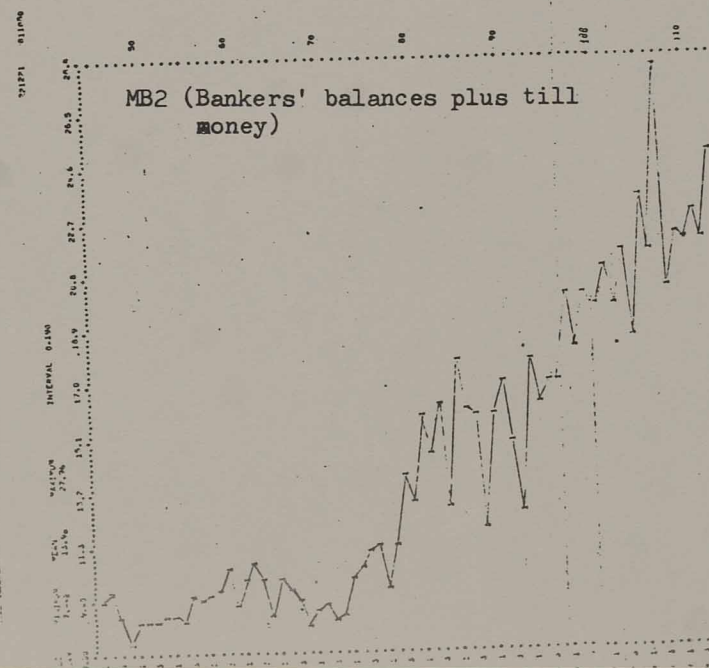
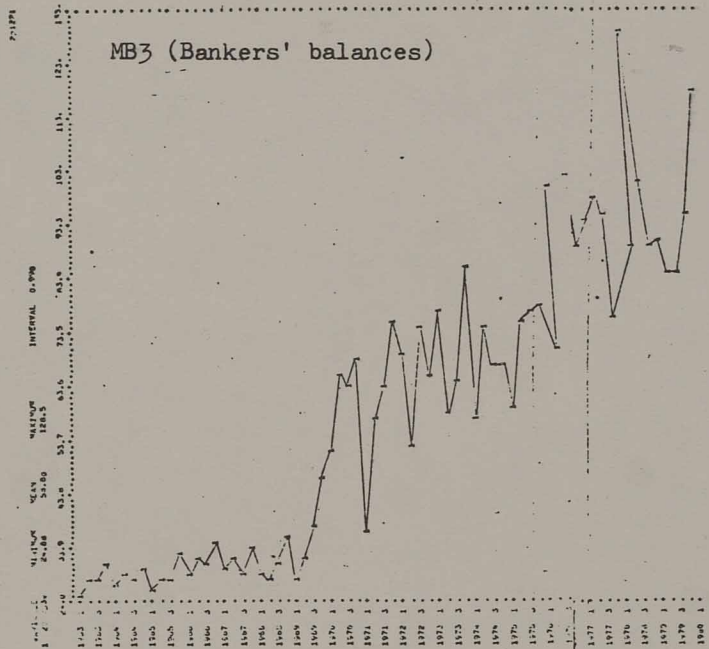
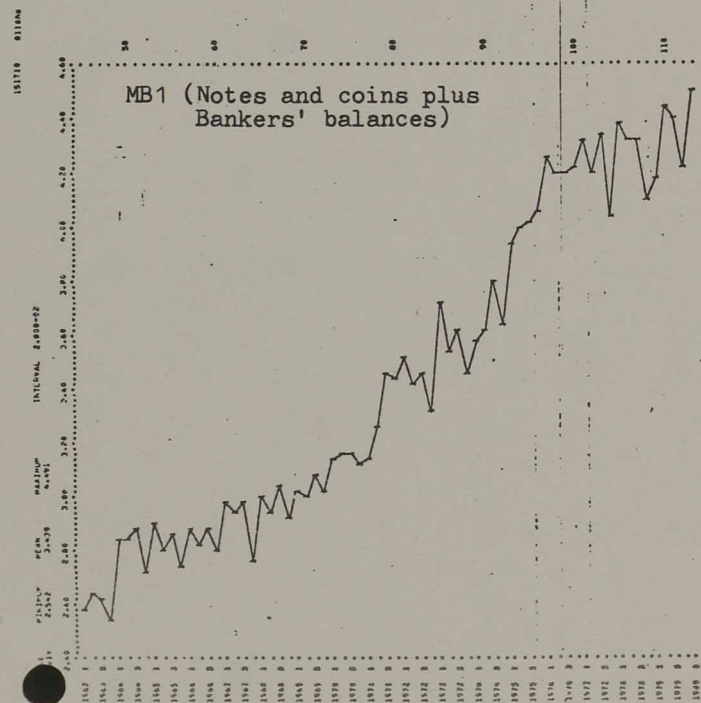
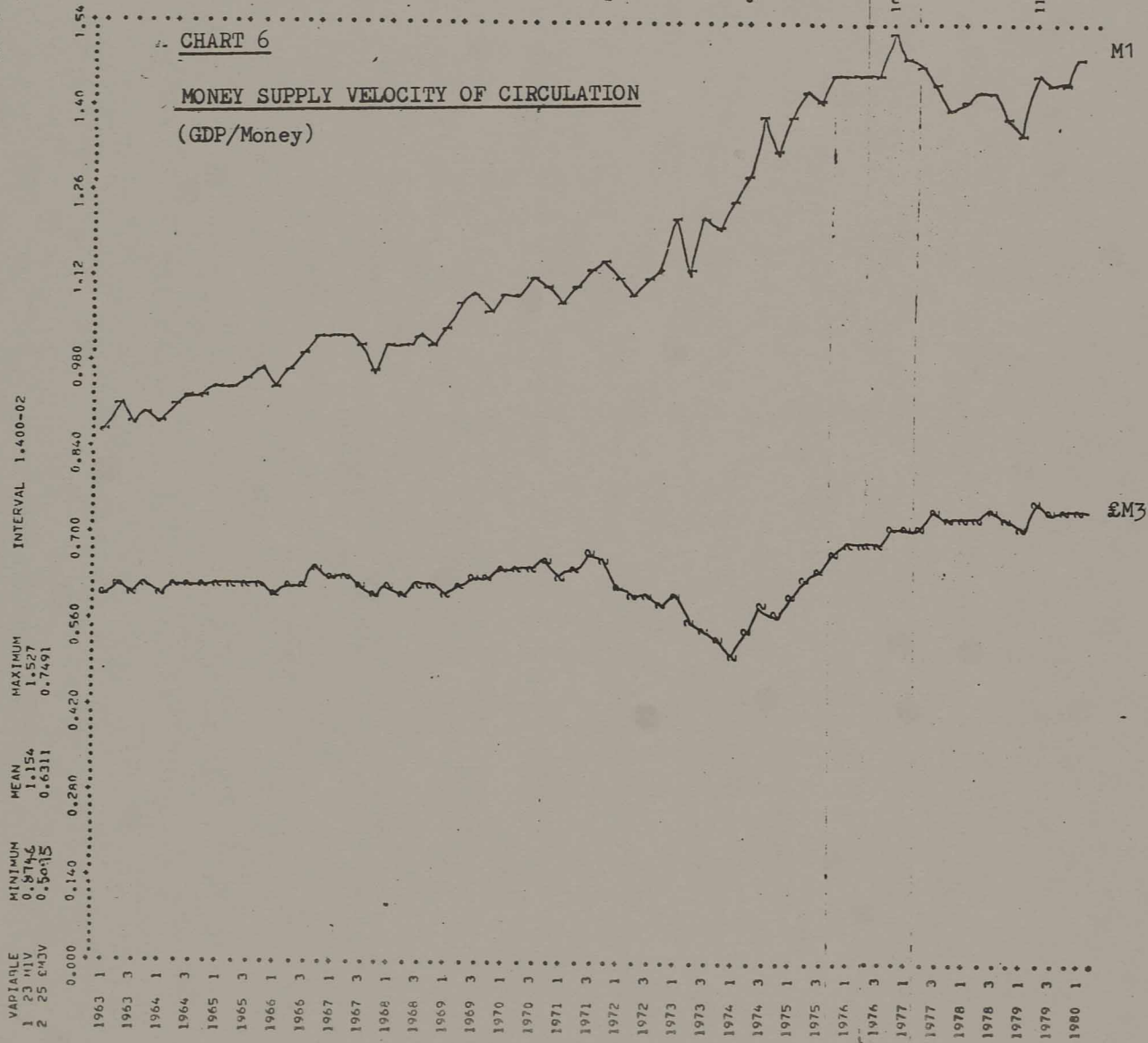


CHART 5

MONETARY BASE VELOCITY OF CIRCULATION



11552 07100



AN ILLUSTRATIVE SCHEME OF MONETARY BASE CONTROL

1. This Annex considers the issues involved in designing a workable system of mandatory monetary base control and draws up an illustrative scheme suitable for use in the United Kingdom.
2. There are six sections of the note:
 - (i) the illustrative scheme;
 - (ii) how it would work;
 - (iii) the transition to the scheme;
 - (iv) the rationale of the scheme;
 - (v) consequential institutional changes from its implementation;
 - (vi) the potential for later transition to a non-mandatory system of control.

- (i) The Illustrative Scheme

3. It is important that the system of monetary control should be well understood and accepted by the financial community if it is to function smoothly. The details of any scheme would, therefore, all have to be subject to discussion with the banks and other financial institutions prior to its announcement. That said, a workable control system for the United Kingdom might look as follows.

- (a) Banks would be required to hold a specified proportion of their qualifying liabilities - 8 per cent, for example - in the form of base assets.
- (b) Base assets would consist of bankers' balances at the Bank of England.
- (c) Interest would be paid on the required base at a daily rate equal to that which the banks could obtain in the market. No interest would be payable on excess holdings.
- (d) Qualifying liabilities would consist of the banks' retail sterling deposits*.

*There is no statistically accepted definitions of wholesale deposits. Broadly, wholesale money covers large scale deposits (say, over £50,000 lodged mainly by financial institutions and large corporations which bear money market rates of interest. They include deposits taken at branches, inter-bank deposits and those raised in the money markets. Retail deposits include current accounts as well as traditional 7-day time deposits.

- (e) For the purpose of calculating the banks' base asset/qualifying liabilities ratio, the following accounting procedure would be used. Each bank would report its qualifying liabilities on the monthly make-up day, as at present, and this would form the denominator of the ratio. The numerator would be taken as the banks' minimum weekly average holding of base assets over the period of the succeeding banking month.
- (f) From the outset, there would be heavy and indeed prohibitive financial penalties on individual banks for breaches of the required base/qualifying liabilities ratio. These would be designed so that it never paid banks to respond to the control by breaching the requirement.
- (g) the Bank of England would announce its intention of ceasing to operate as an automatic day-by-day lender of last resort. Instead, the Bank would stand ready to lend without limit to the market on either of two conditions applying:-
- (i) at times of financial crisis, when the Bank would act as genuine lender of last resort; and
 - (ii) when inter-bank rates had risen to a level considered excessive. The level at which the Bank would lend would not be announced in advance.

(ii) How The Control Scheme Would Work

4. The Initial Situation: To illustrate the workings of the scheme, suppose that at the make-up day of the January banking month, the banks reported qualifying liabilities of £50,000 million. In the first instance, the scheme provides for a mandatory base/deposits ratio of 8 per cent (point (a)). This is backed up by penalties for non-compliance (point (f)). Banks, therefore, need to hold at least £4,000 million in base assets. Moreover, each individual bank may want to hold excess base even though the excess does not pay interest (point (e)). This is to guard against the possibility that other banks may bid base assets away from it, thus leaving the first bank below the prescribed ratio and liable to heavy penalties. In order to ensure that banks collectively hold sufficient excess reserves to make the system workable, it is important that the penalties for breaches of the prescribed ratio be severe. Otherwise, the banks might be prepared to incur mild penalties from time to time rather than holding excess

reserves at no interest. Given sufficiently stiff penalties, these excess holdings might be of the order of 2 per cent so that banks would, in fact; wish to hold £5,000 million of the base.

5. At the outset, the authorities are taken to be content with the growth of banks' qualifying liabilities which they believed to be consistent with the monetary target. In January, the supply of base will be close to the demand. But suppose that the monetary growth inherent in the reported January figures is too high to be acceptable. The authorities' reaction must be to restrict the base.

6. The Authorities' Behaviour: In order to tighten the base, the authorities have to operate on the following identity:

Change in Bankers Balances at the Bank of England (ie Change in the Base)	=	Central Government Borrowing Requirement	+	Net Official Intervention in the Foreign Exchange Market	-	All Sales of Public Sector Debt (including Notes and Coin)
---	---	---	---	---	---	---

7. Of the three items on the right-hand side of the base identity, the central government borrowing requirement will normally be outside the control of the monetary authorities in the short run. Moreover, the size of the foreign exchange market intervention will be fixed by exchange rate policy. The authorities must then sell sufficient public sector debt over the February banking month so that, taking account of the CGBR and changes in the foreign exchange reserves, the base is small enough to put the banks under pressure. Because of their January qualifying liabilities, the banks must hold £4,000 million and would like to hold £5,000 million in base. Public debt sales must then be such as to reduce the base to below £5,000 million. This would represent a disequilibrium situation for the banks, who may be expected to take steps to try to restore their desired base/deposit ratio. As debt sales are increased so that the base falls towards £4,000 million, the pressure on the banks to do so is stepped up. Indeed, if the authorities were to reduce the base below £4,000 million, the disequilibrium would have become so great that the banks were quite unable to meet the required base/qualifying liabilities ratio and would be forced to incur the penalties for default. It should be noted that from the point of view of controlling the base alone, it does not matter what public sector debt is sold or indeed to whom. On the other hand, these factors may affect the behaviour of some wider aggregates. Sales of Treasury Bills to the non-bank private sector, for example, will increase PSL1 whereas sales of gilts will not.

8. From the point of view of monetary control, the direct effect of these actions is to make bank deposits less attractive. In order to sell the extra debt needed to restrict the base, the interest rate on public sector debt will have to rise and the demand for bank deposits will be reduced. This effect will occur whoever buys the extra debt.

9. The Banks' Behaviour: But as well as the direct effects of the authorities' actions, there will be further effects on monetary growth stemming from the fact that the banks are now in disequilibrium. There are a number of ways in which individual banks can try to restore their base/deposit ratios, and they will resort to some or all of these:-

- (i) They may try to borrow base assets from each other by bidding for funds in the inter-bank market. This will lead to a rise in inter-bank rates of interest and cause such marginal deposits to become expensive.
- (ii) Each bank can increase its own holdings of base assets by selling its holdings of public sector debt either to another bank or to the customer of another bank. In itself, this action will not increase the base: only if the authorities intervene and repurchase public sector debt will it expand. But, assuming that this does not occur, as the banks collectively sell public sector debt to the non-banks, its rate of interest will rise and the attractiveness of bank deposits will be reduced.
- (iii) They can attempt to switch their qualifying liabilities into forms which are just outside the scope of the control. Since in the above scheme qualifying deposits embrace all retail sterling deposits, the main possibilities would be for the banks to raise the premium they pay to depositors for large quantities or, alternatively to shift liabilities and assets off their books entirely. Acceptance credits and the Euro-markets present a number of possibilities of this latter kind.
- (iv) They can reduce their lending to the private sector, using the proceeds to reduce their qualifying liabilities. This reduction in bank lending would reduce the resources available to the private sector and hence again reduce the demand for bank deposits. Banks could, in fact, accomplish

this reduction in lending in several ways. First, they could raise their base rates on lending and rely on the reduced demand for lending to bring about the reduction. They would indeed have an incentive to do just this in order to prevent the possibility of round-tripping arising from the raised rates in the inter-bank market. Second, they could ration credit without raising its price, merely turning away non-preferred potential borrowers. Third, as an alternative to outright credit rationing, the banks could make changes to the terms on which they lent - for example, lending on less flexible terms or encouraging customers to borrow from non-bank sources.

10. Not all of these alternatives will aid monetary control. Possibilities (ii) and (iv) may be said to constitute asset management by the banks and, if followed, will lead to a reduction in monetary growth. Possibility (i), however, constitutes liability management. Ultimately, this course cannot succeed in meeting the banks' desire to reduce their base asset pressure. But over any period that it is practised by the banks collectively, it could have perverse effects. Since the effect is to raise at least some deposit rates, the non-banks may find bank deposits enhanced in attraction and thus tend to increase monetary growth. On the other hand, possibility (iii) includes disintermediation; the banks would succeed in relieving their base asset pressure, but in a way which would have little genuine monetary consequence for the economy. It could also result in action which reduced the narrow aggregates such as M2 but which had no impact at all on the wider aggregates such as PSL1 or PSL2.

11. It is not easy to tell which of these paths the banks would follow in advance of imposing the scheme. But three points in particular seem to be relevant:-

- (i) Over a reasonable period of time, the banks would probably act in ways which maximised their profits or at least minimised the loss of profits due to the control.
- (ii) But banks would not necessarily act as profit maximisers over very short intervals of time. They are sensitive to sharp short run increases in their profits which may lead to hostile public comment. Thus, at times when their profits are erratically high, banks may not be averse to making losses on some of their operations.

(iii) The potential perverse response of monetary growth from liability management by the banks can only arise if one or more short-term interest rates moves inflexibly. In particular, a perverse response is likely to occur if the Treasury Bill rate is not allowed to move upwards in line with the rate on the banks' liabilities or if the banks do not move their lending rates in line with the rates they pay on their marginal deposits.

12. From the point of view of operating monetary control, there are four implications. First, to the extent it is possible at low cost, in general the banks will resort to disintermediation to relieve their base asset pressure. It is this course which will have least effect on their profits: other routes are only likely to be followed if methods of disintermediation are either not available or at high cost. Second, in the longer term and if disintermediation is not possible, asset management will take place and monetary growth will be reduced. This will be so because, for the banks as a whole, liability management will not relieve the base asset pressure but will lead to lower profits as bidding for liabilities becomes increasingly expensive relative to the rates obtainable on earning assets. But thirdly, in the short run, liability management may well occur and lead to perverse responses in monetary growth. There are two reasons for this. Disturbing their asset portfolios is likely to be an expensive business for the banks. Contraction of private sector lending may lead to long-term loss of good will amongst the banks' customers, while sales of public sector assets may force realisation of capital losses as interest rates are rising. At the same time, at times when base asset pressure is severe, interest rates in general are likely to be high. It is in these circumstances that banks' profits are also likely to be unusually high because of the endowment income the banks receive on their low interest current accounts. Particularly if the base pressure is expected to be short-lived, loss-making liability management operations may provide a useful device for the banks to dissipate their unwanted short-term profits bulge. Fourth, so far as the authorities are concerned, they must behave in ways which minimise this incentive to liability management rather than asset management. One point is that they must not restrain the Treasury Bill rate at times when base asset pressure is created. A further point is that they must allow the banks time to adjust their own rates. For this reason, sustained moderate base asset pressure is likely to be more successful than sharp but short-lived pressure.

13. The Combined Effects of the Authorities' and the Banks' Actions:

As the authorities took action to restrict the base, the rate on public sector debt will have risen. Provided they have not been able to react entirely by disintermediation, the banks will have had to begin to sell assets to relieve the base asset pressure resulting from the authorities' actions. This will have tended to raise public debt rates further as well as reduce bank lending. All of these effects will reduce monetary growth and by the time of the make-up day in the February banking month, the banks' base asset requirements for the March banking month will have become easier. These processes will continue until the banks are once again holding their preferred excess holdings of base assets.

14. Effectively, the base control has allowed the authorities to control the money stock directly via the (nearly) fixed ratio between the base and the money stock. In the process, the interest rates necessary to control have been generated automatically. The more base asset pressure the authorities cause, the greater will be the interest rate changes generated and the greater the incentives for the banks to reduce their liabilities.

15. But at the same time, it may not be possible for the authorities to control the level of the base with exactitude. Unanticipated short-run movements in the CGBR, for example, could lead to greater base asset pressure than the authorities intended. Moreover, it is likely that as the base is restricted to levels close to the required minimum, small changes in base pressure would lead to large swings in interest rates. For this reason, it is desirable that a safety-valve be built into the system. Point (g) of the scheme thus provides for some high level of interest rates at which the Bank of England should lend base assets to the system to prevent further rises. Why this facility would assume the exact form proposed in the illustrative scheme is discussed further in the next section.

(iii) The Transition to the Illustrative Scheme

16. Under monetary base control, the authorities aim to control quantities and allow the interest rates to be determined by the market. This is a very different world from that of the present monetary control system where the authorities essentially operate on short-run interest rates in order to influence monetary quantities. Neither the authorities nor the banks have experience of this new environment and there is bound to be a learning period of some duration while the controllers and those controlled determine how to operate in it. It is therefore desirable that there should be a period of transition from the existing to the new regime rather than an abrupt and probably disruptive change-over.

17. This transition is most easily accomplished by a gradual change in the role of the Bank of England as lender of last resort. Currently, short-run interest rates are largely administered by the authorities and the lender of last resort function is used to help enforce the authorities' policy. The market is normally able to borrow from the Bank on demand at rates only a little above prevailing market rates. Interest rates cannot move for this reason far above the Bank's lending rate. As the first step in the transition, the Bank would announce that it would no longer lend on demand but only when interest rates had risen by a considerable extent from their original levels. This extent would not be announced, but the effect would be that the market would have a chance to clear at rates over that range, without the authorities intervening. On the other hand, should base pressure be such as to raise rates above the Bank's intervention point, then the Bank would lend at that rate, automatically relieving the base asset pressure and preventing further rises in rates.

18. As the second stage in the transition, the margin between the Bank's intervention point and the initial level of interest rates would be progressively widened. In the first stages, the range over which interest rates could move would be fairly small, the market would borrow from the Bank frequently and base pressure would correspondingly often be relieved. As the range widened, interest rates could move more freely, lender of last resort facilities would be granted less often and base asset pressure thus more completely controlled. Ultimately, the intervention point would be set so high above prevailing rates that the Bank would rarely lend to the market. Normally it would do so only when mistakes by the authorities or the banks had created unintended severe base asset pressure. In this sense, the lender of last resort function would be serving the role purely of the safety-valve, discussed in the last section, and the transition to base control would then be complete.

19. In order for the market to take advantage of these transitional arrangements, the authorities would announce at the outset that the system would be developed in this way. But the intervention point or its projected path should not be made public. If it were, there is a danger the markets would treat it, like MLR, as a discretionary device for administering interest rates. It is important rather, that the markets understand that the intervention rate does not have this function. It is instead only a means of transition to the base control system and then, finally, the safety-valve of the fully-evolved regime.

(iv) The Rationale of the Illustrative Scheme

20. In order to be workable, any scheme of monetary base control has to be specific on the following seven points:-

- (i) Should there be a mandatory base asset/bank liabilities ratio?
- (ii) How is the lender of last resort facility to be used?
- (iii) What assets are to comprise the base?

If there is to be a mandatory ratio:

- (iv) How big is the ratio to be?
- (v) What bank liabilities are to be included in its scope?
- (vi) On what accounting basis is the ratio to be measured?
- (vii) What are the penalties to be for breach of the ratio requirement?

21. In the illustrative scheme, these points have been answered in a particular way. The main paper has discussed why a mandatory ratio has been included and the previous sections have considered what form lending of last resort should take. In this section, the reasoning underlying the rest of the choices is outlined.

(a) What Assets are to Comprise the Base?

22. As the main paper notes (paragraph 36), in a mandatory scheme, it is control of the supply of base assets to the banks which is important. The question is then whether the base should include bankers' balances at the Bank of England, banks' holdings of notes and coin - till money, or both. This issue must turn on which base definition the authorities would find the easiest to control.

23. In control terms, there is a clear case for not including till money in the base. Unlike bankers' balances at the Bank of England, notes and coin are held by non-banks. If they were included in the base, the banks would have to compete with the non-banks for the available base assets. Because we do not fully understand the demand for cash by the non-banks, neither the banks nor the authorities would know how much of the total base would finish in the hands of the banks and thus be available to support deposit creation. This would create unnecessary uncertainty.

24. Against this, under present arrangements, the banks would be able to vary their base beyond the control of the authorities by surrendering spare till money for credit as bankers' balances at the end of the day.

This would be a nuisance but administrative means might be found to limit it. For example, an arrangement whereby till money surrendered to the Bank of England one day did not count in bankers' balances until the next day would remove most of this problem.

(b) How Big is the Required Ratio to be?

25. Three separate points bear on this issue and underly the proposals of the illustrative scheme. First, the required ratio must not be such as to penalise the banks, since to do so would give rise to disintermediation even before the control was made effective. To avoid this occurring, the banks must be remunerated for any loss incurred in being forced to hold required base assets. The obvious way to do this is to make required base holdings interest-bearing at market rates.

26. Secondly, from the point of view of making the authorities' intentions clear to the market, it is desirable that the base should be as large as possible. Not all of the counterparts of the base are under the control of the authorities in the short run. Unforecast swings in the CGBR alone, for example, can be as much as £500 in a single day and this would feed directly into the base. Clearly the higher the normal level of the base, the less important these fluctuations will be. For example, assuming qualifying liabilities of £50,000 million as in the earlier example, a base/deposit ratio of 1 per cent would imply a normal base level of only £500 million and the fluctuations would have a major impact. The banks would not know whether a sudden sharp contraction of the base represented a deliberate change in the authorities' policy, requiring action on their part, or whether it was entirely unintentional. But a ratio of 15 per cent would be consistent with a normal base of £7,500 million and the CGBR swings would have less impact. Another way in which the effects of CGBR fluctuations can be ironed out is to average the base over a period, say a month, in calculating the numerator of the required ratio. Because we can forecast the CGBR with more confidence over a month than on any single day within the month, this provision would make it easier for the authorities to generate the desired degree of base asset pressure.

27. But, thirdly, too high a ratio would militate against the power of control. Clearly the higher the ratio, the greater the contraction in base assets required to achieve a given contraction in the target aggregate. Hence the greater the amount of public sector debt which

the authorities need to sell to maintain control, and there would come a point when so much debt had to be sold that it was just not feasible to control the base at all. Moreover, it is clearly undesirable to compel the banks to hold so much of their balance sheet in risk-free interest-bearing base assets that it dominates or encroaches on their proper business of conducting commercial transactions.

28. Where to strike the balance between these second and third points is a matter of judgement. A ratio of 6-10 per cent might be sufficiently high to prevent gross distortion due to Exchequer fluctuations, especially if the base were averaged for the calculation. At the same time, such a ratio might give sufficient leverage for satisfactory power to be generated, by feasible changes in the base. The proposals of the illustrative scheme thus incorporate an 8 per cent base asset requirement. Interest would be paid on this base in view of the first consideration above.

29. One further point which needs to be borne in mind is the problem of finding income to finance the operations of the Bank of England. Currently, the clearing banks have to maintain interest-free balances with the Bank of England from which the latter is able to generate the necessary amount of income. But this issue is separate from that of monetary control and quite different considerations apply. It will be necessary to reconsider this matter after the decisions on control have been taken.

(c) What Liabilities are to be Included in the Scope of the Control?

30. To a large extent, the choice of monetary aggregate will pre-determine the range of bank liabilities which have to be subject to control. Many issues will bear on this choice and will be of a much wider macroeconomic nature than would stem from the method of control alone.

31. Nevertheless, it remains true that mandatory monetary base control would be more suited to the control of some aggregates than others. In the section above dealing with how mandatory control would work, it was suggested that control would only have achieved its aim, if the banks were unable to relieve base asset pressure entirely or predominantly by disintermediation having no genuine monetary consequence for the economy. Within the range of their deposit liabilities, it is

primarily with wholesale deposits and certificates of deposit that the banks would have most scope to react in this way. Experience of the corset has shown that there are close substitutes for these items which do not appear in banks' books at all. On the other hand, the scope for disintermediation of retail deposits is much less.

32. For this reason, the illustrative scheme proposes to exclude CDs and wholesale deposits from control. This would mean reinstating a monetary aggregate very close to that which used to be known as M2; it is certainly no coincidence that Gordon Pepper, one of the most forceful advocates of monetary base control in the UK, has also been strongly urging an M2 target.

33. For the purposes of control, it would be necessary to define wholesale deposits more strictly than the bankers' customary usage. There are three broad possibilities:

- (i) by size;
- (ii) by original maturity; and
- (iii) by residual maturity.

All these options have advantages and drawbacks, but the first seems the most promising. Wholesale deposits would thus be defined as those in blocks of greater than, say, £50,000. This limit would have to be updated from time to time, perhaps annually. Some distortion might occur from use of this criterion since banks would have incentive to encourage their customers to amalgamate retail deposits into wholesale blocks. On the other hand, the scope for this is thought to be limited. By contrast, definition of wholesale deposits by original maturity would present greater problems. Suppose, for example, a retail deposit was defined as one payable on notice of seven days or less. At times of base asset pressure, banks would merely have to induce their customers to hold deposits payable on notice of 8 days in order to have a large part of their retail deposits re-classified outside the scope of the control. Definition by residual maturity would surmount this particular problem, but in the process largely undermine the case for a monetary target at all. If retail deposits were defined as those bank deposits due to be encashed in 'n' days' time or less, there would be no logical reason for not including all financial instruments due to be encashed over the same in the target aggregate. This would have to include a substantial part of outstanding Treasury Bills and commercial paper as well as, for example, maturing gilts and life

assurance policies. For these reasons, definition of retail and wholesale deposits by size seem, at this stage, the most practical possibility. But this is an area where further work and consultation is needed.

34. It is also proposed that retail sterling deposits made by overseas residents should be included in the qualifying liabilities, to the extent that there are any. Such holdings in retail sizes are more likely to be used for transactions in goods and services which will affect the price level than for speculative purposes which will not. It is therefore correct to include them in the control. On the other hand, all foreign currency deposits would be excluded as at present, though in any case there are likely to be very few such accounts of retail size.

35. Qualifying liabilities would thus consist of all banks' sterling deposits of less than, say, £50,000. One helpful consequence of this definition is that the difference between qualifying liabilities and the banks' contribution to M2 would be small. This is in contrast to the present situation where eligible liabilities and the banks' contribution to £M3 can move over short periods somewhat differently.

(d) On What Accounting Basis is the Ratio to be Measured?

36. The point of a mandatory control system is to ensure that the banks observe a minimum base to deposits ratio. Two questions arise in the calculation of this ratio:-

- (i) How often does it need to be calculated; and
- (ii) What period for the base and qualifying liabilities is to be used in calculating the ratio?

37. In principle, the answer to the first question is as often as possible since this reduces the opportunities for window-dressing by the banks on ratio calculation day. Indeed, since the base consists only of bankers' balances, the authorities do know the base asset position of each bank each day. But banks currently report their liabilities only once a month and so the ratio cannot be calculated more frequently than this. The proposals of the illustrative scheme accordingly allow for monthly calculation of the ratio.

38. Calculation of the ratio could be performed in three different ways: lagged accounting - this period's base divided by last make-up day's qualifying liabilities; current accounting - base on make-up day divided by qualifying liabilities on the same day; lead accounting - last period's base divided by this make-up day's qualifying liabilities. Previous discussion has suggested the desirability of taking the base measure as the average over a period in order to smooth out unintended fluctuations. This consideration alone rules out current accounting, leaving lagged and lead accounting as contenders.

39. In the illustrative scheme, it is proposed that lagged accounting be used, in order to minimise the incentive to disintermediation. Any mandatory scheme of control must involve some such incentive but the problem would be particularly acute with lead accounting.

Given its base asset position over the previous month, an individual bank would know on make-up day precisely what amount of qualifying liabilities it had to remove from its books in order to meet the prescribed ratio. This would be a very direct incentive to disintermediation and would certainly cause marked distortions on make-up day. Under lagged accounting, banks would still have some reason to reduce their declared liabilities at any make-up day. But the incentive would be less direct and hence less powerful.

40. While accepting the need for base averaging over a period, it would not be desirable under lagged accounting to take the base position as the average over the next full banking month. Banks would find it profitable to hold no base in the first part of the period and then to borrow large amounts of base at lender of last resort rates on the last day in order to meet the requirement. This would create gross distortions. To avoid this, it is proposed in the illustrative scheme that the numerator of the required ratio ^{be} defined as the minimum of the 4 or 5 weekly average holdings of base assets over the relevant banking month. In this way, the incentive to the banks to borrow all the base requirement at the last moment would be reduced while the benefits of averaging would be retained.

(e) What Penalties Should be Applied to the Banks for Breach of the Mandatory Ratio Requirement?

41. Penalties have no role in the illustrative scheme other than to enforce the minimum base asset ratio requirement. They are not intended to add flexibility to the scheme since this role is played by the lender of last resort facility, which acts as the safety valve. Consequently, penalties must be prohibitive in order to prevent the banks ever having advantage in breaching the requirements.

42. One possibility is to have no formal penalties but to rely on banks' fear of Bank of England displeasure to prevent breaches occurring. This is the way in which the existing 12½ per cent reserve asset ratio requirement is operated and it has been well observed. But, at the same time, little reserve asset pressure has been applied since 1973 and the Bank of England are not sure that the ratio would continue to be observed if continuous pressure were applied. It would therefore seem necessary to have a system of formal financial penalties for breaches in order to protect the base asset ratio requirement. The exact form would be for consultation with the banks but the principle of their prohibitive nature would not.

(v) Institutional Changes Consequential on Mandatory Control

43. It must be clearly recognised that any scheme of mandatory monetary base control would involve considerable upheaval amongst financial institutions. It could be some time before the ramifications of the change were complete. The proposals of the illustrative scheme would not cause any more institutional mutation than is absolutely necessary but their introduction could certainly involve some disruption. On the other hand, not all of the changes would be necessarily unwelcome.

44. It is possible to identify seven main areas where monetary base control would imply some significant changes:-

- (i) the discount market;
- (ii) the gilts market;
- (iii) central government financing arrangements;
- (iv) local authority financing arrangements;
- (v) the lending operations of the banks;
- (vi) the building societies;
- (vii) prudential control of the banks.

(i) The discount market: It is in this market that base control would imply the most significant changes. Currently, discount houses play two key roles in the interaction of the banking system and the Bank of England. First, in consortium the 13 houses undertake to tender for all available Treasury Bills, at some price, at the weekly auction. In this sense, they guarantee that the residual financing needs of the Government can always be met. As an overt quid pro quo, the discount

market always has access to lending from the Bank of England and at MLR. By use of this facility and on-lending this borrowing to banks, the discount market always ensures that the banking system has the cash available that it needs in order to meet its requirements to the Bank of England and for its own commercial needs. Both the authorities and the banks have found this arrangement convenient.

Monetary base control would entail that this arrangement had to cease. The Bank of England would not lend to the market except in exceptional circumstances when it was acting as genuine lender of last resort. It could not act as day-to-day lender as at present because the banks could always borrow in order to increase their balances at the Bank of England and thus their base assets. Consequently, the discount houses have no daily role under base control. Since it is their daily operations which make their profits while their weekly Treasury Bill tender is an offsetting obligation, the historic nature of their business would no longer be viable.

On the other hand, it is difficult to believe that the personnel of the discount houses would become unemployed. Discount market operators are almost the most experienced and versatile of money market operators. There would have, in any case, to be further changes in central government financing arrangements following monetary base control (see (iii) below). This would generate new business and the discount houses would certainly capture a large share of this. Moreover, the scheme allows for a transitional period while the lender of last resort function was evolving from its present to its new role. By announcing this transitional period in advance, the discount houses would be put on notice that the nature of their business would have to change.

- (ii) Gilts Sales: It was noted in the main paper (paragraph 72) that the Bank's technique for selling gilts involves manipulating short-term interest rates in order to offset expectations about long-term rates.

Under monetary base control, this method would no longer be viable. Adoption of base control would imply that the authorities lost control of short rates of interest. The essence of the system is that the authorities gain control of quantities (the base and hence the target aggregate) but lose direct control of the price (short-run interest rates). These would therefore no longer be available to the Bank for the purpose of influencing expectations. Other methods of selling gilts would thus clearly be necessary.

At the same time, adoption of the new system would partially ease the authorities' problem. Under current control techniques, precision is required in selling gilts to the non-bank private sector. While the authorities might hope to control the total of gilt sales, they cannot tell who is going to buy them. Base control requires control only of total sales: it does not matter who buys them.

- (iii) Central Government Finance: At least three changes would be entailed by monetary base control. First, denial of the discount houses of their access to borrowing from the Bank of England means that they would not be prepared to cover the weekly Treasury Bill tender. Since, however, the Government is always able to borrow its residual finance from some source at some price, the cost would be greater variability of interest rates, not a loss of control. Secondly, base control would be expected to work better if fluctuations in the path of the CGBR can be reduced below their current amplitude. Fluctuations already present some problems for monetary control but these would be much accentuated under base control since the fluctuations would feed directly onto the base, itself the key control instrument. Work is already in hand to see if this nuisance can be reduced to smaller proportions.
- Thirdly, control of the base requires precise sales of public sector debt - to a greater extent than seems to be possible currently. It is hard to believe that, with any techniques, gilts could be sold with sufficient short-term quantitative accuracy to meet the requirement. For this reason, a greater proportion of Government financing would have to be carried

out by means of short-term paper which could be sold more flexibly than gilts. This could be either by way of traditional 91-day Treasury Bills or perhaps by somewhat longer instruments. Markets would have to be created for this new financing, but the City should be sufficiently adaptable to do this. In particular, it is probable that the discount houses, displaced from their traditional functions, would play a key role in making and widening the markets in these new instruments.

- (iv) Local Authority Finance: Currently, about a third of total local authority market borrowing is in the form of temporary debt of less than one year maturity. About a quarter is of less than 3 months maturity. Under monetary base control, it is difficult to see that local authorities could raise substantial finance in this form. First, the greater fluctuations in short rates expected from control of the base would make this an uncertain segment of the maturity spectrum in which to operate. Second, the local authorities would have to compete with the increased volume of central government debt which would have to be sold to control the base, making such borrowing expensive. Both factors would tend to shift the local authorities into longer-term borrowing or to borrowing from the National Investment and Loans Office, rather than the market. Neither development would be unwelcome.
- (v) Banks' Lending Operations: Banks' operations in general would undergo major changes on implementation of base control. The changes have been described at length in earlier sections. But it is worth drawing attention to the changes which would probably occur in the terms on which they made advances to the private sector. First, banks would need greater control over their lending than they have at present. They might therefore reduce advances made on overdraft arrangements, replacing these by term loans or, alternatively charge overdraft commitment fees. This would be particularly true for existing large industrial customers where banks already feel that overdraft facilities are provided too

cheaply. Personal overdrafts would be less affected since these are highly profitable for the banks. The main effect would thus be the loss of some flexibility in the provision of industrial finance. Second, banks' base rates would certainly become more volatile. Some bankers have suggested that there might be a move to a system close to that currently practised by the finance houses. Base rates would then be announced anew each week and probably related by formula to market conditions.

(vi) Building Societies: To a greater extent than for the local authorities, the greater interest rate fluctuations possible under base control would present a major problem for the building societies. These institutions have engaged traditionally in quite the most remarkable maturity transformation in the British financial system. While the bulk of their liabilities are encashable on demand, the average initial maturity of their assets approaches 20 years. While a large proportion of their stock of liabilities comes from small personal savings which are unlikely to be very interest-sensitive, nevertheless rate fluctuations can cause severe variations in their net inflows. Three possibilities are:

(a) that share and mortgage rates would be charged more frequently and by greater amounts than at present, in order to maintain stable inflows. New borrowers would be most affected; although they could be partially protected by arrangements to fix repayments in the critical mortgage period, or to limit the number of rate changes in each period passed on to existing mortgagors.

(b) that societies would maintain greater liquidity on average to insulate mortgage lending from greater variation in inflows.

(c) that societies would increasingly borrow at longer maturity. They already issue variable rate term shares of up to five years' maturity, and they could develop further this method of attracting funds from persons. They could also borrow from institutions, but probably on fixed rate terms which would necessitate introducing matching fixed rate mortgages.

Development (b) would restrict the supply of mortgage funds while societies built up their liquidity. Development (c) could avoid extra mortgage rationing, but it would imply dearer mortgages at the margin. Development (a) would create most problems and hardship for existing mortgage holders, because it would raise the cost of borrowing on all building society deposits.

(vii) Prudential Control of the Banks: Earlier in the year the Bank of England published a consultative document outlining new proposals for prudential control of the banking system. Essentially, the proposals were that banks should hold certain amounts of (primary and secondary) liquidity; and of total liquidity cover, a fixed proportion should be in primary liquidity. Primary liquidity consists of assets held by the banks which the banking system as a whole could always turn into cash if required, because the Bank of England is prepared to rediscount them. Secondary liquidity comprises assets which individual banks could always regard as liquid but which the banking system as a whole could not rely on encasing. Requirements for the total liquidity holding would be determined by the size and maturity of each bank's net liabilities and the nature of its business.

Under monetary base control, a prudential system in terms of primary liquidity would not be possible. Currently, because of the Bank of England's everyday readiness to act as lender of last resort, assets against which they will lend, such as Treasury Bills, local authority bills or fine commercial paper, count as primary liquidity, as well as base assets. With base control, the Bank would only act as lender of last resort in exceptional circumstances and only the base could count as primary liquidity. Under a mandatory base control system, the prescribed base assets/qualifying liabilities ratio already determines required holdings of base and thus primary liquidity. There is no place for any further prudential relationship based on primary liquidity since this would over-determine the system.

These considerations do not mean that no prudential control is possible. In particular controls in terms of either secondary liquidity or total liquidity (ie. primary plus secondary) would still be possible. But it does mean that the Bank's current proposals would all have to be re-examined.

(vi) Potential for Transition to a Non-Mandatory System

45. The illustrative scheme outlined in this Appendix is designed to function as a permanent mandatory scheme of control. If desired, however, at a later stage, the system could be transformed to one of non-mandatory base control. It should be recognised immediately, however, that just as imposition of mandatory base control will necessarily involve some financial upheaval, so the transition to a non-mandatory system would be fraught with uncertainty.

46. Non-mandatory base control relies upon the base asset ratio the banks would want to hold voluntarily for their own commercial reasons, to act as the fulcrum for monetary control. Basically, the problem of the transition is that before operation of the scheme no one - including the banks - can know what the ratio would be. Current experience is no guide because the ready provision of lender of last resort finance means the banks have no real need for base at all.

Moreover, while this facility would be withdrawn under mandatory base control, there would still be no evidence as to the banks' autonomous demand for the base since the mandatory ratio itself would determine the observed amount. There would indeed be excess reserve holdings under such a scheme, but again these would be no guide to non-mandatory behaviour since they would stem entirely from fear of the prohibitive penalties protecting the mandatory ratio.

47. There is no clear way round these problems. Only experience of the operation of a pure non-mandatory scheme can give true guidance as to the banks' voluntary base asset ratio. Nevertheless, it may be possible to do better than jumping abruptly to a non-mandatory regime.

48. In the illustrative scheme, it is proposed that banks hold a compulsory base asset ratio of 8 per cent. Over time the size of this ratio could be reduced step by step towards zero. At the same time, the severity of the penalties protecting the requirement could be reduced. Eventually, the requirement would disappear and the system would then become a non-mandatory one. Over time the observed base assets ratio would become more influenced by the banks' own demand and increasingly less by the effects of the mandatory ratio. In this way, the authorities would acquire an increasing stock of evidence as to the banks' voluntary base behaviour, before the regime became entirely non-mandatory, and thus learn to operate accordingly.

49. There is no denying that this transitional phase would be one of great uncertainty for the authorities. They would not know, over a prolonged period, whether they were operating on the base correctly and what the effects of policy would be. But, having established a mandatory system of control, there is only one alternative to this transitional phase. That would be to switch directly to a non-mandatory scheme and the uncertainty created by such an abrupt step could be many times greater.

MONETARY CONTROL IN THE UNITED STATES

The American experience with monetary control offers a number of interesting analogies for the United Kingdom. The Americans have long imposed mandatory reserve ratios on banks, and have recently increased the emphasis which they put on movements of reserves as a guide to the movements of their target aggregates. Unlike the Swiss, they have never had public targets for bank reserves, on the monetary base, as such, but the authorities use movements in reserves as an internal determinant of their open market operations.

2. This annex outlines:-

- i. The regulatory background in the United States;
- ii. The Americans' experiment with reserve targeting between 1972 and 1976;
- iii. The targeting procedures introduced in October 1979;
- iv. The record since then;
- v. The value of reserves as an indicator over the 1970s as a whole; and
- vi. Some examples of the distortions introduced by mandatory reserve requirements.

Finally, it offers some tentative conclusions on the implications for the UK.

Background

3. Banks in the United States are required to observe reserve ratios which differ from those in the UK in two main respects. Firstly, different ratios apply to deposits of different size and maturity. More importantly, reserves are defined only as bankers' balances and till money ^{holdings} :/of assets

such as Treasury bills do not count towards the required ratios.

4. For the principal US banks, bankers' balances mean balances with their district Federal Reserve Banks. These balances earn no interest. Banks with excess reserves lend to banks with deficient reserves through an inter-bank market in "federal funds" - that is, in bankers' balances with the district Feds. The interest rate on federal funds is a key short-term rate.

5. The discount rate at which banks may borrow from the Fed is administered, like MLR, and is not closely tied to the federal funds rate. Use of the discount window is rationed less by price than by stinginess : it offers only short-term credit, and often has strings attached.

6. Throughout the 1970s, the Fed has described itself as pursuing more of a money supply than an interest rate policy. It has defined its objectives in terms of targets for a number of monetary aggregates, and this has remained unchanged through several variations in tactical control techniques, and several redefinitions of the aggregates. The Fed has used the growth of reserves and the federal funds rate as early indicators of changes in the aggregates. It has also relied on these indicators to determine its open market operations from week to week. The practical question has been whether the growth of reserves or the change in the federal funds rate provides the better indicator of monetary conditions, and the better determinant of open market interventions. The Fed would be the first to admit that neither is reliable. The changes there have been in operating tactics have essentially been changes in the weights put on the two in the directions given to the Fed's open market manager.

Reserve targeting between 1972 and 1976

7. The manager was first given targets for the growth of bank reserves, as an experiment, in early 1972. The Fed's Open Market Committee specified a tolerance range for a two month period. If growth exceeded the top of the range, the manager was to reduce the provision of reserves, which tended to push up the Fed funds rate or to force banks to make more use of the discount window. The manager was also asked to keep the Fed funds rate within a

certain range. If the objectives for reserves and for interest rates proved incompatible, he was to return to the Committee for further instructions.

8. Difficulties soon became apparent. The lag between open market action to regulate reserves and the effect on bank deposits was measured in months - beyond the horizon of the tolerance ranges. Moreover, the relationship between reserves and the main monetary aggregates proved extremely hard to predict. Movements in reserves were difficult to interpret, even as approximate indicators. Reserve targets were dropped in 1976.

Reserve targeting since October 1979

9. They were reintroduced (in slightly different technical form) as part of the package of monetary measures on 6 October 1979. The Fed announced that it would place "greater emphasis in day-to-day operations on the supply of bank reserves and less emphasis on confining short-term fluctuations in the federal funds rate". The change has consistently been presented as one of emphasis, but not, this time, as an experiment. Targets for the main monetary aggregates are again translated into weekly targets for reserves, and open market operations then aim to add or drain reserves as necessary.

10. The Fed funds rate is allowed to fluctuate freely within a wide band. This was initially set at four percentage points, then widened, and then narrowed again. At its maximum, in March, it reached seven percentage points. Only if the Fed funds rate comes up against the limit of the band does the open market manager have to ask for supplementary instructions. Moreover, the interest rate constraint applies only to a week's average : on individual days, rates may go beyond the band. The current policy thus allows more strain to be borne by interest rates than was the case between 1972 and 1976, when the permitted variation in the Fed funds rate was only $1-1\frac{1}{2}\%$.

11. The Fed has been at pains to acknowledge that the link between reserves and the target monetary aggregates is "complicated and variable", changing "with shifts in the currency and deposit mix, with changes in bank demands for excess reserves and borrowing, and with timing problems related to lagged reserve accounting". Indeed, the Fed's evidence to the Treasury and Civil Service Committee, from which these quotations are taken, makes it clear that ^{umpteenth} / assumptions have to be made to derive the reserve target. Each is a matter of judgement, and subject to a large margin of error. ^{practice, the reserve target has been only the most} In/short term of intermediate objectives, adjusted almost on a weekly basis in the light of outturns for the monetary aggregates.

The Fed's record since October 1979

12. Since October, the growth of the monetary aggregates has not, on average, been too far out of line with the Fed's intentions. But the picture has been very confused for at least three reasons.

13. First, the Americans have four different monetary targets - for M1A, M1B, M2 and M3. At different times over the past year, they have been hitting one or two but missing the others - and it is never easy to know what weight to attach to which target.

14. Second, their use of reserve targeting has been clouded by the imposition and then the removal of supplementary credit controls. The package which introduced reserve targeting in October was supplemented by another to impose direct credit controls in March. Only then did interest rates go to their peaks - the prime business loan rate hitting 20% in April. By coincidence, this was also when the recession began to take effect, causing the demand for money and credit to fall, and interest rates to come down rapidly. Credit controls were withdrawn in July.

15. Third, monetary policy in American, as here, has been beset with vast numbers of uncertainties. Quite apart from the real shocks to the system, the institutional structure has been changing rapidly. There has, for example, been a fast expansion of interest-bearing chequing accounts in banks and savings and loans, an explosion and then a contraction of "money market funds" outside the established financial intermediaries, and a growth of innumerable

other devices to get round Regulation Q (which limited the interest rate which banks and savings and loans could pay on savings accounts). The monetary aggregates have had to be redefined more than once on this account. The public's preferences seem also to have been extraordinarily volatile, with the demand for transactions balances falling more sharply in mid-year than previous relationships would have suggested. (This may have been partly the result of credit controls, as people ran down their cash balances instead of using credit). The outlook is now so uncertain that the Fed has been reluctant to roll forward its quantitative targets into 1981, and has only done so under considerable pressure from Congress.

16. It would be wrong to blame all these uncertainties on the Fed's change in operating techniques. But whatever its other merits may have been, it is clear that the increased emphasis on reserve targeting has by no means yielded a smooth path for the target monetary aggregates. The attached table shows that M1A and M1B actually fell in the second quarter of the year. That has been sharply reversed in the third quarter, in which M1A has been expanding at about **twice** the upper target rate of 6% a year.

17. Moreover, the month-to-month changes have been still more volatile. The table also shows that, at the "annual rate" in which American statistics are usually given, the growth of M1A has bounced around from -17.7% in April to +11.4% in June. The estimate for August is +18%. M1B varied between -14.1% in April and +14.9% in June. Nor is the relation between the monetary aggregates (lines 5-9) and the various measures of reserves (lines 1-4) immediately apparent to the naked eye.

18. The swings in the monetary aggregates have not come about because interest rates have been sticky. On the contrary, the bottom lines of the table show that, even in terms of monthly averages, the Fed funds rate has varied between 9% and over 17 $\frac{1}{2}$ % in the space of only four months. At the moment, it is again climbing sharply, and the President and his Treasury Secretary are publicly criticising the Fed on that account.

19. In short, the American experience since last October has been characterized by quite remarkable volatility in both the price and the quantity of money. This is ^{illustrated} in charts 1 and 2. It would be wrong to conclude that reserve targeting has caused this bumpiness - but it has certainly not been able to prevent it. The American record at meeting money supply targets averaged over time may, at present, be slightly better than the British one. But their record at meeting targets smoothly, or even predictably, month by month has certainly been no better than ours. Nor are the Americans better able than we are to interpret the statistics with any confidence.

The value of reserves as an indicator

20. Taking a slightly longer perspective, chart 3 illustrates the point that the movement of reserves has not, in any case, been a terribly reliable guide to the movement of the target monetary aggregates. Chart 4 suggests that it has been an indicator, of sorts, of the change in the price level - but no better an indicator than, say, the movement of M1.

Mandatory requirements as a distortion

21. In a similar perspective, the mandatory basis of the Americans' control has helped to bring about the sorts of financial distortion which we think a mandatory system of monetary base control would produce in this country. Because the authorities have imposed requirements which the banks would not observe of their own accord, the banks have had a continuing incentive to get round them; because the required reserves have not borne interest, that incentive has been intensified; and because the requirements have applied more to banks than to other financial institutions, other institutions have been helped to compete business away from the banks.

22. One way in which the banks have responded has been to push business offshore. The Caribbean branches of US banks have liabilities of over \$ 20 billion to US residents, and their business is often run directly from New York. (\$20 billion is equivalent to about 6% of M1, 1-2% of M2). Banks have also been adept at moving funds to and from their overseas

branches as a way of reducing the average liabilities against which they have to hold reserves. Indeed the "weekend eurodollar game" has become a huge merry-go-round. In mid-1979, weekend avoidance transactions totalled \$20 billion each Friday, and seven banks were using them to such an extent that they were reducing their net deposits subject to reserve requirements by over 20%. These eurodollar transactions have drawn the Fed into a long and complicated series of regulatory moves, trying to balance a number of different objectives. They have also led the Fed to include certain eurodollar deposits in M2 and the wider monetary aggregates.

23. A second form of response has been the substantial growth in the commercial paper market, which has been broadly comparable in effect to the UK Bill leak. Again, the Fed has felt it necessary to intervene by asking companies to report transactions in this market.

24. A third has been the boom in intermediaries which were not subject to the existing reserve requirements : money market funds have been the most conspicuous example. Money market funds have both given people easy access to money market interest rates for their savings, and enabled them to write cheques on those savings. Congress has now decided that reserve requirements should be applied equally to all deposits which have essentially the same characteristics, regardless of the institutions in which they are held. The requirements will therefore apply to savings and loans as well as to banks, and also to newer kinds of intermediaries such as the money market funds. The imposition of mandatory requirements has thus had to be backed up by successive extensions of those requirements.

Conclusions

25. To sum up, the use of reserve targeting as an internal guide to the Fed's open market operations has not solved the problem of smoothing the growth of the money supply, or making it more predictable. Nor has it put clear rules in place of discretion, if only because the many assumptions needed to derive the weekly reserve targets are all a matter of judgement. The existing control techniques have had to be supplemented temporarily by credit controls, and permanently by an extension of reserve requirements.

In principle, reserve targeting has had the advantage that it has given more scope for short rates to be determined in the Fed funds market; and the authorities were lucky earlier this year in seeing the recession bring rates down rapidly from their 20% peak. But rates are now rising again, and the Fed has by no means been able to distance itself from this result, which is a matter of hot political contention.

26. Finally, in considering this from a UK perspective, it must be remembered not only that there is nothing quite like the Fed funds market here, but also that the gyrations there have been in interest rates have not had the same effects on mortgagors in the United States as they would have had in this country. When rates rose sharply in the spring, the supply of mortgages dried up, and savings and loans were put under considerable strain. But existing borrowers were protected (in the main) because American mortgages have traditionally been at fixed rates. In this country, variable rate mortgages are of course the norm, and something like a quarter of all households hold them.

MONETARY AGGREGATES AND INTEREST RATES

Item	1979		1980		1980					Targets Q4 79- Q4 80
	Q3	Q4	Q1	Q2	Feb.	Mar.	Apr.	May	June	
Monetary and credit aggregates (annual rates of change, seasonally adjusted in percent) ¹										
Member bank reserves										
1 Total	5.0	12.7	4.4	2.0	-0.8	4.4	4.3	-9	-1.0	
2 Required	4.7	11.7	5.4	2.0	0.3	4.6	2.7	1.3	-1.8	
3 Nonborrowed	6.9	7.1	3.6	8.1	-12.7	-29.3	15.5	41.1	17.1	
4 Monetary base ²	9.3	9.7	7.6	5.4	7.5	6.9	1.7	7.7	6.1	
Concepts of money and liquid assets³										
5 M-1A	7.8	4.5	4.8	-3.9	9.4	-1.9	-17.7	.7	11.4	3 1/2-6
6 M-1B	9.6	5.0	5.9	-2.4	9.9	-.3	-14.1	-1.6	14.9	4-6 1/2
7 M-2	10.7	7.1	7.2	5.4	9.5	5.0	-2.6	9.8	17.5	6-9
8 M-3	10.8	9.1	7.8	5.7	11.8	4.4	.0	8.9	12.8	6 1/2-9 1/2
9 L	12.2	8.5	8.4	n.a.	11.5	7.9	5.6	8.9	n.a.	
Time and savings deposits										
Commercial banks										
10 Total	9.1	12.4	8.4	9.8	14.6	8.5	15.0	6.6	-1.6	
11 Savings ⁴	.4	-16.5	-19.3	-22.6	-22.5	-35.6	-43.3	-7.5	32.9	
12 Small-denomination time ⁵	22.5	32.1	29.1	33.9	25.9	42.5	54.4	14.1	-3.1	
13 Large-denomination time ⁶	4.5	19.7	11.3	10.1	34.0	7.6	16.2	8.5	-24.8	
14 Thrift institutions ⁷	7.4	6.7	2.7	4.9	1.6	4.0	3.0	7.9	9.2	
15 Total loans and securities at commercial banks ⁸	13.4	8.7	9.4	-.5	18.7	2.6	-4.3	-6.1	-2.8	
Interest rates (levels, percent per annum)										
Short-term rates										
16 Federal funds ⁹	10.94	13.58	15.07	12.67	17.19	17.61	10.98	9.47	9.03	
17 Federal Reserve discount ¹⁰	10.21	11.92	12.51	12.45	13.00	13.00	12.94	11.46	10.87	
18 Treasury bills (3-month market yield) ¹¹	9.67	11.84	13.35	9.62	15.70	13.20	8.58	7.07	8.06	
19 Commercial paper (3-month) ^{11,12}	10.64	13.35	14.54	11.18	16.81	15.78	9.49	8.27	8.41	
Long-term rates										
Bonds										
20 U.S. government ¹³	9.03	10.18	11.78	10.58	12.49	11.42	10.44	9.89	10.32	
21 State and local government ¹⁴	6.28	7.20	8.23	7.95	9.17	8.63	7.59	7.63	8.13	
22 Aaa utility (new issue) ¹⁵	9.64	11.21	13.22	11.78	14.00	12.90	11.53	10.50	11.60	
23 Conventional mortgages ¹⁶	11.13	12.38	14.32	12.70	16.05	15.55	13.20	12.45	12.45	

1. Unless otherwise noted, rates of change are calculated from average amounts outstanding in preceding month or quarter. Growth rates for member bank reserves are adjusted for discontinuities in series that result from changes in Regulations D and M.

2. Includes total reserves (member bank reserve balances in the current week plus vault cash held two weeks earlier); currency outside the U.S. Treasury, Federal Reserve banks, and the vaults of commercial banks; and vault cash of nonmember banks.

3. M-1A: Averages of daily figures for (1) demand deposits at all commercial banks other than those due to domestic banks, the U.S. government, and foreign banks; and official institutions less cash items in the process of collection and Federal Reserve float; and (2) currency outside the Treasury, Federal Reserve banks, and the vaults of commercial banks.

M-1B: M-1A plus negotiable order of withdrawal and automated transfer service accounts at banks and thrift institutions, credit union share draft accounts, and demand deposits at mutual savings banks.

M-2: M-1B plus savings and small-denomination time deposits at all depository institutions, overnight repurchase agreements at commercial banks, overnight Eurodollars held by U.S. residents other than banks at Caribbean branches of member banks, and money market mutual fund shares.

M-3: M-2 plus large-denomination time deposits at all depository institutions and term RPs at commercial banks and savings and loan associations.

L: M-3 plus other liquid assets such as term Eurodollars held by U.S. residents other than banks, bankers acceptances, commercial paper, Treasury bills and other liquid Treasury securities, and U.S. savings bonds.

4. Savings deposits exclude NOW and ATS accounts at commercial banks.

5. Small-denomination time deposits are those issued in amounts of less than \$100,000.

6. Large-denomination time deposits are those issued in amounts of \$100,000 or more.

7. Savings and loan associations, mutual savings banks, and credit unions.

8. Changes calculated from figures shown in table 1.23.

9. Averages of daily effective rates (average of the rates on a given date weighted by the volume of transactions at those rates).

10. Rate for the Federal Reserve Bank of New York.

11. Quoted on a bank-discount basis.

12. Beginning Nov. 1977, unweighted average of offering rates quoted by at least five dealers. Previously, most representative rate quoted by these dealers. Before Nov. 1979, data shown are for 90- to 119-day maturity.

13. Market yields adjusted to a 20-year maturity by the U.S. Treasury.

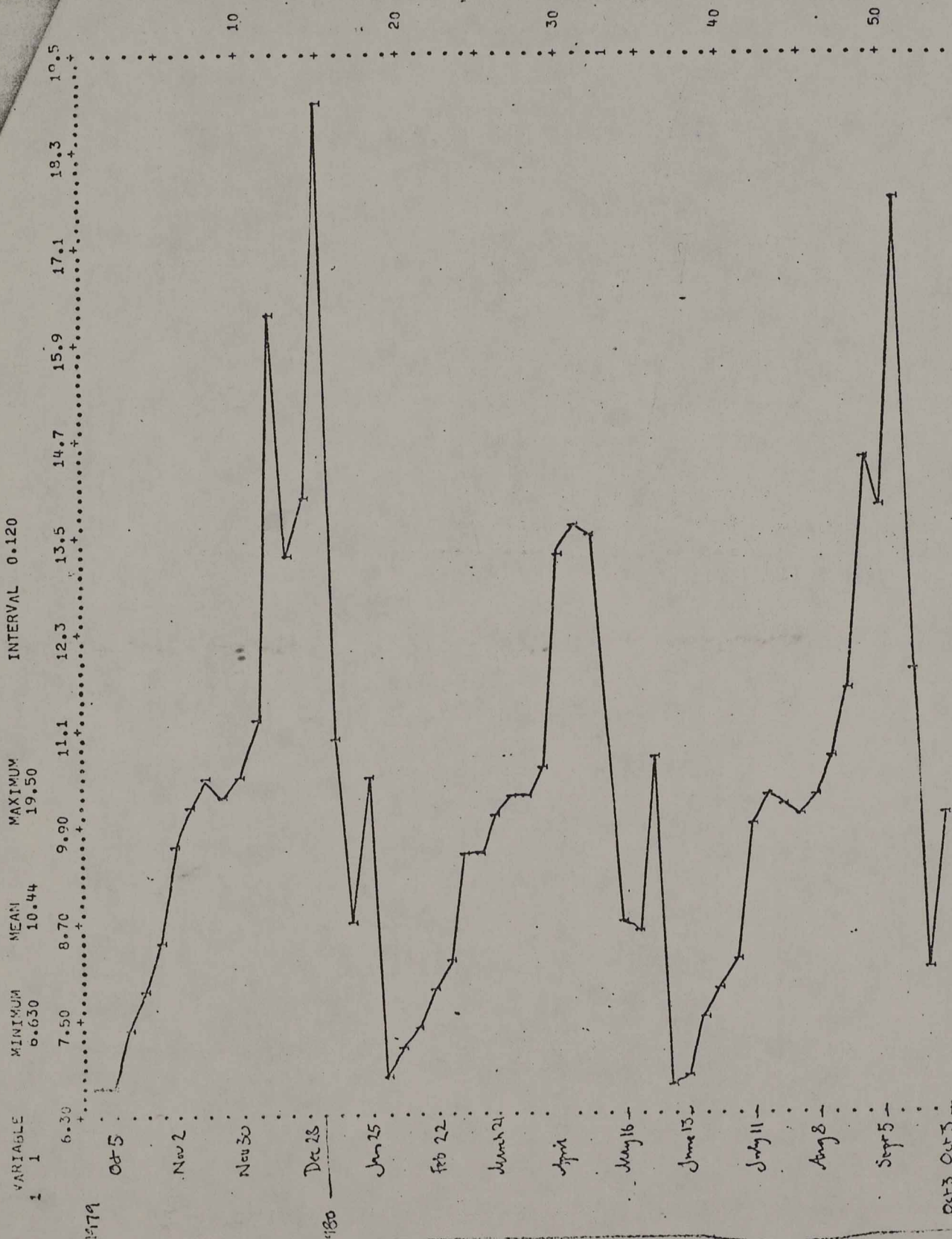
14. Bond Buyer series for 20 issues of mixed quality.

15. Weighted averages of new publicly offered bonds rated Aaa, Aa, and A by Moody's Investors Service and adjusted to an Aaa basis. Federal Reserve compilations.

16. Average rates on new commitments for conventional first mortgages on new homes in primary markets, unweighted and rounded to nearest 5 basis points, from Dept. of Housing and Urban Development.

Source : Federal Reserve Bulletin, August 1980.

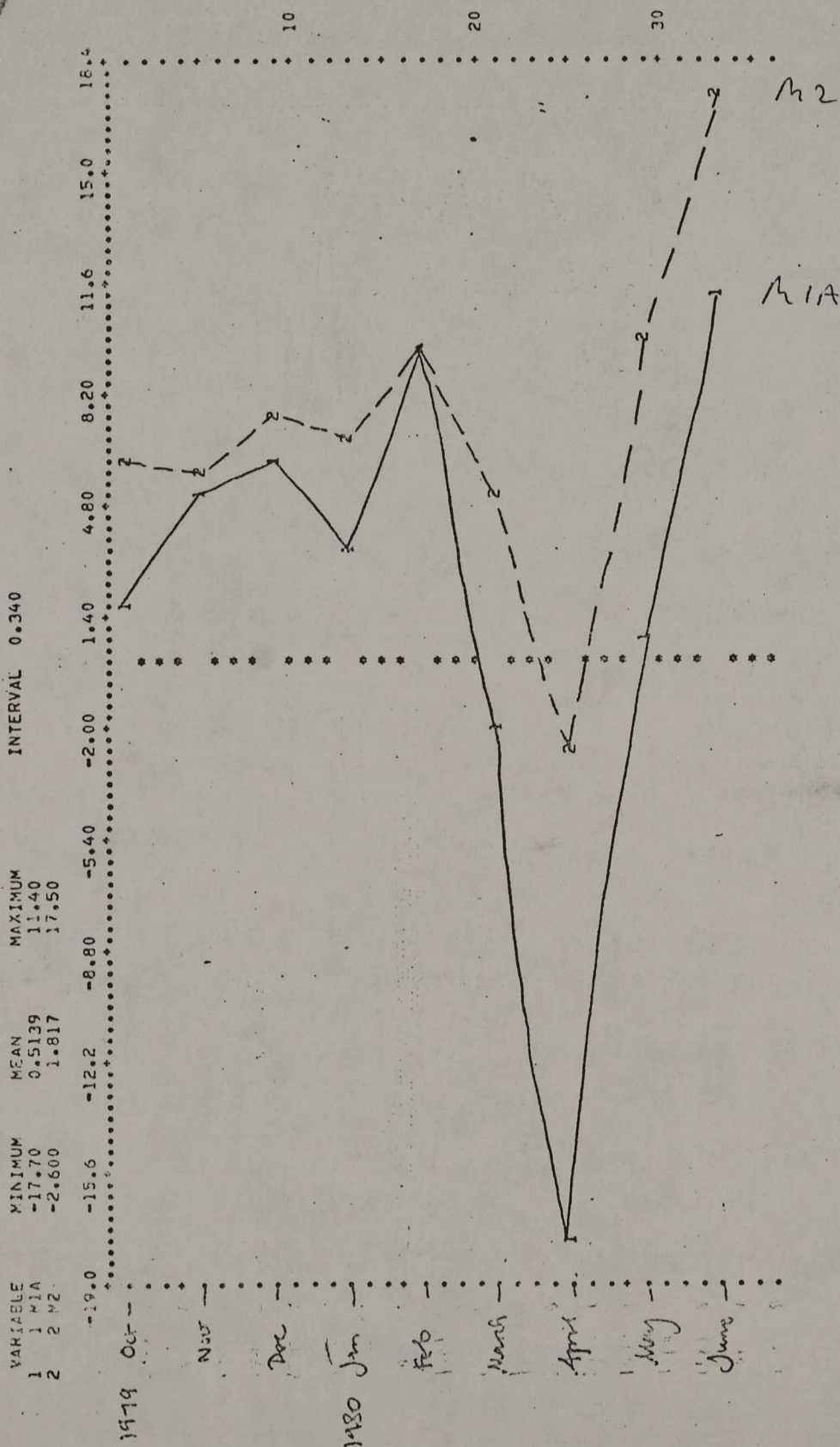
FEDERAL FUNDS RATE EACH FRIDAY



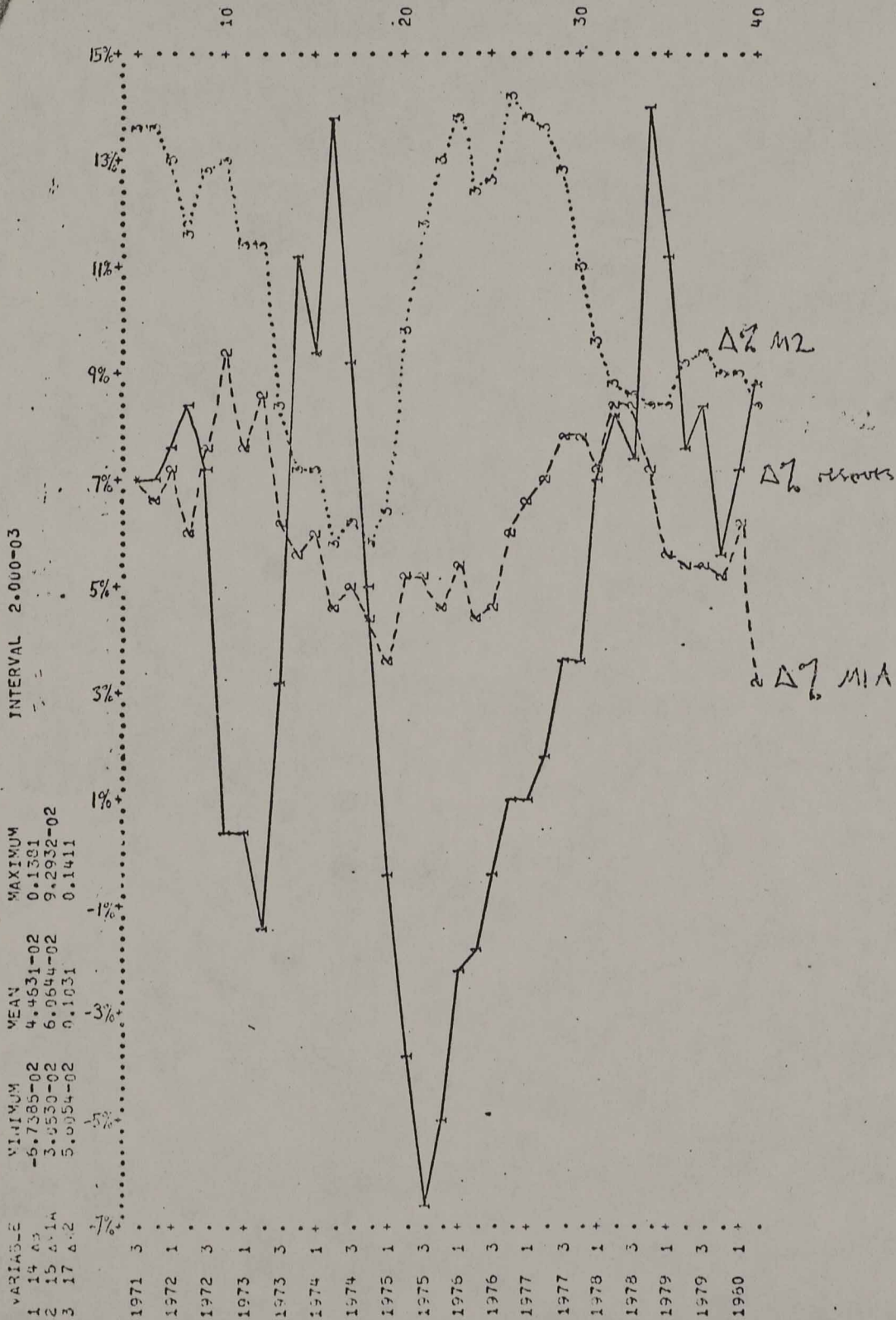
GROWTH OF THE MONEY SUPPLY.

MONTHLY CHANGES IN M1A AND M2 EXPRESSED AT AN "ANNUAL RATE" (SEASONALLY ADJUSTED, IN PERCENT)

11255



Reserves, M1A and M2 - percentage change on same quarter of previous year



SWISS MONETARY POLICY

1. This Annex examines the relationship between the monetary base and the monetary aggregates, principally M1 which the Swiss authorities used between 1975 and 1978 to express the monetary target. Chart 1 compares the percentage changes over four quarters for monetary base and M1. There appears to be quite a close relationship between the two, though this is not surprising since the base represents just over half of M1. Chart 2 shows the relationship for M2.

2. Divergences between the growth rates of the base and M1 are reflected in changes in the multiplier. Chart 3 shows the multiplier, defined as an elasticity, (the ratio of the absolute changes shows exactly the same profile). Over the 20 years to 1972, the multiplier was moderately stable, averaging about 1.0 (1.8 if measured as the ratio of the absolute changes). During this period there was one major aberration in 1959-60, and a less pronounced disturbance in 1962. Apart from these two periods, the multiplier fluctuated within a range of 0.1 to 3.6, 90% of the readings lying in the range 0.3 to 2.9. It is also noticeable that there is no trend in the multiplier.

3. Since 1972, there have been 3 major disturbances to the multiplier relationship, those in 1972-73 and 1978-79 being attributable to currency disturbances, in particular weakness of the US dollar against the DM. In 1975 there was a change in relative interest rates in Switzerland which caused a shift between M1 and M2. The M1 and M2 multipliers moved in opposite directions as opposed to many together in the periods of currency upheaval.

4. However the fact that, with hindsight, it has been possible to identify discrete events which have caused the deviations from the norm may be little comfort if it is not possible to predict either the timing of these events or the extent to which they will distort the picture. With the experience of 3 major deviations since 1972 it is difficult to rely on the stability of the multiplier.

5. Chart 4 shows the development of velocity, calculated on an annual basis. The velocity of the monetary base and M1 have shown wide variations, apparently around a rising trend. The velocity of M2 has moved cyclically with no trend.

6. Chart 5 shows the development of interest rates over the past 10 years. In the first half the period there were no public targets though control of the monetary aggregates was still exercised via the base. There appears to be little difference in the behaviour of interest rates since targets were adapted. Call money has exhibited great volatility, but three month rates have followed a smoother cyclical pattern, with peaks of around 6% being reached in 1974 and 1980, after the two oil shocks. There was a minor and short lived peak in 1977.

7. Chart 6 shows the development of prices and M1. Though the surges in M1 in 1972-73 and 1978-79 were followed, with differing lags, by periods of accelerating prices, it is possible that the relationship is coincidental, with a third factor - higher oil prices - being the explanatory variable. It is noticeable that the periods of accelerating monetary growth in 1968-69 and 1975-76 were not followed by peaks in the inflation rate.

IG3 Division
8 October 1980

VARIABLE	MINIMUM	MEAN	MAXIMUM	INTERVAL
1 BASE	-0.967	6.295	24.61	0.420
2 MI	-14.01	6.237	26.08	

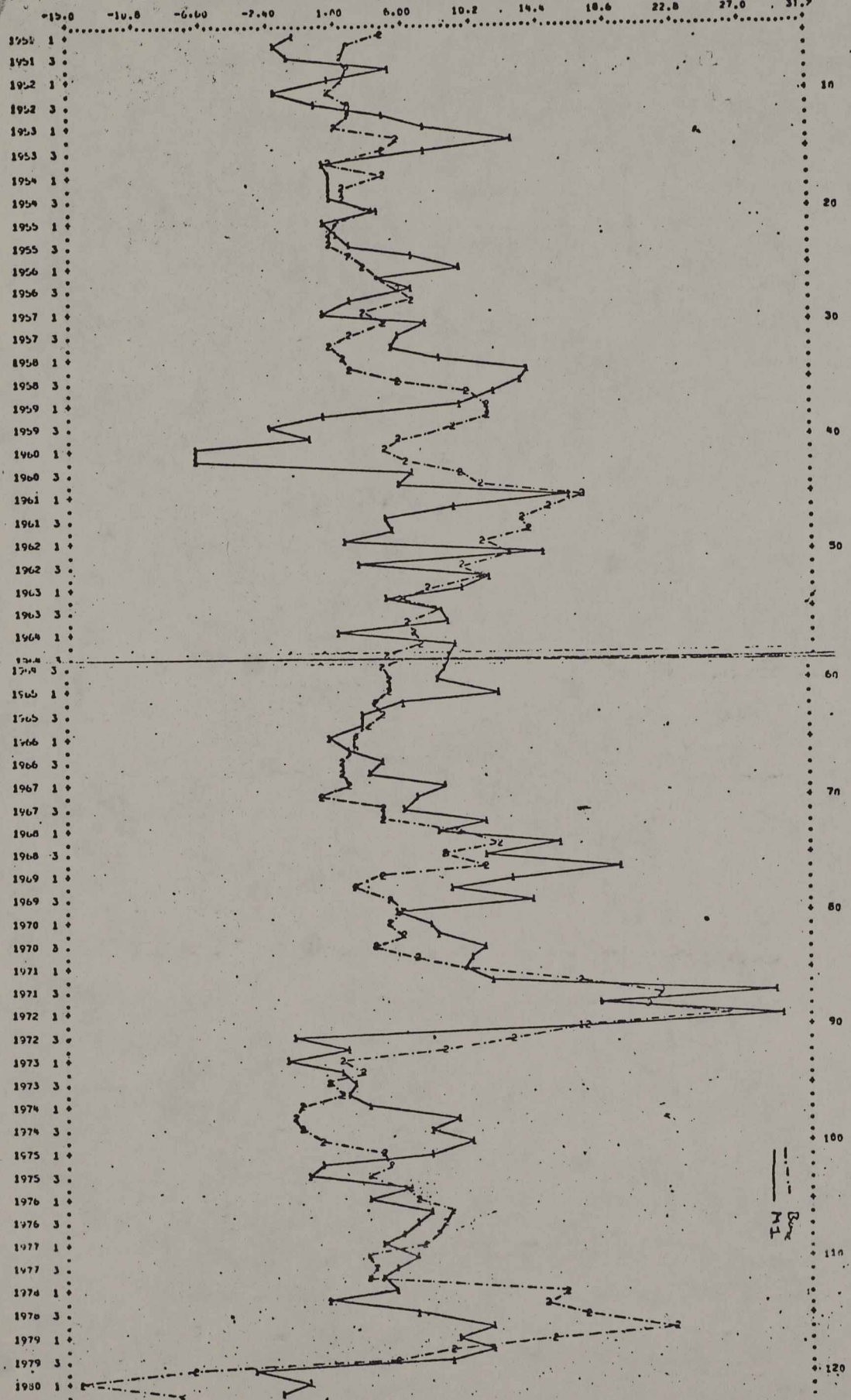


CHART 1. SWITZERLAND: Deviation of Precipitation (Percentage change on a year basis)

MI
BASE

MINIMUM -6.967 MEAN 6.293 MAXIMUM 29.61
-0.7205 7.416 23.34

INTERVAL 0.350

30 -3.80 -0.300 3.20 6.70 10.2 13.7 17.2 20.7 24.2 27.7 31.2

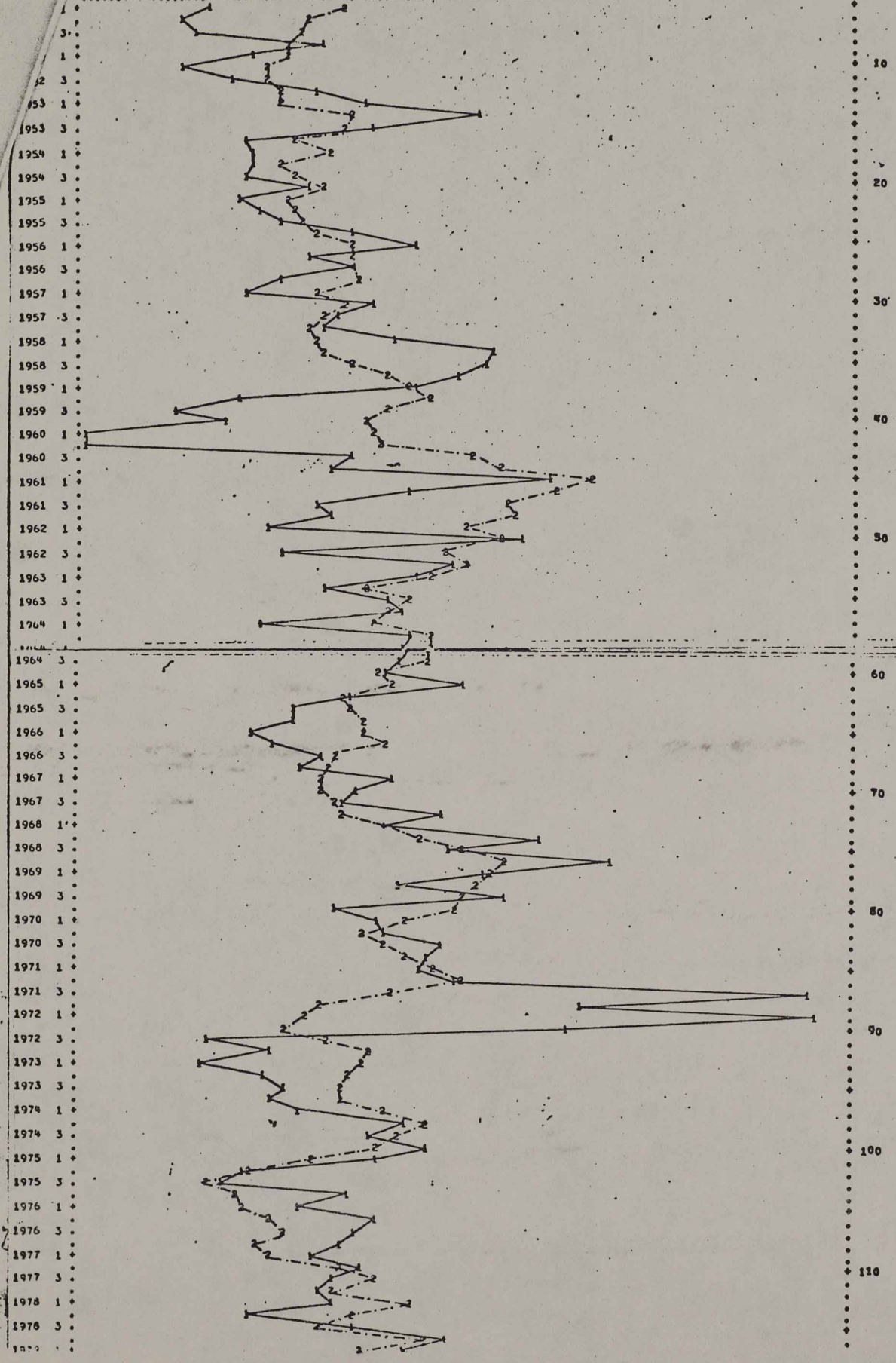
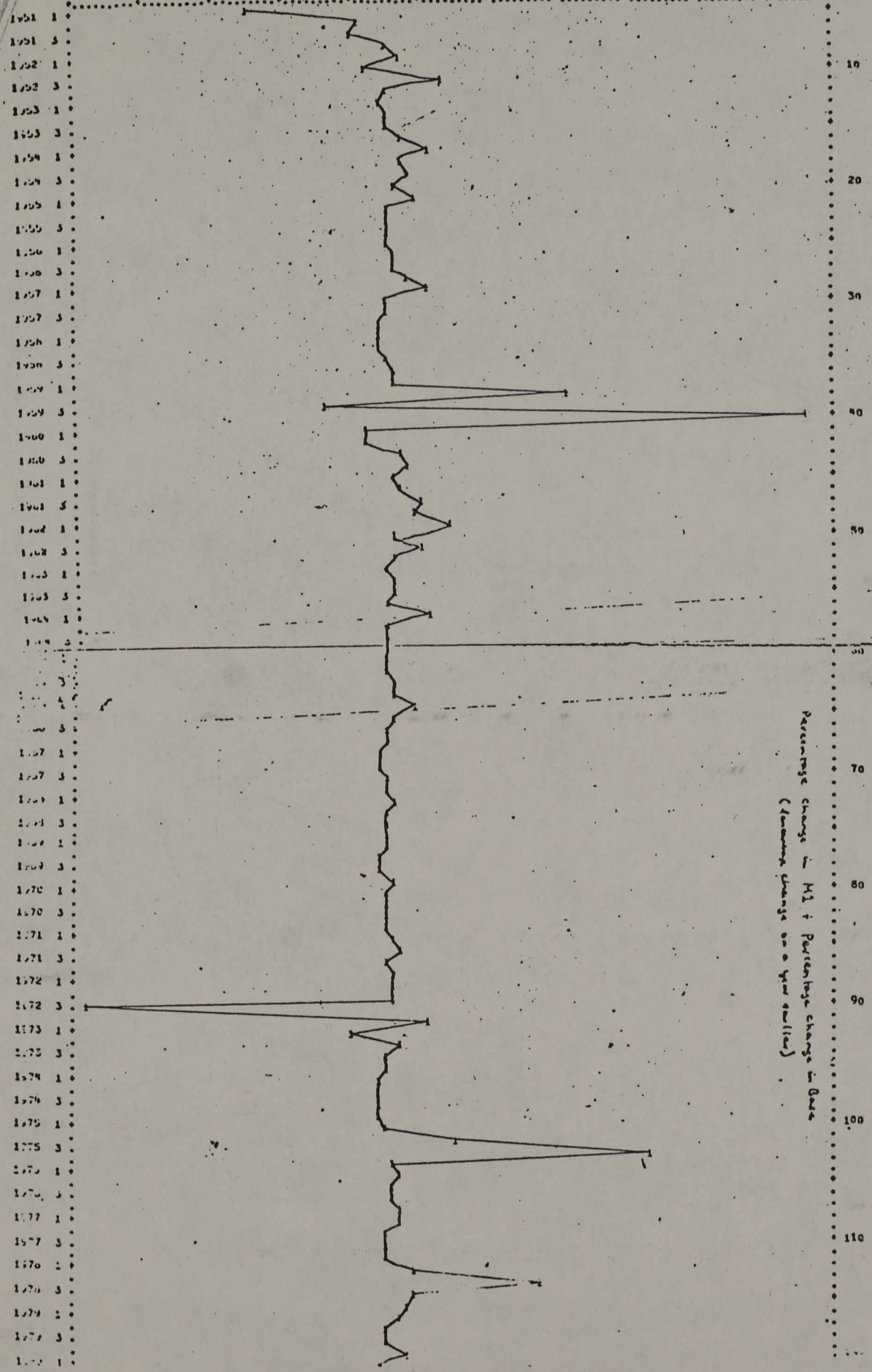


CHART 2: SW HZELLAND: DEVELOPMENT OF BME AND (Pawankamp camp region below)

10 (-17.0) -20.14 (2.300) 30.00
 -21.0 -10.2 -11.4 -6.70 -1.00 3.00 7.00 12.6 17.4 22.2 27.0 31.0



Percentage change in M1 + Percentage change in GDS
 (Seasonally adjusted)

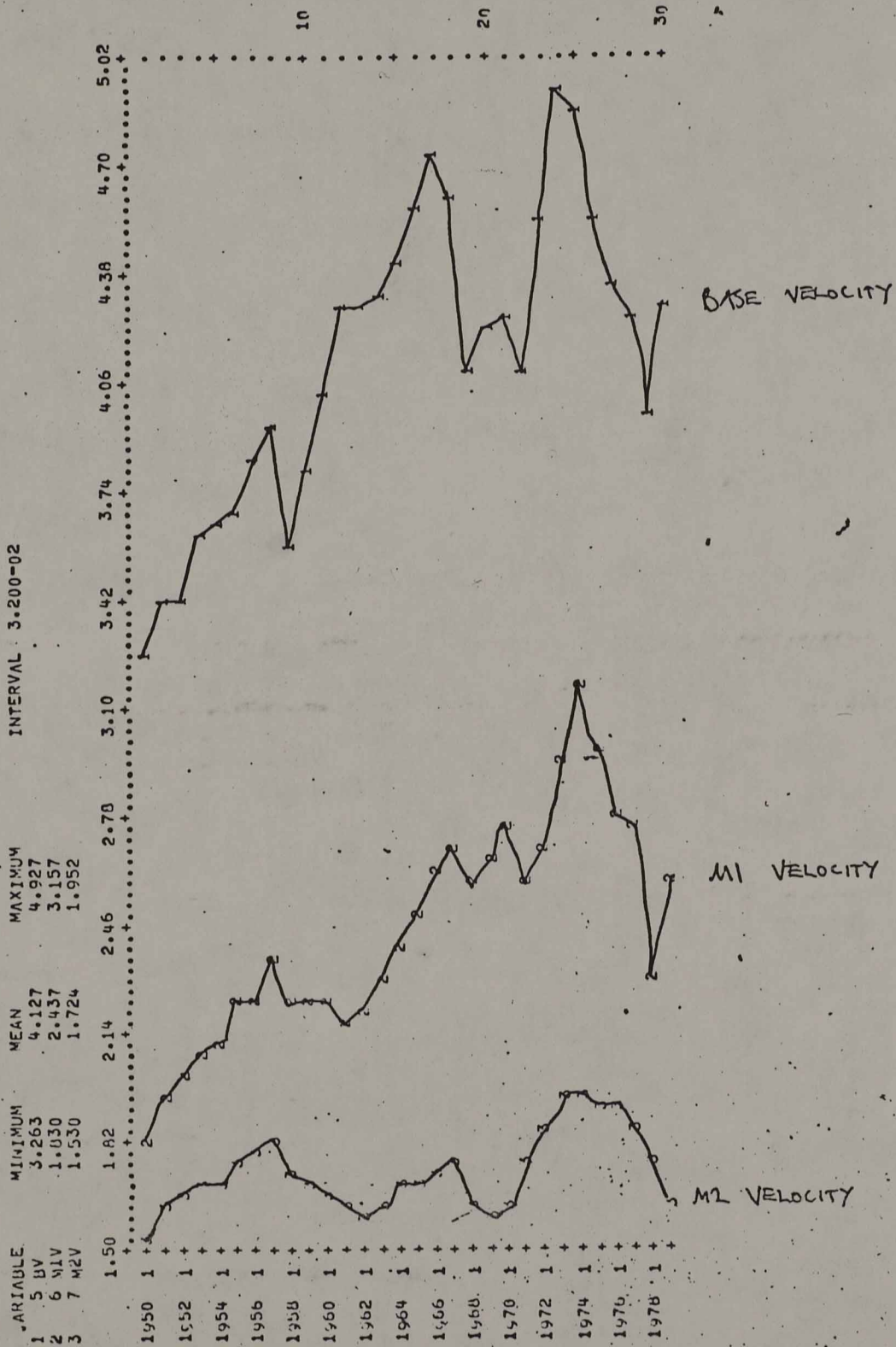
Switzerland: Money Multiplier

Chart 3

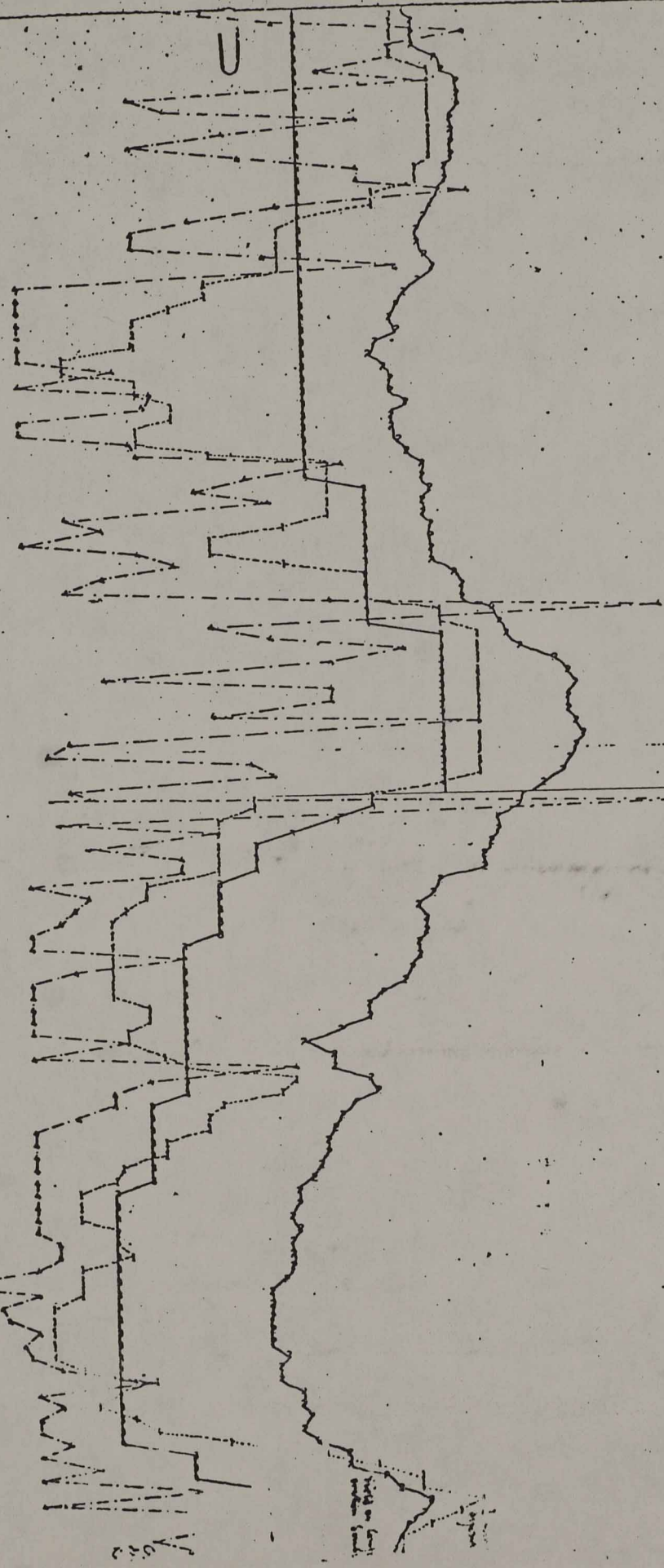
174844 031080

Switzerland: Velocity
(Annual data)

Chart 4



1970 11
 1970 1
 1970 3
 1970 5
 1970 7
 1970 9
 1970 11
 1971 1
 1971 3
 1971 5
 1971 7
 1971 9
 1971 11
 1972 1
 1972 3
 1972 5
 1972 7
 1972 9
 1972 11
 1973 1
 1973 3
 1973 5
 1973 7
 1973 9
 1973 11
 1974 1
 1974 3
 1974 5
 1974 7
 1974 9
 1974 11
 1975 1
 1975 7
 1975 9
 1975 11
 1976 1
 1976 3
 1976 5
 1976 7
 1976 9
 1976 11
 1977 1
 1977 3
 1977 5
 1977 7
 1977 9
 1977 11
 1978 1
 1978 3
 1978 5
 1978 7
 1978 9
 1978 11
 1979 1
 1979 3
 1979 5
 1979 7
 1979 9
 1979 11
 1980 1
 1980 3
 1980 5
 1980 7
 1980 9
 1980 11



170
 180
 190
 200
 210
 220
 230

CHART 5
 INTEREST RATES - SWITZERLAND
 Jan 1969 to July 1980

Japan
 UK
 Switzerland

MINIMUM	MAXIMUM	INTERVAL	0.000
1 8 APR	0.0707	8.115	1.76
2 8 APR	-14.61	7.192	29.04
	-15.0		
	-11.1		
	-7.50		
	-3.30		
	0.600		
	4.40		
	8.40		
	12.3		
	16.2		
	20.1		
	24.0		
	27.9		

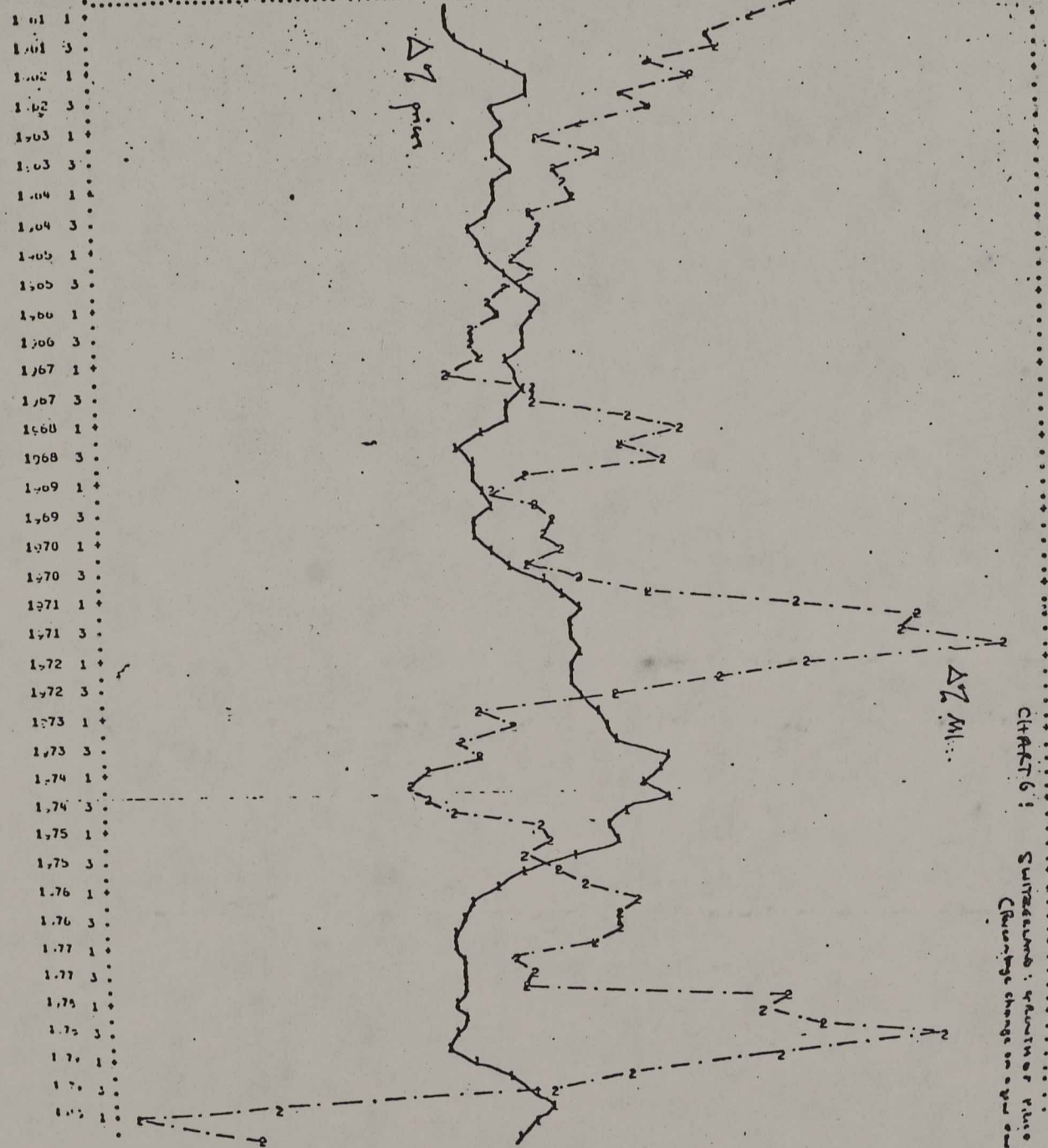


CHART 6: SURVEIL: FRACTIONAL RESERVE AND MONEY
(Percent change on year ending)

MONETARY POLICY IN SWITZERLAND

1. The Swiss were early converts to monetary targets. The advent of floating exchange rates provided the opportunity for setting independent monetary objectives as part of a policy of ensuring price stability. Monetary targets were first set in 1975. These were expressed in terms of the annual average rate of growth of M1. In 1975 and 1976, a target for the growth in monetary base was published alongside the M1 target but it was dropped in 1977 and 1978. For the first 3 years, the outturn was quite close to the target, though there was a small overshoot in 1976 as a result of a shift from time deposits to sight deposits associated with lower interest rates on savings.
2. In 1978, however, the Swiss franc came under intense pressure despite very low interest rates and the introduction of a number of inflow controls. In effective terms the exchange rate appreciated by 20% between December 1977 and September 1978. In October 1978, the Swiss National Bank (SNB) announced a major change of policy. No further appreciation against the DM would be permitted and the SNB would intervene to achieve a rate of at least SF80 per DM100. (Germany accounts for about 1/5th of Swiss exports). This decision, which was related to the SNB's participation in the central bank arrangements to stabilise the dollar, implied the abandonment of the monetary target. During 1978 M1 rose by 22%, December to December, or 16% on average for the year, against a target of 5%.
3. No monetary target was set for 1979. During the course of the year monetary conditions gradually returned to "normal", and the exchange rate fell back from its peak. The excess of liquidity was gradually reabsorbed. M1 fell back from SF66 billion at the end of 1978 to SF62 billion by the middle of 1979 and it remained at that level for the rest of the year. By the end of the year, the SNB was able to unwind a number of measures aimed at discouraging capital inflows and in December the negative interest rate on foreign bank deposits was abolished.
4. At the end of 1979, the SNB decided once more to announce a monetary target. This was set at 4% for the period November to November 1980 and it was expressed in terms of the growth in the monetary base rather than M1. By mid 1980, the monetary base had

shown no increase over a year earlier and M1 had fallen about 8% below the level of a year earlier.

5. In response to the questionnaire sent by the Treasury and Civil Service Committee, the SNB reaffirmed its belief in the use of monetary targets but it was prepared to be pragmatic.

Its memorandum stated:

"On the whole, we believe that the benefits exceed the costs of a money stock target. However, as far as the Swiss approach is concerned, we do not apply monetary targets in a rigid manner. Normally, we attempt to stick to the target as closely as we can, but are also prepared to depart from the target if major unforeseen events should occur. Even though our approach to targeting the money stock is not rigid, we do not consider it to be ineffective. An unforeseen event really must have a major detrimental impact on the Swiss economy if the money stock target is to be abandoned temporarily".

6. Prior to 1978, when the monetary target was expressed in terms of M1, there was thought to have been a fairly stable money multiplier ie the ratio between the monetary base and M1.

Developments in 1978 and 1979 have called that into question. The SNB now believes that the demand for money is subject to shifts induced by exchange rate expectations. At times when the Swiss franc is expected to appreciate, investors alter the currency composition of their portfolios pushing up the demand for Swiss money and other Swiss franc assets.

7. With a target set in terms of M1 there was a danger of the authorities responding inappropriately if the money stock began to expand rapidly. The central bank would not know whether this was because monetary policy was too lax or because exchange rate expectations had changed. If it were wrongly interpreted as the former, the authorities would contract the monetary base and add to the deflationary pressures caused by the strong exchange rate.

8. To counter these problems, the SNB decided to set its target for 1980 only in terms of monetary base. In an interview last May, when the latest statistics for M1 were showing a fall of 12% on a year earlier, Dr Leutwiler, the SNB President, stated that the

decision to fix the target in terms of monetary base has been the correct one. If the target had been set for M1, it would have allowed the monetary base to expand too fast, further weakening the Swiss franc, ie the converse of para 7.

9. The SNB memorandum to the TCSC described the short run volatility of the money stock and the monetary base as "considerable", but this is not thought to weaken the impact of targets if public confidence that they will ultimately be met is retained. It warned that an attempt to eliminate the short run volatility of the monetary aggregates would be liable to increase interest rate and exchange rate volatility.

10. Irrespective of the aggregate for which the target has been set, monetary base has always been the instrument of control. There are several reasons for this stemming from features of the Swiss financial system. Swiss banks are normally willing to hold significant balances with the central bank even in the absence of monetary cash requirements. This reflects the fact that there is not a well developed domestic money market in Switzerland and that banks have thus no alternative source to the central bank for privacy liquidity. The absence of a money market, which makes it difficult to conduct open-market operations in short term domestic securities, rules out a strategy of monetary control based on short term interest rates as an instrument of policy.

11. The conduct of monetary policy has been aided by the small size of the public sector. In 1977 tax revenue was equivalent to 31.5% of GDP, compared with the OECD average of 36.2%, and the average for OECD Europe of 38%. The public sector deficits have also been small by international standards. Over the last 3 years the general government borrowing requirement has averaged around 1%.

12. It is dangerous to generalise from Swiss experience as it is an economy sui generis. Certainly, the experience of 1978 seems to have had little permanent effect on inflation which accelerated from 1% in 1978 to about 5% by December 1979. This was still the best performance in the OECD area. By June 1980 inflation had dropped to 3%.

13. By contrast, its growth performance has been the worst in the OECD area. Virtually alone among industrial countries, the level of

GNP in 1980 will still be below (2%) the 1973 level. This has, however, been consistent with the maintenance of an unemployment rate of less than $\frac{1}{2}$ %. The burden has fallen on foreign workers. Between 1974 and 1977 the total labour force contracted by 270,000 (10%) of which 210,000 was accounted for by foreign workers.

IG3 Division
HM Treasury
26 September 1980

The progress of consultations on the Green Paper on
Monetary Control

A Introduction

1 Since the Green Paper was published in March, written comments from the main banking associations, a number of other financial institutions and from individuals have been submitted to the Treasury and the Bank (see Appendix). In addition, there have been two open conferences at which senior officials have spoken, and two seminars organised by officials (one limited to UK participants, one drawing on overseas experience). The Select Committee of the Treasury has published an interim Report, a Working Party of EEC experts (WHMPI) drawn from central banks and finance ministries has studied the Green Paper at length and the Bank of England's Panel of Academic Consultants has also debated the subject. This note attempts to summarise the responses to date.

2 Inevitably, in what follows, there is a somewhat arbitrary choice and ordering of subject heads. The first two - the choice of target (Section B, paras 3-4) and the time horizon for control of the money stock (paras 5-6) - are perhaps clearly distinguishable as prior questions on which a particular stance was assumed in the Green Paper. The approach subsequently is to note briefly the extent of agreement on the abolition of direct controls and on the need for flexibility of interest rates (Section D, paras 7-8) and then to switch to the question of whether the authorities should operate a discretionary monetary policy or opt for a greater degree of automaticity (Section E, para 9). This leads on to views on the monetary base control (MBC) (Section F, paras 10-27) and indicator systems (Section G, paras 28-32) of various kinds discussed in Chapters 4 and 5 of the Green Paper. Finally, in the light of comments here, it is possible to summarise the views on the use of the main existing instruments of monetary policy (debt sales, lender of last resort facilities, MLR and the reserve asset ratio), Section H, paras 33-40. Only insofar as they are directly related to questions of monetary control are comments on the Bank of England's discussion paper on banks' liquidity considered. Throughout, unless otherwise stated, the analysis assumes that the exchange rate is floating.

B The choice of target aggregate

3 The Chancellor of the Exchequer's introduction to the Green Paper was written on the view that (i) a target should be set for only one monetary aggregate, that (ii) this aggregate should be sterling M3 but (iii) that account of the movements of other aggregates should also be taken in the formulation of policy.

4 A wide range of views was expressed on all these points during the consultations. All the overseas and some of the domestic proponents of MBC saw the ideal solution as setting a target for the base (M0) instead of the money supply because only M0 was directly under the influence of the authorities. They acknowledged the case for a money supply target in the immediate future but tended to argue for an aggregate narrower than sterling M3. Pepper wanted to revive M2; Griffiths supported an M1 target but this aggregate otherwise attracted little interest. Many UK commentators (particularly those hostile to MBC) accorded considerable relevance to credit aggregates, notably DCE, and to measures of liquidity and credit encompassing a wider range of financial institutions than the present sterling M3. Others, however, took the view that sterling M3 is familiar and important in its own right or because it bears a "fairly simple relationship to credit counterparts which are economically significant" (Phillips & Drew). There was little apparent support for multiple targets.

C The time horizon for monetary control

5 The Chancellor's introduction to the Green Paper said that it was "desirable for the authorities to have at their disposal instruments to moderate short-term fluctuations in monetary growth." The main paper commented that month-to-month control was not necessary but that there would "be advantage in shortening the period within which it is possible to exercise control if it were practicable to find ways of doing this."

6 There was near universal agreement that it was very important to ensure adequate monetary control in the "medium-term". However, this view was accompanied by an almost total denial of the value of short-term control (Bain, Coghlan) or, at the other extreme, heavy

emphasis on the harm done by "massive" swings in monetary growth in recent years (Griffiths). The overseas experts were concerned overwhelmingly with the growth of MO. Brunner saw fairly close week-to-week or month-to-month control of that aggregate as desirable, others were more relaxed on the question. Majority opinion fairly clearly considers short-run control not to be of "fundamental importance" (Accepting Houses Committee); but there was extensive agreement with the argument that whatever the importance of short-term control it would be reduced once the credibility of government's medium-term aims had been established. ("If longer-term requirements are met, the short-term choice is less vital" - the Select Committee). Several writers (the EEC Group of Experts, a member of the British Overseas and Commonwealth Banks' Association) went on to assert that undue regard for short-run control could be counter-productive.

D The abolition of direct controls and encouragement of flexible interest rates

7 There was a widespread welcome to the end of the corset and agreement with the analysis of the Green Paper on the disadvantages of direct controls. The only dissent came from the TUC (who consider that such controls have an important part to play in the allocation of credit) and one clearing banker who thought it would prove politically impossible for banks to operate solely with regard to market forces.

8 There was also general acceptance of the view - and it was stressed by the overseas contributors - that for monetary policy to operate properly, the authorities must be prepared to let interest rates move flexibly and, if necessary, rapidly. A number of reservations were, however, expressed about how far this could be carried. The Building Societies Association would not view significantly faster swings in interest rates "with equanimity"; while the Local Authorities' Borrowing Committee called for a smoother and more predictable money market than in recent years. Several commentators noted the "stickiness" of the banks' base rates in the present structure and considered that this would have to be changed if interest rates were indeed - at need - to move more freely.

E Discretion versus automaticity in the operation of monetary policy

9 The only general agreement in this crucial area could be found over the proposition that, at least at particularly difficult times (eg, in a banking liquidity crisis), the authorities should be able to exercise discretion. On wider use of discretionary powers, there was no agreement. All those favouring monetary base control (MBC) regarded it as an important feature of a new system that, so far as possible, the market should be left to establish the interest rates necessary to achieve the Government's policy aims. Those hostile to this view did not then necessarily find themselves agreeing with every aspect of the present system; but they argued either that markets could not be relied upon to set interest rates which cleared the market or that these interest rates would not necessarily be those appropriate to achieving the Government's monetary target. This issue reappears in a number of the sections to follow.

F Attitudes to Monetary Base Control (MBC)

(i) General issues

10 There was no general agreement over the question of whether MBC would significantly affect the volatility of short-term interest rates or not. Proponents, talking usually in the context of a non-mandatory scheme, generally stressed that very short-term rates of interest might become more volatile but that there need be no reason why these swings should carry over into longer-term rates. Indeed, they hoped that the cyclical swings in interest rates apparent from the operation of the present system would diminish in size, as the new system of control came to give greater assurance about the Government's ability to control the base and helped to avoid major swings in inflationary expectations. The opponents of MBC generally disagreed, though some accepted that the details of a new scheme and the way in which it was operated would be of crucial importance in this respect. Several opponents, notably Johnson, went on to argue that instability in short-term markets would spill over into the longer-term markets for credit as (they claimed) it had done in the United States over the last year.

11 A second important question, relating to any form of MBC, emerged during the consultations: would MBC change banks' behaviour significantly by encouraging them to ration loans independently of any interest rate effect on the demand for credit, by making the banks uncertain about the future availability of base? Put another way, is MBC just another method of adjusting interest rates to achieve a given policy aim?

12 Those sceptical of or hostile to MBC essentially answered "no" to both these questions ("A pure monetary base system would operate through the same mechanisms as other systems; control would be effected ultimately through the generation of changes in the level and structure of short-term interest rates" - the CBI). A number - bankers and academics - suggested that various forms of MBC would put at risk particularly valued elements of flexibility in the banking system, notably the overdraft. They went on to posit that in response, customers and banks might change their behaviour to the extent of establishing new ways of providing flexibility and, in the process, perhaps significantly changing the significance of, and demand for, sterling M3. They did not think the banks would change so much as to subordinate their lending function to the management of their base position and this was the essential change if banks were to ration lending in the way implied by the arguments of some proponents of MBC. Dudler reported that such a change had not happened when the Germans experimented with a form of MBC in the early 1970s.

13 Those favouring MBC tended to answer "yes". As Milton Friedman is reported to have put it to the Select Committee, "of course, direct control of the monetary base will affect interest rates but that is a very different thing from controlling monetary growth through interest rates." Lewis explored the question more fully, arguing that control of the base would enter as a new and separate factor determining banks' lending behaviour, at least for retail banks; uncertainty over the availability of base would reduce the supply of credit at any given set of interest rates. The UK proponents of MBC put considerable weight on the view, arguing that the present nature of the banking system was the result of the present market signals and that change would come rapidly as the management by a bank of its base position came to affect profitability significantly. The overseas experts agreed that banks would have to adjust their behaviour under MBC much faster than opponents feared but did not endorse, to any significant extent, Lewis' argument.

(ii) Non-mandatory MBC

14 The Green Paper described non-mandatory MBC as a system in which "the bankers' need for base assets stems from their own requirements for operating their business, rather than from a mandatory requirement imposed by the authorities. If such schemes are to control the growth of the money supply by the authorities controlling the size of the base, bankers' requirements for base money must bear a fairly stable relationship over time to their total liabilities." The essence of the summary was not challenged during the consultations. Instead debate revolved around the central questions of the stability of the base: money relationship, the relevance of targeting wider aggregates at all, and the implications (particularly for financial markets) of moving to such a system.

15 Switzerland is the only example of a system operating along non-mandatory lines and the Swiss National Bank have published evidence which suggests a predictable relationship over time (not, say, from month-to-month) between the base and the subsequent level of M1. (They have, however, also noted that this relationship appears to have become somewhat less stable in the last couple of years.) It was widely accepted that a major factor in the establishment of this relationship was that Swiss banks hold prudential as well as transactions balances with the Swiss National Bank, because Switzerland does not have developed markets in high-quality short-term debt; thus balances at the central bank are held instead of the portfolios of money at call, Treasury bills and other short-term 'near-cash' assets held by banks in the UK.

16 A number of UK academics (notably Griffiths) and the large majority of our overseas contributors favoured the creation of a similar system in the UK, which - if it were designed to reflect the Swiss approach fully - would imply the end of the provision by the authorities of funds through a "discount window" at a pegged rate of interest (though the central bank could still choose to intervene to provide more base) and a complete reappraisal of the concept of liquidity for banks.

17 Criticisms of non-mandatory MBC systems were expressed on a priori grounds by a number of other academics and on a priori and/or practical grounds by all the banks who commented on this question. The relevance of Swiss experience was questioned by several, the Accepting Houses Committee in particular arguing that the Swiss record of low inflation and very limited need for government debt greatly facilitated monetary control, while the existence of large amounts of high quality short-term debt in the UK would greatly reduce the chance of a stable relationship between the base and the money stock. The fact that the Swiss consider M1 rather than M3 as the important aggregate to control was also picked up, indirectly, by Lewis who - although a proponent of MBC - felt it could be applied only to retail deposit banking. Several other commentators (Alford, Johnson) argued that many non-clearers would have little or no voluntary demand for base assets; while the Committee of London Clearing Banks (CLCB) and the Co-operative Bank both doubted strongly whether a relationship between base assets and their deposit liabilities could be expected. ("Our own experience shows that the expected level of cash requirement and the outturn of our cash balances(s) are extremely volatile and could not be taken as an indicator of the level of our own deposit liabilities" - the Co-operative Bank.) This view was also expressed by the EEC experts, while Phillips & Drew talked of "insurmountable difficulties relating to the probable instability of bank demand for base assets".

18 The proponents of a non-mandatory system responded by arguing that a reasonably stable relationship might develop between the base and M1 (Griffiths) or, less certainly, wider aggregates. (Certainly as Brunner put it, wider aggregates would not rise by 10% year in year out, if the growth of the base was kept to, say, 2% a year). However, (and the overseas contributors felt this particularly strongly), the absence of a stable relationship would not greatly matter, because control of the base was far more relevant to the final objective of controlling prices and nominal incomes than was any single monetary aggregate like sterling M3.

19 The problems of transition to a non-mandatory system naturally seemed greatest to the opponents. There seemed to be two possible approaches but one - the adoption first of a mandatory system with the aim of using information thus gained to move towards a non-mandatory system - attracted only lukewarm support from UK proponents and none from the overseas contributors. The latter, instead, thought it possible to move straight to a non-mandatory system and, to limit the difficulty that the authorities would not know how much base to supply initially because nothing is known of banks' voluntary demand for cash, the authorities should institute a floor and ceiling for short-term interest rates. Initially, these would be quite close to ruling rates but, as experience was gained, the band would be steadily widened and eventually dropped. Opponents of MBC, for their part, doubted the merits of targeting solely MO and the speed with which information about the banks' demand for base would become available during the transition. They consequently foresaw a long period in which the authorities could lose influence over both the course of the wider monetary aggregates and movements of short-term interest rates.

(iii) Mandatory MBC

20 A mandatory MBC system would require the authorities to set some minimum ratio between banks' holdings of base and their deposits*. The Green Paper noted that there were three possible ways in which the requirement could be set:

- (a) Lagged accounting - where current base requirements are fixed by reference to deposits in a previous period.
- (b) Current accounting - where required base assets relate to the same make-up date as the relevant deposits.
- (c) Lead accounting - where the holding of base assets would put a limit on deposits at some future date.

* Because no official paper has been produced on the cash ratio or on the aggregate to which it might relate few commentators discussed these questions although a number thought them very important. The CLCB were particularly concerned because they thought it likely that the whole burden of adjustment to any shortage of base would fall on the clearers, while the Co-operative Bank argued that a requirement on non-clearers was a tax, while a requirement on the clearers alone would be inequitable.

21 Four UK commentators [Pepper, Victor Morgan, Smithers (of Warburgs) and Lewis] plus Monti of the overseas contributors favoured some form of mandatory MBC⁺, and Pepper, in particular, went into some detail as to how his scheme might operate.

22 It was clear that no-one favoured lead accounting, despite the possibility that it might give a warning about the immediate future development of the money supply as foreseen by banks. It was stressed by the CLCB, the Co-operative Bank and the Japanese Bankers' Association that banks would have great difficulty in making accurate predictions of the size of their future balance sheets. The CLCB went on to agree with the point made in the Green Paper that an underforecast by a bank of its need for base would encourage that bank to disintermediate (presumably along the lines developed during the corset) to avoid penalties for underforecasting. The Accepting Houses Committee, however, thought that banks could in time adjust to any form of mandatory MBC (though they would not welcome its introduction).

23 On lagged and current accounting systems it seemed to be common ground that the details of the system would determine such important questions as whether banks would hold significant excess reserves to guard against unforeseen circumstances. Under Pepper's and Smithers' proposals, banks would indeed want to hold excess reserves; but of course, as the CLCB pointed out, the short-term link between base and money would thereby be weakened.

24 On the practicalities of such schemes, the views of the AHC have already been noted. The Co-operative Bank considered that "lagged accounting would be the easiest to manage from our point of view but could be a severe restraint on growth and in our case could be as restrictive as the corset." The Midland Bank Review thought a mandatory MBC would be difficult but not impossible to manage; while Victor Morgan (one of the proponents) argued that the difficulties foreseen in the Green Paper were exaggerated because too rigid a form of MBC had been assumed.

⁺ Pepper favoured it as a necessary step towards a non-mandatory system.

25 As to the desirability of such schemes, the balance of opinion against has already been noted. Some of those averse to the proposal (eg, the CBI) said little more than that they agreed with the reservations expressed in the Green Paper. Others (notably Phillips & Drew and the AHC) were concerned that any form of mandatory MBC would encourage banks to hold more easily disintermediated assets on their balance sheets, thereby changing the nature and reducing the economic significance of sterling M3. One or two commentators (especially Lomax) were more sympathetic though on balance sceptical, while Rose deliberately left the question open.

(iv) Negotiable entitlements

26 The Green Paper noted that it had been suggested (Turner of James Capel had produced a detailed plan) that any problems in controlling the cash base could be side-stepped by creating special negotiable entitlements and requiring banks to hold these in proportion to the deposits that they wished to take. There could then be no question of deposits rising above a specified multiple of the volume of entitlements issued by the authorities.

27 Turner apart, this suggestion found little support during the consultations (most papers made no mention of this scheme at all) and indeed several distinctly adverse comments came from those not ill-disposed towards conventional forms of MBC. Lomax saw "various and substantial disadvantages" because, as the Green Paper had argued, such a system could only encourage disintermediation of business into forms and organisations not subject to the rules on entitlements. The Midland Bank Review thought it possible that a non-bank inter-company market in deposits might well result, completely distorting the significance of sterling M3. There was also concern that a system of entitlements would lack flexibility and be more likely to cause interest rate instability than other forms of MBC. Only Victor Morgan was more open-minded, saying that he could see no reason why "the scheme should be worse than other forms of MBC [in promoting disintermediation] but it is also hard to see any positive advantages in it". At a late stage, Miller did express some interest in the proposal, in part as a new way of taxing the banking system.

G The indicator system

28 The Green Paper devoted a chapter to systems in which movements in the base or the money stock would be used as an indicator for the appropriate level of short-term interest rates. The thinking behind this idea, which was largely developed by officials in the course of preparing the Green Paper, was that it might provide the reassurance some critics sought that the authorities would not delay necessary monetary action through the use of their discretionary powers, while avoiding the major structural changes in financial markets and practices implicit in many forms of MBC. The Green Paper concluded that an indicator scheme, if adopted, should relate directly to the target aggregate, sterling M3, should contain some limit (at least initially) on how far interest rates could move without discretionary intervention and should have provision for discretionary override because of the impossibility of devising any rule appropriate to all occasions.

29 In the event, the approach does not seem to have provided reassurance to the more committed proponents of MBC. Pepper regards the indicator system as providing the worst of all worlds since it could mean disruptive and volatile interest rate changes in often unnecessary response to fluctuations in the supply of money. Griffiths also attacked it, apparently regarding it as an attempt by officials to retain the freedom to peg interest rates and because of a fear that rational speculation could be highly destabilising with an indicator system.

30 Among those favouring discretion rather than rules, criticism came in a number of forms. Several commentators thought that while, in theory the adoption of a rule might make it easier politically to accept high interest rates, in practice the Government would not find things any different. There was also concern over how often discretion could be used without undermining the whole approach (it seems to have been generally accepted that some element of discretion would be needed and that the rule should relate to sterling M3 not the base). The London Discount Market Association feared that the discretionary override would always be used at times of crisis, with unfortunate market repercussions, while the Select Committee was unconvinced that

the distinction between a discretionary system and an automatic approach with override would remain clear or helpful for long. The CLCB was one of several to note the possibility that an automatic rule could induce policy reactions in totally the wrong direction (which was one reason why the Green Paper argued for an override): it was, further, concerned that the indicator could encourage an "unhealthy preoccupation with very short-term monetary developments". The Accepting Houses Committee was also against, in part because there was a "real danger that the authorities might be inhibited by the system from a proper exercise of their judgment and in consequence lose their direct responsibility for the outcome".

31 A number of respondents - particularly in the banking sector - were, however, in favour of some form of indicator with override. The CBI regarded it as the best of the alternative systems of control under discussion, while the Association of Consortium Banks, the Japanese Banks' Association and the Co-operative Bank all said that it would be acceptable or, at the least, that they could "live with it". Sargent went further and welcomed it as a step which would enable the water [of MBC] to be tested.

32 No-one pursued the technical aspects of the scheme very far, though several respondents were chary of the Green Paper's suggestion that the rule could be related to movements in the money stock over the previous four or five weeks.

H Present instruments of policy (earlier discussion of these topics in this paper is not repeated in detail)

(i) Sales of government debt

33 Quite a number of commentators expressed regret at the lack of discussion of debt policy in the Green Paper and, among non-monetarists and monetarists alike, there is pressure for change.⁽¹⁾ However, there remains the uncertainty, with regard to many of the comments, whether the aim is really greater assurance of a stable level of debt sales or whether it should be a greater certainty of selling whatever the

(1) The official response has been throughout that the Bank of England's article on the gilt-edged market in its Quarterly Bulletin for June 1979 remains on the table for discussion.

Government want to sell. Perhaps - insofar as there is a consensus - it is that short-term debt markets should take the greater share of ironing out short-term monetary volatility, though not - in the view of some - to the extent of appearing to undermine the significance of sterling M3 by the creation of near-money assets just outside the definition of this aggregate.

34 There was thus a call for greater use of short-term debt instruments as a form of monetary control from Pepper, Bain and Coghlan (who want a much wider range of such debt than at present), while Griffiths' views clearly ran the same way. All of these, plus Rose, Sargent, Lewis and Petherbridge in a more qualified fashion, wanted changes in gilt-marked techniques as well. Rarely were the desired changes described in detail. Rose said that the shorter the period in which monetary control was required, the more important was it to sell gilts by tender; while Bain talked about the need for the authorities and the major long-term financial institutions to devise methods for funding which would encourage a smoother flow of savings into gilt-edged. Petherbridge called for a more aggressive pricing policy on long taps in the gilt-edged market, while Lewis wanted "more positive action" in the same area.

35. Perhaps a little surprisingly, there was not any great discussion of non-marketable forms of government debt, although the AHC did anticipate the recent announcement on National Savings, by arguing the need to tap the personal savings market more vigorously.

(ii) The use of MLR and short-term interest rates

36 As noted earlier, there was fairly general agreement on the need for short-term interest rates to move flexibly when need be, and only limited interest in tying MLR directly to deviations of the money stock from target. The only other specific comments in the area came from Griffiths who called for MLR to be tied to inter-bank (ie "free market") rates and from Coghlan with the not dissimilar point that there is no need for MLR to lead market interest rates; rather, the authorities should sell the appropriate amount of short-term debt to control the money stock and this would engineer the necessary change in market rates, which MLR could then follow.

(iii) Lender of last resort facilities

37 Not surprisingly, criticism of the present facilities was concentrated among advocates of some form of MBC. Both Pepper and Griffiths argued that any official lending should genuinely be "last resort", and, except at times of crisis, should not involve the ready provision of official finance at pegged interest rates. However, under Pepper's scheme, official finance would be available fairly freely, so long as monetary developments were satisfactory.

38 Bankers were not keen to see changes in this area. The London Discount Market Association was broadly content with the present system, while the CLCB wanted an extension of the range of intervention techniques in the money markets available to the authorities to avoid rapid movements in interest rates during the day. Phillips & Drew also urged that lender of last resort facilities should not be abandoned.

(iv) The reserve asset ratio (RAR)

39 The proposed abolition of the RAR requirement has been accepted with virtually no comment. To the proponents of MBC, the present RAR is anathema, because the authorities cannot control the volume of reserves. Among the others, the only specific comments made were by Coghlan (to the effect that the problem of monetary control stems from the size of demands for credit not from the present definition of reserves), from Bain (who was concerned that the liquidity proposals would not keep a tight enough rein on the banking system's liquid position) and from the CLCB and Wills who considered the RAR an artificial control with "unpleasant and destabilising side effects" (Wills).

40 This is not to say that the abolition of the RAR without any other action would find general acceptance. Indeed, it is known that Pepper and Griffiths would regard the result as a control mechanism even weaker than that in force at present.

APPENDIX

CONTRIBUTORS OF WRITTEN COMMENTS ON THE GREEN PAPER

- 1 Accepting Houses Committee
- 2 Association of Consortium Banks
- 3 Bain, Professor A, University of Strathclyde
- 4 British Overseas and Commonwealth Banks' Association
- 5 Building Societies' Association
- 6 Coghlan, R
- 7 Committee of London Clearing Banks
- 8 Committee of Scottish Clearing Banks
- 9 Confederation of British Industry
- 10 Congdon, T, Messel and Co
- 11 Courakis, A G, Brasenose College, Oxford
- 12 Greenwell and Co
- 13 Grenfell and Colegreave
- 14 Grieveson Grant and Co Ltd
- 15 Griffiths, Professor B, City University
- 16 Hall, M J B, Loughborough University
- 17 Insurance Company Associations
- 18 Japanese Banks in London
- 19 Karakitsos, Rustin and Zarrop Imperial College London
- 20 Lewis, M, University of Adelaide
- 21 Local Authority Associations
- 22 Lomax, D, National Westminster Bank
- 23 London Discount Market Association
- 24 Phillips and Drew
- 25 Post Office Staff Superannuation Fund
- 26 Rose, Professor H, Barclays Bank Ltd
- 27 Samuel Montagu and Co Ltd
- 28 Sargent, Professor R, Midland
- 29 Sheppards and Chase
- 30 Smithers, A, I G Warburg and Co Ltd
- 31 Trades Union Congress
- 32 Wills, H, London School of Economics

£25 b.

Adv. to U.K. residents.

£6.7 b.

Total Investment.

£3.6 b.

Other Prod. Adv.

£2.0

By

£1.5

Contract.

26.9.

12 /

15 /

27.9.

THE ECONOMIC PROSPECT AND IMPLICATIONS FOR POLICY

Introduction

Last March Cabinet endorsed the Medium Term Financial Strategy (MTFS) for bringing about a permanent reduction in the rate of inflation, and thereby creating the conditions for a sustained growth of output, employment and living standards. Essential to the strategy was a decline over the period in public sector borrowing, so that the monetary deceleration could be achieved while at the same time reducing interest rates.

2. There are some encouraging signs that the strategy is beginning to bring about greater realism in pay and pricing. We must build upon this success by holding to the strategy. This means that we must take the decisions necessary to ensure that public expenditure, borrowing and the growth of money supply - which have all been too high recently - are brought firmly under control. If we fail to do this we will do immense damage to the overriding objectives we have set ourselves of reducing inflation, interest rates and the tax burden.

3. This paper outlines the economic prospect and sets out the policy decisions we need to take to implement our strategy.

THE ECONOMIC BACKGROUND

4. We are clearly in a period of recession for the industrialised countries. World inflation rose and output began to decline from the first quarter of 1980. This decline is likely to continue through the rest of this year, and 1981 could be a year of relatively slow recovery.

5. The prospects for the UK economy are dominated by the cumulative effects of past and present inflation and low productivity. These can be seen most clearly in the serious loss of competitiveness and the low level of company profitability. The volume of exports has so far held up well, but the very rapid rise in world trade during 1979 and the early months of 1980 to some extent masked the effects of the loss of competitiveness. With world trade slackening the volume of exports may fall from now on. Lower exports and reductions in stocks are likely to be the main factors reducing output in the short-term.

6. The fall in gross domestic product (GDP) this year seems likely to be close to the 2½ per cent forecast at Budget-time; but the recession may be deeper in 1981 than had been thought earlier. The latest forecasts suggest that output in 1981 may fall by about the same amount as this year, but within the year the pace of decline should slacken and there may be some upturn in the second half leading to resumed growth in subsequent years.

7. On inflation the picture is brighter. There has been a marked reduction in the rate of inflation in the past six months. In the immediate future progress may be slowed by the lagged effects of the rise in wage costs in the 1979-80 pay round and by increases in nationalised industry prices; the 12-month increase in the RPI is expected to be about 11½ per cent by late 1981 (this would be equivalent to 12 per cent between the financial years, which is relevant for cash limits). A single figure outcome is possible but a number of favourable factors - for example, a continuing rise in the exchange rate, a further substantial squeeze in profit margins, a fall in mortgage rates, continuing weak world prices, and single figure average pay settlements - would generally have to go in the right direction. On balance we must expect some of these factors to go in the wrong direction.

8. Further progress in reducing inflation will depend critically on the course of pay increases. The most effective way in which we can influence the private sector is to convince everyone that we will stick to the financial strategy, whatever the short-term difficulties, and to settle public sector pay at a low figure.

9. So far the reduction in inflation has come about in a way that has permitted a further rise in real personal incomes because it has affected prices before earnings. The burden of adjustment has fallen disproportionately on company profits. This means that the finances of many companies are extremely vulnerable in the immediate future unless wage settlements are low. A fall in real earnings over the next year or so is essential, and indeed this seems now to be widely accepted.

Public Finances and the PSBR

10. The Treasury's latest forecasts put the PSBR for 1980-81 at over £10 billion. This is £2 billion above the Budget forecast, mainly reflecting over-runs in expenditure. This over-spending

has been a major reason for the difficulties we have experienced this year in getting to the point when we can look forward to a significant fall in interest rates.

11. For 1981-82 the forecast PSBR is over £11 billion. This assumes that the cuts in programmes proposed by the Chief Secretary in July are fully achieved, but allows the expenditure totals to increase to the full extent of the adjustment in demand-determined programmes (such as social security) and expected expenditure shortfalls caused by the revised economic prospects. It also assumes full inflation adjustment of personal and expenditure taxes in the 1981 Budget and public services pay rises of 9 per cent. A PSBR of the size implied by this forecast would have the most serious implications for interest rates.

IMPLICATIONS FOR POLICY

Monetary Policy

12. We must stick to our two main objectives: lower inflation and lower interest rates. This means that there can be no question of departing from our monetary objectives. To do so would have a disastrous effect on inflation, interest rates and the climate for pay bargaining.

13. One consequence of the recent high public sector spending and borrowing is that interest rates will need to remain high for longer than we had hoped. The first requirement now is to secure an out-turn for the money supply in the current financial year that is consistent with the target range set last Spring. For this we shall have to rely primarily on monetary instruments, particularly selling more government debt to persons by "granny bonds" and other means.

14. For 1981-82 and later years we must take action to keep monetary growth within the range set out in the MTF5. This will entail fiscal measures to reduce the prospective PSBR.

The PSBR

15. What size of PSBR in 1981-82 we should aim at cannot be decided now. But it is clear that we must aim at a borrowing requirement substantially below that indicated in the latest forecasts.

16. The illustrative path in the MTF5 envisaged a PSBR equivalent to about 3 per cent of GDP in 1981-82: The forecasts imply one of around 4½ per cent. To get back to the MTF5 figure would entail a reduction of about £4 billion. To go that far in a year of

CONFIDENTIAL

22. There is thus a strong case that we should seek larger cuts. But I recognise the difficulties of this. Even if we modify the objective of restoring the planning totals by not deducting the full savings from the EC settlement, keeping within them would require cuts in programmes other than the nationalised industries of nearly £2 billion (at late 1979 prices) in 1981-82 (and somewhat larger sums in the later years) and severe restraint in public sector pay increases. As the proposals in the Chief Secretary's paper make clear this will entail some very difficult and disagreeable decisions. But unless we face up to this issue there is no prospect of getting back to the path of our medium-term strategy and securing the reductions in monetary growth and interest rates we seek. And in the nearer term there would be very bleak implications for taxation.

Conclusion

23. The prospects for this financial year and next are extremely difficult. For both years the PSBR on present policies is likely to be much higher than is compatible with easing the pressure on interest rates within the continuing framework of our medium-term financial strategy.

24. For the current year monetary instruments must continue to bear the main strain, though it is vital that cash limits should be held.

25. For next year, although I am considering what extra revenue can be obtained, we must as a minimum restore the White Paper levels of expenditure as agreed in July. Without this there is little hope of getting interest rates down.

26. In the later years, the PSBR and interest rate problems may be less acute. But if these are to be years in which, as we all hope, taxes and interest rates are coming down and industrial and economic confidence going up then it is vital that we contain public expenditure within the earlier plans.

recession would not be warranted; but if we wish to create conditions in which interest rates can fall we must seek a reduction of at least [£2½] billion from the current forecast figure of £11 billion.

17. Since that forecast already assumes that the specific reductions in programmes proposed by the Chief Secretary in July are fully achieved this is a formidable objective.

Taxation

18. On the tax side I am considering a number of options for raising revenues, including the possibility of obtaining additional revenue from the North Sea. But these obviously cannot close more than part of the gap. Even with the cuts in public expenditure proposed in the Chief Secretary's paper (reference) it will almost certainly be necessary to raise the real weight of personal taxation. The real tax burden was increased in the last Budget; I need hardly stress the difficulties, and disappointments, that any further increase would entail.

Public Expenditure

19. The credibility of, indeed the chances of achieving, our whole strategy rests upon, at a minimum, holding public expenditure within our own published planning totals.

20. The changes in the prospects for the economy from those that underlay the White Paper figures mean that there is likely to be higher spending on social security and items such as housing and export credit subsidies. In addition, discussions with the nationalised industries reveal a serious deterioration in their financial prospects.

21. The proposals in the Chief Secretary's paper are addressed to the aim of re-establishing the planning totals. But in itself this would do little to reduce the PSBR below the present forecast. We need to go virtually that far to validate the assumptions already in the forecast.

THE MONETARY SITUATION

MT

Introduction

The sharp burst of growth in the recorded money supply in July and August took the increase in £M3 since February to 26% pa, well above the top of its current target range. Much of the growth in the two months can be directly attributed to the ending of the "corset" in June, but the size of the burst reveals that underlying growth during the operation of the corset had probably been well in excess of what had been previously thought. It now looks as if £M3 was probably growing in underlying terms at an average rate of over 17% pa in the 14 months following the present Government's first Budget.

2. It seems that there were probably three separate stages of monetary growth within the 14 months. The first was a period of about five months in which underlying growth of £M3 may have exceeded 18% pa. This was followed by five months during which £M3 decelerated to a rate of growth of about 10% pa. The third stage, up to August of this year, was a short period of strong acceleration of well over 20% pa.

3. Preliminary figures for September suggest a slowdown in the month. Although it is far too early to say that this itself implies a change in trend, there does seem to be a good prospect that the acceleration seen up to August will be short-lived. Both the profile of the CGER through the financial year and the downturn expected soon in bank lending point to much more moderate growth in £M3 in the near future.

4. This paper considers what factors may have led to the recent acceleration in the money supply and whether these could have been foreseen. It also tries to reassess whether financial conditions have in fact been looser than was intended when the target was set or whether what happened in terms of excess monetary growth was more a reflection of changes in the relationship between particular monetary

indicators and the economy than of underlying economic developments.

Previous Monetary Targets

5. The 26% pa growth of £M3 between February and August of this year represented a sudden and substantial acceleration in recorded monetary growth. Although monthly rates of growth of £M3 have always tended to be rather volatile, average growth rates since the establishment of monetary targets have generally tended to fall within the range of 10-15% pa: near the top or just above the target ranges. The performance of £M3 relative to the targets since the beginning of 1977 is plotted in chart 1, where the original moving targets are identified by solid black lines radiating from their base points and the operational periods of the targets (ie before rebasing) are represented by the shaded areas.

6. The chart shows that the only target which was comfortably met was Mr Healey's second one, but that - until this summer - the size of the deviations of recorded £M3 from the target ranges were fairly small. This was however achieved only with the aid of the "corset" (the Supplementary Special Deposits Scheme) for much of the period. Since the corset was in part a cosmetic operation only - restraining the growth of recorded £M3 but allowing faster growth in close substitutes - the modest growth of recorded £M3 at times disguised a much faster rise in underlying terms. Only now is it becoming clear how great the distortion may have been.

The Corset

7. The Supplementary Special Deposits scheme was first introduced in December 1973 as a means of restraining directly the scale of banks' activities with the specific aim of limiting the size of one of their principal liabilities, private sector bank deposits. These deposits form the major component of the money supply £M3 . The scheme worked by penalising any increase in banks' interest-bearing eligible liabilities above a specified growth rate and was in force from December 1973 to April 1975 and November 1976 to August 1977. It was last reintroduced in June 1978 and only finally removed in June of this year.

8. By imposing penalties based on increases in the size of their balance sheets, the corset provided an incentive for banks either to redefine elements of their business or to restrict purchases of assets where the margins over the cost of funds would be lowest. This seems to have resulted in four major types of distortion. The largest and most well-known operation concerned the "bill leak", which involved an increase in non-bank holdings of acceptance credits. Instead of granting a bank loan to a company and obtaining an equal deposit to finance it, banks behaved in such a way that the borrower effectively gained his funds directly from the lender (by having his bills placed outside the banking system). The banks meanwhile continued to earn a margin by accepting the bills. They also apparently deflected some of their business into the euro-sterling market by using their overseas branches (we do not know from the statistics whether this involved any breach of the Governor's instructions earlier this year that they should not take advantage of the relaxation of Exchange Control to circumvent the corset in this way). A further method of reducing their liability to penalties was by rearranging their foreign currency portfolios to gain the maximum allowances available under the corset. Finally, banks seem to have reduced their holdings of public sector debt (primarily local authority short-term and longer-term debt, gilts and Treasury Bills) below the levels which normal liquidity considerations would have suggested. The table showing the effects of these various forms of "disintermediation" is provided in Annex A, together with an assessment of their implications for recorded £M3 .

9. The principal net effect of these various operations by the banks was to change the composition of the liquid assets held by the rest of the private sector. Instead of holding deposits in the banks, companies and individuals were encouraged by the interest differentials which opened up to hold commercial bills, euro-sterling or foreign currency deposits or short-term public sector debt instead. Thus, when the corset was biting hard, these "near money" assets

grew at an appreciably faster rate than £M3. Since, to the private sector, these assets were virtually as liquid as £M3 the ultimate effect on behaviour would have been much the same as if they had instead been counted within £M3. The dividing line between those assets which are included in the target aggregate and those excluded must always be a fairly arbitrary one. Normally the choice is not critical because, in a financial environment free from direct controls, holdings of most of the assets would grow at roughly comparable (although not necessarily identical) rates and, more importantly, would react in a similar way to changes in monetary conditions. It is only when controls distort this process that the definition employed can become crucial. In the circumstances of the corset, it is clearly necessary to take special account of increases in holdings of these near-money assets which have arisen as a direct consequence of the control.

10. Although it was clear during the operation of the corset that these channels for disintermediation were open, it was not in general possible to gauge their impact. Some guide was provided by movements in one of the broader measures of private sector liquidity, PSL1, since this measure included holdings of commercial bills and short-term public sector debt. But there were three major problems in using it effectively. The first was that PSL1 excluded euro-sterling deposits and foreign currency deposits. The second was certain known deficiencies with the data employed (particularly the fact that overseas holdings of bills were not excluded). And the third problem, a general one in assessing disintermediation into particular forms of debt, was that there was no way of knowing what would have been the growth relative to £M3 in the absence of the corset.

11. Of the measurement problems associated with disintermediation, the most intractable has been that arising from the euro-sterling and foreign currency leak. The abolition of Exchange Control in October 1979 fundamentally altered the

financial environment. Not only did this provide new potential leaks under the corset; by presenting certain types of financial channels to business for the first time it made it impossible to assess what would have been the underlying situation in the absence of the corset. This was fully appreciated at the time the controls were abolished, but was a cost which had to be faced. In addition, data for the euro-sterling market have to be compiled by the BIS from information provided by other countries. They are thus very slow to arrive (the latest we now have relate to March) and can never be fully comprehensive.

12. Estimates of the extent of disintermediation were of course made during the operation of the corset, but it was only after it was lifted and banking figures for July and August and euro-sterling figures for March were known, indicating a swift and substantial amount of "reintermediation", that the possible true scale of the distortion became apparent. Even now, information in some areas is so sparse that some of our figures for distortion are little more than guesswork. Some refinement may be possible over the next few months, but a significant deal of doubt is certain to remain.

Underlying Monetary Growth During the Corset

13. The figures for July and August provided some indication of how much distortion had occurred in previous months, but even so there were problems in interpreting the significance of some of the developments in the two months. The banks, for example, bought a large amount of gilts in July and seem to have persuaded the non-bank sector to part with a significant quantity of Treasury Bills. The gilt purchases by themselves would not have had any direct effect on the money supply if they simply represented a substitute for additional holdings of Treasury Bills by the banks but they could have been bid away from the non-bank private sector, increasing the total size of banks' balance sheets and raising temporarily monetary growth. Similarly, although the change in non-bank holdings of Treasury Bills may only have been a chance

financial environment. Not only did this provide new potential leaks under the corset; by presenting certain types of financial channels to business for the first time it made it impossible to assess what would have been the underlying situation in the absence of the corset. This was fully appreciated at the time the controls were abolished, but was a cost which had to be faced. In addition, data for the euro-sterling market have to be compiled by the BIS from information provided by other countries. They are thus very slow to arrive (the latest we now have relate to March) and can never be fully comprehensive.

12. Estimates of the extent of disintermediation were of course made during the operation of the corset, but it was only after it was lifted and banking figures for July and August and euro-sterling figures for March were known, indicating a swift and substantial amount of "reintermediation", that the possible true scale of the distortion became apparent. Even now, information in some areas is so sparse that some of our figures for distortion are little more than guesswork. Some refinement may be possible over the next few months, but a significant deal of doubt is certain to remain.

Underlying Monetary Growth During the Corset

13. The figures for July and August provided some indication of how much distortion had occurred in previous months, but even so there were problems in interpreting the significance of some of the developments in the two months. The banks, for example, bought a large amount of gilts in July and seem to have persuaded the non-bank sector to part with a significant quantity of Treasury Bills. The gilt purchases by themselves would not have had any direct effect on the money supply if they simply represented a substitute for additional holdings of Treasury Bills by the banks but they could have been bid away from the non-bank private sector, increasing the total size of banks' balance sheets and raising temporarily monetary growth. Similarly, although the change in non-bank holdings of Treasury Bills may only have been a chance

fluctuation in a rather volatile series it could indicate a generalised movement by the banks into public sector debt, having as its counterpart a sustained growth in private sector bank deposits and £M3 . For the purposes of constructing the estimate that follows, it has been assumed that the effects of these on £M3 have in fact been fairly small. There is a risk therefore that the figures for the distortions induced by the corset may be underestimated and that underlying growth during the corset may have been faster than indicated. More importantly, however, it is possible that these balance sheet adjustments may continue for some time, thus providing an additional boost to recorded £M3 in the future.

14. Even without allowing for these effects associated with central government debt, the apparent extent of reintermediation from local authority debt and the euro-sterling market points to much higher estimates of disintermediation during the corset than previously thought. The timing of the disintermediation itself nevertheless remains uncertain. By looking at the sparse data that are available on total flows of debt an assessment has been made of the monthly profile of disintermediation, but much of this remains very speculative and the crucial division between distortion which occurred after rather than before the beginning of the current target range is unfortunately very uncertain.

15. The path of £M3 corrected for these estimated distortions is shown in Chart 2 under the heading "adjusted £M3 ". Also included on the graph are the target range for £M3 specified in the period since the beginning of 1977. The targets have been rebased to align them in level terms with our estimates of "adjusted £M3 ". The graph indicates that, whilst in terms of recorded £M3 , growth of £M3 above its target range had generally been modest up to this summer, the excess in terms of adjusted £M3 had been significantly greater and getting worse over time.

16. The distortions were such that whilst recorded figures showed £M3 growing at a fairly steady rate (or even slowing down) in 1979 and early 1980, there was, in underlying terms, a persistent reacceleration.

17. The misleading impression of the path of £M3 over the period given by the recorded figures can also be indicated by comparing the growth rates with those of "adjusted £M3" and PSL1 in the three yearly periods up to this June:

	<u>Recorded £M3</u>	<u>"Adjusted £M3"</u> (approx.)	<u>PSL1</u>
June 1977-78	<u>15.3%</u>	<u>15%</u>	13.7%
June 1978-79	11.5%	13%	16.1%
June 1979-80	11.7%	17%	13.5%

18. These estimates of "adjusted £M3" are of course highly tentative. Although shown to the nearest percentage point, they could in fact be several percentage points different and are being constantly revised as new information becomes available. Nevertheless, some guide to the general robustness can be provided by a comparison of the longer-run path of adjusted £M3 with that of the broader aggregate PSL1. The two sets of figures are by no means independent in their compilation but, despite the occasional shorter-run divergences in path such as those noted above, the generally similar profiles shown in chart 3 are reassuring. Annex B provides monthly totals for the adjusted figures compared with PSL1 and M1.

The Last Fourteen Months

19. Looking in more detail at the estimates of adjusted £M3 since this Government's first Budget through to August of this year, it is perhaps most helpful to divide the period into three discrete sections. In the first period there was a fairly sustained acceleration in £M3, precipitating the sharp increase in MBR from 14% to 17% in November 1979. There then followed a period of fairly slow growth in the aggregates,

lasting about five months. Finally, there seems to have been a strong burst of growth at rates well above those experienced at any time in the past four years. Using recorded £M3 also for comparison the figures are as follows:

	Annual rates of growth		
	June 1979 -Nov 1979	Nov 1979- Apr 1980	Apr 1980- Aug 1980
"Adjusted £M3"	19%	10%	27%
Recorded £M3	14.8%	6.0%	38.1%

The specific months chosen to illustrate this profile are to some extent arbitrary - monetary growth in the month to mid-November for example was actually relatively modest - but it seemed convenient to choose as a break-point the time when MLR was raised. The paths are also slightly distorted by the particular shape of monthly profiles of e.g. bank lending.

20. The sharp changes in monetary growth rates over the period have clearly made any assessment of underlying trends extremely difficult. To the extent that they were anticipated by the market they might not have had a lasting effect on confidence or behaviour but in fact our own forecasting procedures did not pick up the extent to which such fluctuations were likely. In addition, the problems that the gilts market experienced last autumn indicated the considerable difficulty that such profiles can cause. It is therefore instructive to look at the main influences behind the profile and to consider whether these should have been predictable or avoidable.

21. In the short run, the influences over monetary growth can best be considered by looking at the main credit counterparts: lending by the banking system to the public and private sectors. Breaking the public sector credit counterpart down into the CGBR, debt sales and the contribution of the rest of the public sector - and correcting the figures as far as

possible for the effects of corset distortions - these have had the following pattern in the recent past:

£ million

(Figures in brackets show estimated percentages of adjusted £M3 at annual rates)

<u>All figures are approximations</u>	Banking Months			
	<u>Jun 78- Jun 79</u>	<u>Jun 79- Nov 79</u> (5 months)	<u>Nov 79- Apr 80</u> (5 months)	<u>Apr 80- Aug 80</u> (4 months)
Adjusted £M3	6290 (13%)	3910 (19%)	2270 (10%)	4990 (27%)
CGBR	8990 (19%)	4420 (21%)	1650 (7%)	5340 (30%)
C G debt sales to non-bank private sector	-9720 (-21%)	-2310 (-11%)	-4070 (-18%)	-3210 (-17%)
Other public sector bank borrowing (ie contribution to DCE)	780 (2%)	-80 (-)	470 (2%)	260 (1%)
£ private lending	7090 (15%)	4210 (20%)	4580 (21%)	3130 (17%)

22. There are of course considerable interactions between these counterparts. It is therefore not possible to infer directly from a correlation between the movements of any one with the total that it was the direct "cause" of movements in the total. However, the striking similarity between the CGBR profile and that of adjusted £M3 is worthy of particular note. There was also a burst in gilt sales in the middle period following the increase in MLR but this seems to have given a slightly less powerful "push" to the profile of £M3 than the CGBR itself.

23. The link between the CGBR and movements in £M3 is also consistent with that we consider to be the underlying influences behind monetary growth. The most powerful influences that have been identified are changes in the private sector's holding of financial assets (either gross or net of their financial liabilities) and movements in relative interest rates, corrected for the effect of any capital gains or losses made on gilts. Since the PSBR is a major counterpart of the private sector's net holdings of financial assets it will clearly be a determining factor in demand for £M3 - or at least to the extent that its effects are not offset by developments in the current account of the balance of payments or changes in interest rates. It is therefore reasonable to infer (subject to the time lags involved) that the combination of a slowdown of the PSBR over the turn of the year and the rise in interest rates and effective differentials contributed markedly to the temporary slowdown in £M3 at the beginning of 1980.

24. Similarly, the acceleration in monetary growth since the spring can be attributed to a significant extent to the burst in the PSBR in this period. This was not expected to happen on a scale of anything like the sort actually experienced. An additional factor seems to have been the steady improvement in the current account over the period. The net external position was a significant positive factor in the acceleration in £M3 . But as far as the underforecasting of monetary growth in this period is concerned, an important feature was the continued rapid growth in bank lending. It was no surprise that it remained high (even after allowing for the effect of the increase in short-term interest rates) but there were several months in which its growth did exceed expectations.

25. The implications of recent developments for monetary growth depend very much on whether there is a fairly quick reversal of these special factors. The estimate of a 22% p.a. rate of growth of adjusted £M3 between February and August is in no sense a true guide to "underlying"

growth over a longer period if the profile of the CGBR and the level of bank lending turn down as expected over the next few months.

Underlying financial conditions

26. Although £M3 has grown considerably faster than intended over the past year, and accelerated in recent months, there is a widespread feeling in the business and financial communities that in fact monetary policy has become exceedingly "tight". This feeling is of course most prevalent in the manufacturing sector where the combination of a high exchange rate, high interest rates and labour costs which are still generally growing rapidly has given rise to a marked decline in profitability. For all non-North Sea industrial and commercial companies the estimated pre-tax real rate of return had declined to 3½% by March 1980, a record low. In addition, low sales and a high exposure to short-term liabilities (the ratio of current assets to current liabilities in the manufacturing sector fell again in March) has strained the financial viability of many companies. Total liquidations rose to 3,000 in the first half of 1980, the highest level ever recorded.

27. This raises the possibility that, perhaps because of the particular way that the recession has struck, movements in £M3 may be departing from their normal relationship with the rest of the economy (even after allowing for distortions) and therefore may be providing a less reliable indicator of underlying developments than usual. It has been observed, for instance, that M1 has been growing in a very different fashion from £M3. Over the past three years, whilst £M3 has been accelerating, M1 has been slowing down appreciably (and was indeed declining in the early months of this year).

% changes at annual rates

Banking months

	<u>June 1977- June 1978</u>	<u>June 1978- June 1979</u>	<u>June 1979- Aug 1980</u>
"Adjusted" £M3	15%	13%	18%
M1	20.8%	12.8%	5.7%

28. Given the pattern of nominal interest rates over the period, however, this relationship is not actually very surprising. Chart 4 compares the movements in £M3 and M1 against a plot of MLR. With MLR and other short-term interest rates rising strongly over the latter part of the period we would expect to see much slower growth in M1 than £M3. This is because M1 contains a very high proportion of non-interest bearing money (cash and current accounts) from which there will be a strong incentive for the private sector to switch without necessarily having lasting implications for future economic behaviour. £M3, on the other hand, contains a significant proportion of deposits on which market-related interest rates are payable, reducing its likely responsiveness to changes in general nominal interest rates. This does not, however, rule out the possibility that other developments are also having a strong effect on the relationship. Company borrowing has recently been particularly high, itself probably an indicator of severe pressure, and it may be that one of the reasons why £M3 growth has exceeded that of M1 is because the company sector has been using this borrowing primarily to build up its own liquidity. If this is the case, the broader aggregates may be giving a rather more reliable indication of true underlying monetary conditions.

29. The main financial indicators to which reference is made when claims about financial 'tightness' are made are nominal interest rates and the exchange rate. It is clear that these have been causing increasing difficulty for manufacturing companies over the past year. Whilst profitable companies could initially offset their additional interest costs against tax (and thus bring their net outlays on interest payments well below the rate of inflation) the scope for making offsets against tax has now been considerably reduced. As the rate of increase in output prices has also decelerated sharply, the "real" cost of borrowing has probably now turned significantly positive for most companies. Added to the front-end loading problems associated with high nominal rates this has put a new and sizeable burden on industry. That it has not

yet brought down the rate of increase in bank lending is perhaps an indication of the extent of distress lending within that total. Although the causes of the high exchange rate are not all associated with monetary policy, the monetary stance has clearly been an important contributing factor in the sharp reduction in competitiveness which has taken place over the last year, exerting considerable strain in terms of both profitability and sales on the manufacturing sector. Outside the manufacturing sector, the effects have perhaps been most noticeable in the housing field, with record mortgage rates, a sharp deceleration in house prices and declining rates of activity.

30. In terms of aggregate indicators for the "real" economy, it also appears that the squeeze has recently been exceptionally severe. Manufacturing output has fallen over 7% so far this year; unemployment has risen by nearly 2 percentage points. The behaviour of these variables over the three discrete periods of varying monetary growth of the last year and in the previous year is shown below in comparison with measures of the "real" money supply and the effective exchange rate.

	% change at annual rates			
	Mid-June 78 to mid-June 79	Mid-June 79 to mid-Nov 79	Mid-Nov 79 to mid-Apr 80	Mid-Apr 80 to mid-Aug 80
Adjusted £M3	13%	19%	10%	27%
Recorded £M3	11.5%	14.8%	6.0%	38.1%
Recorded M1	12.8%	11.7%	-2.7%	9.3%
Retail Prices Index	11.4%	20.9%	24.9%	9.3%
"Real" adjusted £M3*	2%	-2%	-12%	17%
"Real" recorded £M3*	0.1%	-5%	-15%	26.5%
"Real" recorded M1*	0.4%	-7.6%	-22%	0%
Manufacturing output	3.1%	-6.3%	-15.9%	-3.6%
Effective exchange rate	11.4%	0.4%	16.5%	11.1%
Unemployment (as proportion of labour force)	-0.5%	0	2.2%	3.0%

*These series are deflated by movements in the RPI

The figures indicate that whilst the tightest period of "squeeze" did seem to have occurred during the period when real money supply was declining fastest, there were few signs of respite during the subsequent period of relatively fast real monetary growth.

31. That this contradictory picture should emerge of relatively fast growth recently in the wider monetary aggregates alongside a worsening squeeze in the real economy is not altogether surprising. Even allowing for the recent burst in monetary growth, the overall picture over the past year or so is of growth in the money supply held for the most part well below the growth of nominal GDP. The scale of tightening has been considerable, even if the desired target has not been fully achieved. The worry is not so much whether recent monetary growth is consistent with current developments in the real economy but rather with future objectives for inflation.

32. One feature of recent months has been the extent to which growth in bank lending has at times exceeded that of £M3. In part, this has been achieved through external financing of the money supply, giving a higher rate of growth of DCE than £M3, a feature itself giving rise to concern about DCE. However, the relevance of DCE as an indicator in its own right seems small in the context of a country not pursuing a target for the exchange rate. It is only when the exchange rate is being pegged that DCE assumes an obvious role. Since the money supply cannot then be separately controlled, DCE and the change in reserves serve as the only indicators of whether there is consistency between the desired rate of growth of the money stock and the level chosen for the exchange rate. Under floating exchange rates, there is unlikely to be a persistent discrepancy between DCE and £M3; and, if there is, it will reflect the fact that non-resident demand for sterling is moving in a different relative fashion from non-bank resident demand - with possible consequences for the exchange rate, but not the relationship between money supply and inflation.

Implications of the Monetary Figures

33. The implications of recent monetary figures for the rollover of the monetary targets and methods of monetary control are addressed in companion papers, but it is appropriate at this point to consider whether the reacceleration in monetary growth should perhaps have given rise to offsetting action under existing control techniques.

34. The main difficulties in assessing underlying developments in the early months of this year were undoubtedly associated with the corset scheme. At that time, the only certain effects of the scheme had been the growth in holdings of commercial bills outside the banking system. Even then, because of doubt about the size of overseas holdings and what the growth of the market would have been in the absence of the scheme, the net effect on the recorded money supply was not known with any certainty. It was also observed that interest differentials had appeared between certain types of bank deposit and close "near-money" substitutes but there was no way of knowing with what scale of disintermediation this might be associated. Overall, it was thought, both by the authorities and most outside commentators, that total disintermediation during the corset had probably been in the range of 2-3%. This meant that, in underlying terms, £M3 had probably been growing above its target range for some time but not by particularly large amounts.

35. Growth in the money supply had of course accelerated even in recorded terms in the middle of 1979, but due to the combination of a sharp rise in MLR, strong gilt sales and a very low PSBR (in fact negative in unadjusted terms) it appeared that £M3 had been sharply reined back. In the event, the target range was not achieved, but again the overshoot (although unintended) was not very great. The incorporation of this overshoot into the base for the current target and the MTF5 was not subject to great criticism by market commentators - a point obviously helped by the implied allowance for reintermediation included within the new targets.

36. Looking ahead towards the current target period, it was appreciated that the target would be very difficult to achieve and might not be associated with any sustained fall in short-term interest rates during the period. It was also foreseen that the scale of bank lending at the beginning of the period could present a problem for monetary control at that time. What however was not envisaged was the extent to which the profile of the FSBR might add to that problem. The fact that the CGBR in the first quarter of the financial year turned out to be running at twice the rate expected for the year as a whole (in seasonally adjusted terms) seems to have been an important factor in pushing the recorded growth of £M3 above its target range at the beginning of the financial year.

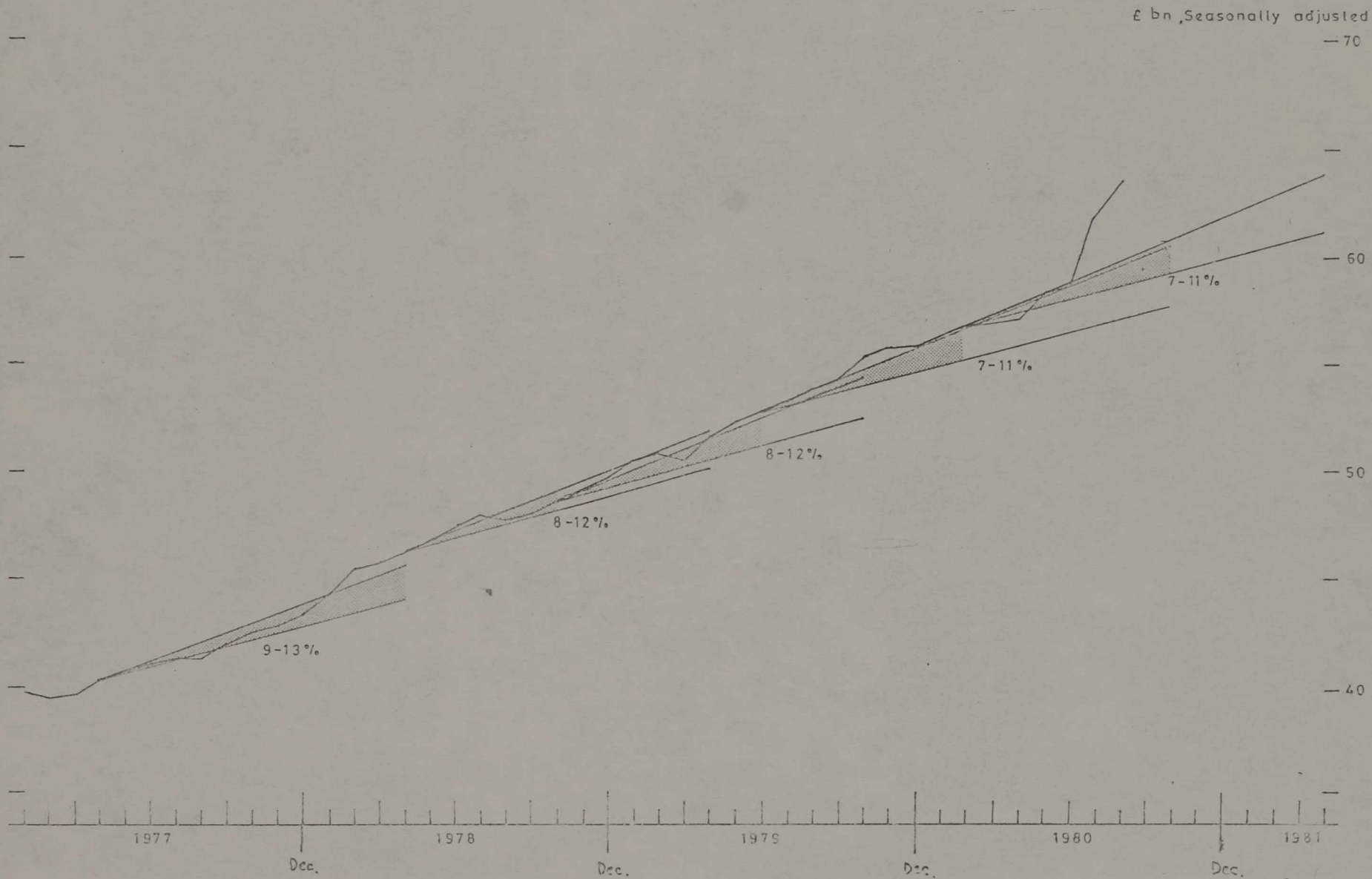
37. The fact that £M3 was seriously overrunning its target range therefore emerged only slowly at the beginning of the summer. Not only was some temporary bulging in recorded £M3 not entirely unexpected, but the fact that it could be identified with what was expected to be a soon-reversed movement in the CGBR meant that no offsetting action was necessarily needed. Had the scale of disintermediation going on at the same time been appreciated - or what the underlying growth had in fact been in the recent past - the impression would of course have been very different. But neither the authorities nor outside commentators had the information available on which to base such a judgement.

38. It is true that if there had been an automatic response of policy to observe undershooting or overshooting of the target range, a reaction could have been brought about at the beginning of the summer even on the basis of the recorded figures. It is nevertheless extremely unlikely that the scale of this could have been sufficient to have brought the underlying growth rate near to its target track by August.

39. There is little doubt that most of the problems associated with determining an appropriate reaction to the underlying rate of growth earlier this year were associated with the final stages of the particular system of direct controls that were being operated. This means that drawing any direct conclusions from this experience for methods of monetary control is not, in general, possible.

CONFIDENTIAL

Recorded £M3 and the targets, Jan. 1977 to April 1981.



CONFIDENTIAL

Adjusted £M3 and the targets, Jan. 1977 to April 1981.

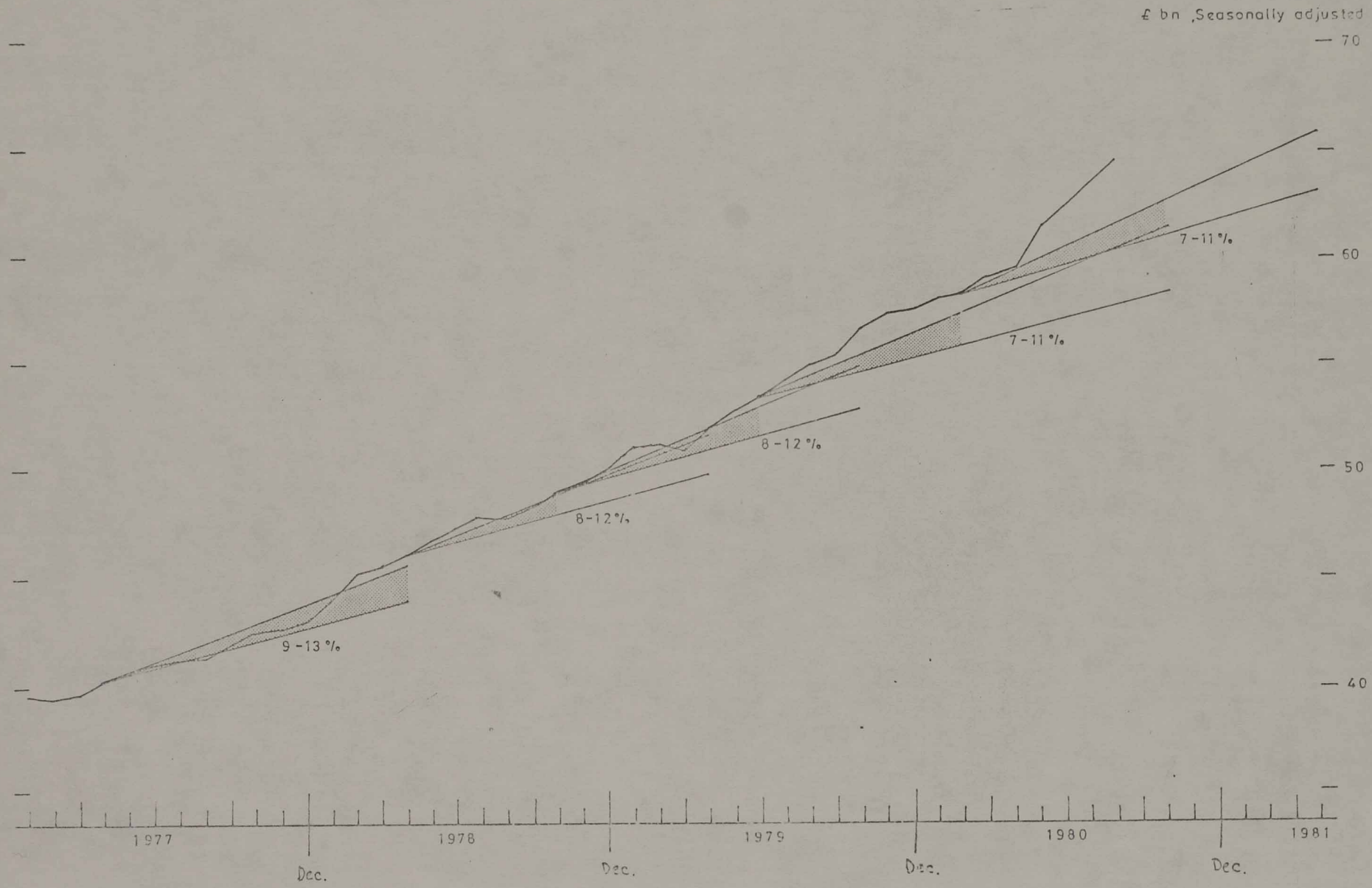
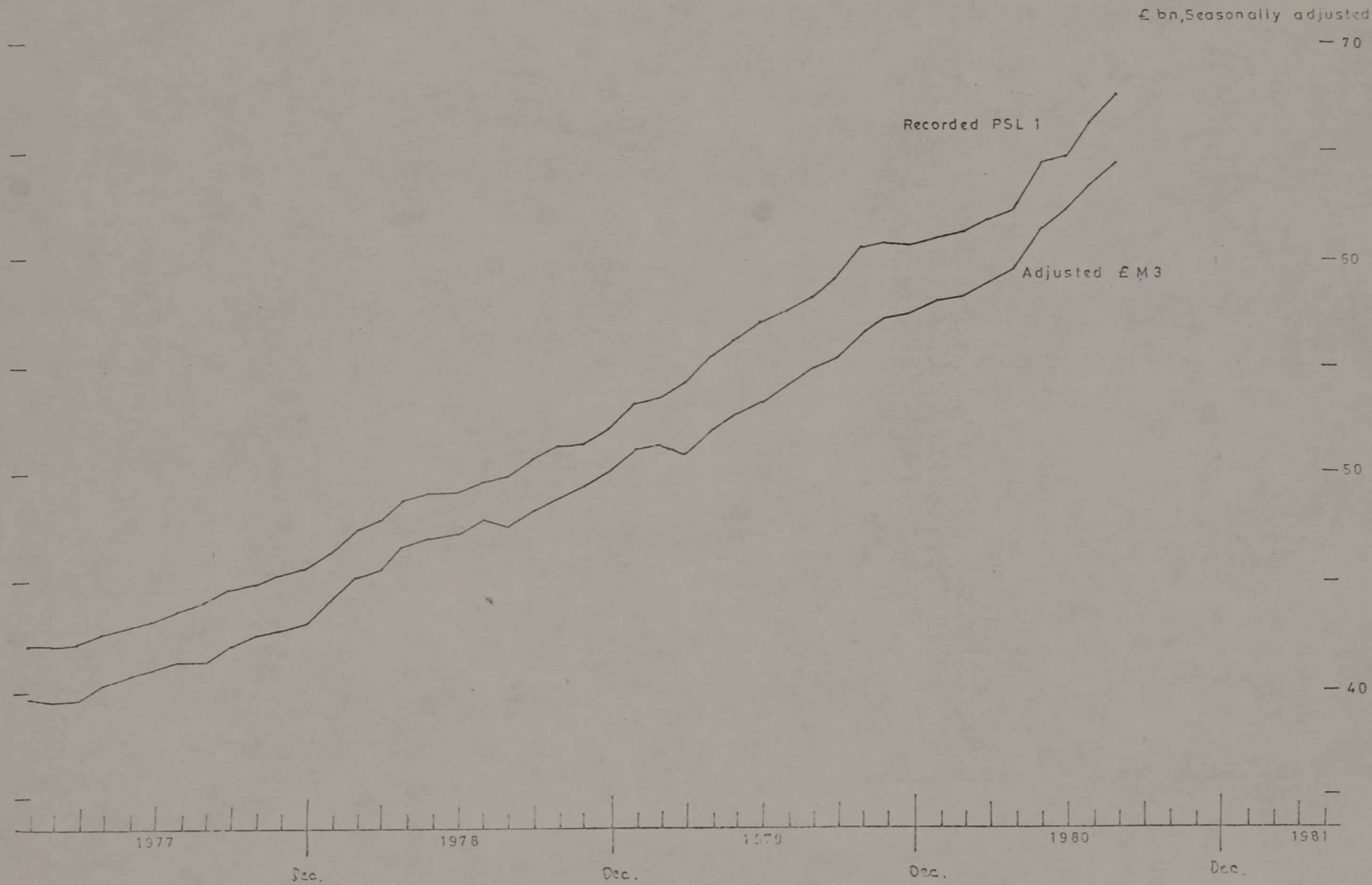


Chart 2

Adjusted £M3 and recorded PSL1, Jan.1977 to Aug.1980.



MLR, Recorded £M3, Recorded M1, 1977Q1 - 1980Q2

Let 1977Q1 = 100,
LR = 100.

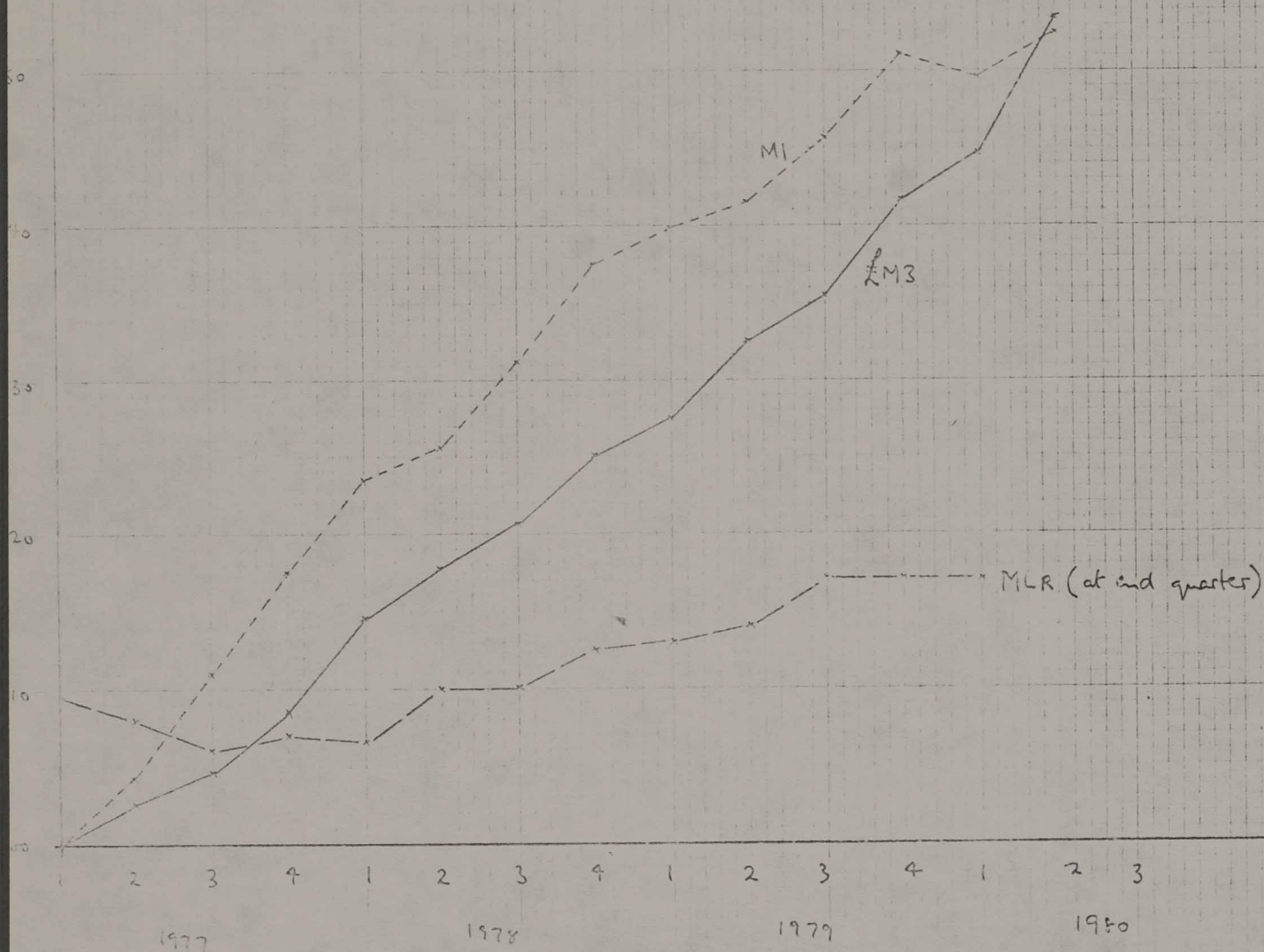


TABLE 1: DISINTERMEDIATION AND REINTERMEDIATION

(£m)

	The Corset Period:			The Post-Corset Period:		
	<u>(Disintermediation)</u>			<u>(Reintermediation)</u>		
	(1) June 1978- Feb 1980	(2) Feb 1980- June 1980	Total June 1978- June 1980	(3) July 1980	(4) August 1980	
<u>Adjustments to £M3</u>	<u>Due to excess holdings of:</u>					
	(a) Commercial bills	- 1150	- 810	- 1960	+ 900	+ 360
	(b) LA Debt	- 400	- 250	- 650	+ 350	+ 150
	(c) Euro-£	- 710	- 400	- 710	+ 400	+ 200
	(d) Foreign currency deposits	-	- 400	- 400	+ 200	+ 100
	<u>Total:</u>	<u>-1860</u>	<u>-1860</u>	<u>-3720</u>	<u>+1850</u>	<u>+ 810</u>
	% age of recorded £M3 at end of period:	- <u>3.3%</u>	- <u>3.2%</u>	- <u>6.3%</u>	<u>3.0%</u>	<u>1.3%</u>

TABLE 2: RECORDED AND UNDERLYING MONETARY GROWTH

	<u>Current target period</u>		
	June 1978- Feb 1980	Feb 1980- June 1980	Feb 1980- Aug 1980
<u>Recorded growth in £M3 (£m)</u>	9250	2214	6994
<u>% rate of growth (annualised)</u>	11.3%	12.2%	26.3%
<u>Adjusted growth in £M3 (£m)</u>	11110	4074	6194
<u>% rate of growth (annualised)</u>	14%	22%	22%

NB: Although the adjustments above are shown for the sake of consistency to the nearest £10m, the figures are broad approximations only.

TABLE: Recorded and Adjusted £M3, PSL1 and M1
% age changes on previous months

<u>Banking Months</u> <u>(seasonally adjusted</u> <u>data)</u>	<u>Recorded</u> <u>£M3</u>	<u>Adjust-</u> <u>ments</u> <u>to £M3</u>	<u>Adjusted</u> <u>£M3</u>	<u>PSL1</u>	<u>M1</u>
October 1977	1.4	- 0.2	1.2	0.2	2.8
November	0.7	0	0.7	1.1	1.5
December	1.0	- 0.2	0.8	0.4	1.1
January 1978	1.7	0	1.7	1.7	2.7
February	1.9	0	1.9	2.3	1.7
March	0.5	0	0.5	0.9	0.6
April	1.9	0	1.9	1.9	0.4
May	1.1	0	1.1	0.6	1.5
June	0.8	0	0.8	0.1	- 0.2
July	1.4	0.3	1.7	0.8	2.2
August	0	0.1	0.1	0.7	1.3
September	0.9	0.5	1.4	1.0	1.3
October	0.8	0.2	1.0	1.2	0.9
November	0.8	0	0.8	0.1	0.6
December	1.1	0.1	1.2	1.3	1.6
January 1979	1.7	0.1	1.8	2.4	1.5
February	0.6	- 0.3	0.3	0.4	0.5
March	- 0.8	0.2	- 0.6	1.4	0.1
April	2.0	0.2	2.2	2.4	3.0
May	1.5	0	1.5	1.2	0.3
June	0.9	0.3	1.2	1.5	- 1.1
July	0.9	0.3	1.2	0.8	2.2
August	1.4	0.5	1.9	1.3	0.5
September	0.7	0	0.7	1.4	0.7
October	1.9	0.4	2.3	2.4	3.0
November	1.0	0.1	1.1	0.4	- 1.5
December	0.1	0.2	0.3	- 0.1	- 0.4
January 1980	0.9	0.1	1.0	0.5	0.2
February	0.6	0	0.6	0.5	- 1.5
March	0.5	0.7	1.2	0.9	1.1
April	0.4	0.5	0.9	0.9	- 0.4
May	2.2	1.0	3.2	3.0	0.4
June	0.8	0.8	1.6	0.8	- 1.1
July	5.0	- 3.2	1.8	2.3	3.6
August	2.9	- 1.3	1.6	2.2	0.2

NB: Although the adjustments above are shown for the sake of consistency to the nearest decimal point (ie approx £60m of £M3), the figures are based on broad approximations. The distribution of adjustments between months is particularly uncertain.

B

MONETARY POLICY: ROLLING OVER THE TARGET

A statement on monetary policy will be needed before the end of November. As well as reaffirming the Government's commitment to the monetary policy set out in the Budget Speech and to the medium term financial strategy, it will also need to cover specifically:

- a. a commentary on the growth of £M3 and other monetary aggregates since last February, the start of the current 14 month target period ending in April 1981;
- b. the objectives for monetary growth from now on;
- c. the consultations on methods of monetary control, a subject dealt with in a companion paper, and any conclusions on it.

This paper discusses the options on b. in the light of recent monetary statistics, the new forecast and the issues it poses for economic strategy generally.

2. Since 1978 it has been the practice to "roll-over" targets for monetary growth at roughly half-yearly intervals and the Budget Speech mentioned the need to reassess the effects of the corset "when the target is rolled forward in the autumn". But this practice does not necessarily fit in with the annual ranges set out in the MTFs and there is no need to maintain this recent pattern. The broad choice is either:

- a. to stick to the present target period starting last February and state what would effectively be an objective for the remaining 6 months to April 1981 (the "April option");
- b. to announce a new target covering a longer period ahead ending in October 1981 (the "October option".) The base date could be this September, but there are variants with earlier base dates.

The options are discussed in paragraphs 11 to 21 below. If the April option were chosen, the Government would need to announce a new 12 month target at the time of the 1981 Budget. This paper therefore focusses on the 18 month period up to the end of the 1981/82 financial year.

Recent and Forecast Monetary Growth

3. Between February and September $\pounds M3$ grew at an annual rate of 23%, well above the target range of 7-11%. If the growth rate is "adjusted" for the distortions associated with the corset, it would be perhaps four percentage points lower, an annual rate of about 19%. There is still some doubt about the extent of this distortion, particularly on the euro-sterling side (see separate note on "The Monetary Situation", though the figures quoted there are for February to August).
4. Table 1 (at the back of the paper) sets out the growth - both past and forecast - of $\pounds M3$ over the last 12 months and the next 18 months, showing both the recorded figures and the current estimates of the "adjusted" path
5. A marked slow down is expected over the next few months. The "central" forecast puts recorded growth between now and next April at about 4%. At an annual rate this is equivalent to 7 $\frac{1}{4}$ % recorded and 5 $\frac{1}{2}$ % adjusted.
6. For the whole target period from February 1980 to April 1981 the forecast puts recorded growth at an annual rate of nearly 15%, with an adjusted figure of nearly 12%, a small overshoot beyond the top of the target range.
7. A critical assumption for the slow growth from September to next April is that short-term interest rates are maintained at their present level. Given the uncertainties of the forecast - the risks that the restructuring of the banks' balance sheets may add more than has been assumed to the money supply, and that the PSBR or bank lending will fall less than forecast - an increase in interest rates above their present levels might well be needed to keep the growth of $\pounds M3$ reasonably close to the top of the target range. The forecast takes credit for the marked slow-down in the PSBR in the second half of 1980/81 (to a little over $\pounds 3$ billion compared with

CONFIDENTIAL

- 3 -

nearly £7½ billion in the first half) and for substantial sales of National Savings - perhaps around £2 billion - following the recent announcement of the new index-linked certificate, as well as some slowing down in bank lending.

8. Looking further ahead, the forecast assumes that £M3 grows at the mid point of the MTFS ranges. The forecast for September 1980 to October 1981, is that £M3 would grow at an ^{adjusted} annual rate of about 7 %. For April 1981 to April 1982 the growth is 8%, the mid point of the MTFS range of 6-10% for that year.

9. To achieve these growth rates the forecast envisages that short-term interest rates must be maintained at their present level until the end of 1981. Because of the rise in the composite tax rate, the mortgage interest rate may have to rise from 15-16% in April 1981. A slight decline in long-term rates is however envisaged by the end of 1981.

Other Features of the Forecast

10. Some of the main features of the forecast over this period (see Annex A) are:

- a. the rate of inflation moderates, but only slowly;
- b. the recession continues with manufacturing output falling more than GDP;
- c. unemployment rises by as much in 1981/82 and in 1980/81;
- d. the exchange rate remains high during 1981 and labour cost competitiveness does not improve; and
- e. the PSBR forecast for 1981/82 is £11¼ billion. But further public expenditure cuts or tax increases may well be needed to achieve that figure.

- 3 -

CONFIDENTIAL

- 4 -

The Options

11. By assumption the forecast gets the path of £M3 close to that of the MTFS from now on. Table 2 sets out the recorded and adjusted growth rates in the forecast for the April and October options described in paragraph 2 above. It includes two variants of the October option with earlier base dates and for completeness covers the forecast for a new target for the 12 months from next April which would be announced at the next Budget.

TABLE 2
Central Forecast of the Growth
of £M3

	% at annual rate	
	<u>recorded</u>	<u>adjusted</u>
<u>The April Option</u>		
February 1980-April 1981	14.9	12.1
<u>The October Option</u> (with variants)		
September 1980-October 1981 (13 months)	7.5	6.6
February 1980-October 1981 (20 months)	12.8	10.8
October 1979-October 1981 (24 months)	12.0	10.6
<u>From Next Budget</u>		
April 1981-April 1982	8	8

The differences in the figures simply reflect the different period chosen. In all cases the sharp slow down in monetary growth between now and April 1980 described in paragraph 5 above, which depends on maintaining interest rates at or above their present level, is assumed to take place.

- 4 -

12. If it were decided to pursue a tighter or looser policy than assumed in the forecast, this would, of course, change the numbers corresponding to any of the various period covered in the table. It would be difficult to present a looser policy in a way that concealed the move away from the MTFs path but arguably the 13 month formulation of the October option would be the least transparent (see paragraph below).

The April Option

13. The presentation of a revised target for the period from February 1980 to April 1981 would need great care but the bones of the statement would be as follows. As envisaged in the Budget Statement, the Government had reviewed the movement in $\pounds M3$ and other monetary aggregates since February including the period since the ending of the corset. Although it was too early to reach a firm view about the extent of distortions, it appeared so far that these were at ^{least} 3% and might prove to be larger. The Government had decided not to roll-over the target at this time when the figures were still unclear. But its intention would be to get the growth of $\pounds M3$ on an adjusted basis within the top of the target range over the whole of the current target period. This would leave some room for a later change of view about the extent of distortion but could, if necessary, be interpreted in specific terms as a recorded growth rate over the period of at most 14% on the basis of information available so far. This would mean adopting a target we did not quite expect to hit. The normal error margin of 2% either way implies a forecast not of 14% but of 13-17%.

The October Option

14. The forecast growth in Table 2 for the 13 month period from this September to October 1981 is extremely low. This is because, unlike the variants of the October option, it assumes substantial base draft. A tight policy in line with the forecast would involve a target for the period of about 7% at an annual rate.

15. But if a looser policy were preferred, it might be possible to make use of the base drift to set a target growth rate resembling the annual ranges in the MTF^s, ^{with a mid point of} say 8½% or even 9%, and so to present a significant departure from the MTF^s path in a way that would not be entirely obvious, though commentators would see through it. This would not be possible with the 20 months and 2 year variants of the October option.

16. All variants of the October ^{we} option would avoid setting an objective for only 6 months ahead which/would be more likely than not to overshoot.

Choosing Between the Options

17. It is clear that on any option clawing back the monetary overshoot and moving back towards the MTF^s path will involve extremely tight interest rate and fiscal policies at a time when the Government will be under mounting political pressure for relaxation.

18. Given all the uncertainties it is doubtful whether announcing a target for a period beyond the next Budget would make sense. The October option would only offer significantly more room for manoeuvre than the April option, if the target range were in fact a relaxation compared with the forecast path. If Ministers were to favour such a relaxation at this stage, this is probably the most presentable way of doing it.

19. If on the other hand they wish to keep open the option of sticking close to the MTF^s path, the lower figure of about 7% that would be required would be unlikely to be achieved except on the basis of a very tough Budget. Thus any form of the October option effectively anticipates in one direction or the other decisions about the 1981 Budget.

20. This would be apparent to commentators and it is doubtful whether such a tough policy, aiming at a marked improvement compared with the past, would be credible unless announced together with the necessary fiscal decisions. The extent of the credibility problem would be

increased if the forecast PSBR for 1981/82 were included in the Industry Act forecast published in November.

21. The arguments for the April option rather than any variant of the October option are that, although it amounts to a holding operation and there is of course a risk of an overshoot:

- a. it will allow fiscal decisions for 1981/82 to be taken at the same time as decisions about the monetary target for that year. These decisions will involve not only the balance between overall fiscal and monetary policy but also measures affecting the relative position of the personal and company sectors;
- b. it allows time to consider fully the question raised by the forecast, namely whether the path of the MTFs, in which there is some flexibility, envisages a faster deceleration of monetary growth in 1981/82 than is credible or desirable;
- c. it would allow time for disintermediation to work itself out to a greater extent; and
- d. for progress to be made on any changes in the present method of monetary control that are decided upon.

The April option would, however, still require firm resolution that the stance on interest rates between now and the Budget must be determined by success in containing monetary growth.

Other Monetary Issues arising before the Budget


22. Two other issues are likely to arise in the next 6 months. Unless a change is made in the present reserve assets requirement the forecast suggests that the Bank of England will need to continue giving the banks

assistance for some time ahead to avoid raising short-term interest rates unnecessarily. The forecast suggests that this will continue throughout this financial year and next.

23. Secondly, the forecast assumes that the eligibility for the new indexed savings certificates will be extended to people further below the retirement age. Work is also progressing on an indexed gilt for which eligibility would be restricted (RIG) to pension funds and perhaps the pension business of the life offices (Annex B).

Conclusion

24. Ministers are invited

- a. to decide on the period to be covered by a statement on future monetary growth - between the current target period ending next April and a period ending next October - and on whether they wish that growth to be in line with the forecast, which is close to the MTFS path. Irrespective of the period chosen, keeping monetary growth in line with the forecast would mean accepting that interest rates would remain at or perhaps above their present level at least until the Budget;
-  b. to note that it will be necessary to provide the banks with special assistance to meet their reserve asset requirement for some time ahead and that work is in hand on a restricted indexed gilt.

CONFIDENTIAL

TABLE 1

<u>Banking months</u>	<u>Recorded £M3</u>		<u>Adjusted £M3</u>		<u>PSL1</u>	
	<u>Actual</u>	<u>annual rate</u>	<u>Actual</u>	<u>annual rate</u>	<u>actual</u>	<u>annual rate</u>
Oct. 79 - Feb 80	2.6	7.9	3.1	9.5	1.3	3.9
Oct. 79 - Sept 80	15.8	17.4	14.1	15.5	12.0	13.1
Oct. 79 - April 81	20.6	13.3	17.7	11.5	13.5	8.8
Oct. 79 - Oct 81	25.3	12.0	22.3	10.6	17.6	8.5
Feb 80 - Sept 80	12.9	23.2	10.7	19.1	10.6	18.8
Feb 80 - April 81	17.6	14.9	14.2	12.1	12.0	10.2
Feb 80 - Oct 81	22.2	12.8	18.7	10.8	16.2	9.4
<u>April 80 - April 81</u>		<u>16.6</u>		<u>12.0</u>		<u>10.1</u>
Sept 80 - April 81	4.1	7.2	3.2	5.5	1.3	2.3
Sept 80 - Oct 81	8.2	7.5	7.2	6.6	5.0	4.6
April 81 - Oct 81	3.9	8.0	3.9	8.0	3.7	7.5
April 81 - April 82		8		8		7.5

CONFIDENTIAL

THE AUTUMN FORECAST

1. The recently completed autumn forecast is summarised in tables 1-3, attached. The forecast has been prepared on the assumption that recorded monetary growth in the current target period is held to 15% at an annual rate, or about 12% when adjustments are made for known distortions to the money supply statistics. In 1981-82 monetary growth is assumed to be in line with the medium term financial strategy, namely 8%.
2. The forecast suggests that the current recession will extend through 1981, with output falling by 1% through the year to the first quarter of 1982 after a fall at nearly 4% in the previous year. The rate of inflation is forecast to moderate, although only slightly, with the increase on a year earlier in the RPI falling from about 14½% in the first quarter of 1981 to 12½% a year later.
3. The PSBR in 1980-81 is now forecast at about £10¾ billion, although as usual the margin of error surrounding this estimate is very wide. In 1981-82 the PSBR is forecast to rise in nominal terms to over £11¼ billion on existing policies, although as a share of nominal GDP it falls slightly from 4¾% to 4½%. Industrial and commercial companies, excluding north sea companies, are forecast to remain in financial deficit, although some improvement is expected in 1981-82.
4. In the light of the rest of the forecast, the monetary target will undoubtedly prove difficult to achieve. Nominal GDP is forecast to grow by over 11% in 1981-82 compared with monetary growth of only 8%, and although the PSBR is forecast to decline as a share of GDP, the private sector is expected to accumulate financial assets faster than the permitted rate of monetary growth. Furthermore the banks' can be expected to try to restructure their balance sheets following the end of the corset and this will add to upward pressure on interest rates.
5. There will be some factors which tend to offset this upward pressure: national savings are assumed to play a greater part in

CONFIDENTIAL

in financing the PSBR following the initiative announced last month, and expectations of declining industry growth and inflation should also ease the pressure somewhat. But nevertheless the forecast is for no decline in short term interest rates before the end of 1981, and as a result of the upward revision to the Building Society composite tax rate this would probably mean a 1 point rise in the mortgage rate next spring. Long term rates might decline slightly during 1981, however, as inflation expectations improve and pressure on the gilt market eases somewhat.

6. The margin of error surrounding interest rate forecasts is considerable. The monetary target could perhaps be achieved with lower rates given the fiscal assumptions in the forecast, but by the same token it is very possible that some further rise in short term rates may in practice prove necessary.

CONFIDENTIAL

CONFIDENTIAL

TABLE 1: MONEY, INFLATION AND OUTPUT (Percentage changes on a year earlier)

		<u>£M3</u>					<u>GDP</u>			
		<u>Recorded</u>	<u>Adjusted</u>	<u>M1</u>	<u>PSL1</u>	<u>PSL2</u>	<u>current prices</u>	<u>constant prices</u>	<u>RPI</u>	<u>Unemployment (narrow definition, millions)</u>
1980	Q1	12.9	15.4	6.8	13.2	11.5	+20.6	+0.8	19.1	1.4
1981	Q1	16.1	12.7	2.7	11.6	11.2	+12.6	-3.8	14.3	2.0
1982	Q1	8	8	7	7.5	9.1	+11.2	-0.9	12.6	2.6

TABLE 2: SECTORAL SURPLUSES AND DEFICITS AND THE PSBR (£ billion)

	<u>PSBR</u>	<u>Personal Sector Surpluses</u>	<u>Deficit of Industrial and commercial companies' (excluding North Sea)</u>	<u>Balance of Payments Current Account</u>
1979-80	10.0	11.4	2.2	-1.1
1980-81	10.7	16.3	1.6	+2.1
1981-82	11.3	14.2	0.8	+0.2

TABLE 3: INTEREST RATES AND EXCHANGE RATE

	<u>Interest Rates</u>			<u>Effective Exchange Rate</u>
	<u>3 month interbank</u>	<u>20-year gilts</u>	<u>Mortgage Rate</u>	
1979-80	14.9	13.3	12.8	70
1980-81	16.2	13.3	15	75
1981-82	15.5	12.3	16	75

CONFIDENTIAL

ANNEX B

RESTRICTED INDEXED GILTS

Early this year the Bank and the Treasury explored in some depth the advantages and disadvantages of issuing index linked gilts. It was concluded that such a security would be an attractive addition to the range of financial assets available. It would eliminate the risk faced by both lender and borrower as a result of uncertainty about future rates of inflation.

2. In the event it was decided not to issue an index linked gilt, mainly because it was thought that oil producers, who have long demanded indexed assets in which to invest their surplus, might find such securities attractive: they would discount the exchange risk in favour of a guaranteed real sterling rate of return. Even a tiny fraction of the current OPEC financial surplus could have a significant market impact. There was also a risk that it would compete too effectively with equities and damage the financial prospects of the company sector.

3. The Bank and the Treasury have, however, done some preliminary work to design an indexed security that could overcome this difficulty. They have in particular focused on a security that would be restricted to the long term institutions and transferable only between eligible holders. A restricted indexed gilt (RIG) of this kind would offer a number of advantages over a generally available security; not only would it avoid the risk of sharp upward pressure on the exchange rate, it would also avoid complaints from our partners in OECD that the UK was breaking ranks in the face of OPEC demands for indexed securities, and avoid the risk of a substantial tax loss which might have arisen from a security that was attractive to individual (particularly higher rate) taxpayers. The possibility of damage to the equity market remains.

4. Under the scheme proposed, RIGs could be purchased by self administered pension funds, and by life insurance companies in respect of their pension business only. Extending eligibility to life funds, other businesses would risk giving non-residents too easy access.

5. A number of technical difficulties in the design of the security have yet to be resolved; tax legislation and complicated registering or monitoring arrangements will probably be needed, and an element of rough justice in drawing up the detailed criteria for eligibility. There are potential difficulties for other policies; Department of Trade in particular are concerned about a scheme that in effect would discriminate in favour of pension funds and against insurance companies; and the life funds themselves could be expected to object strongly. It will probably prove impossible wholly to exclude non resident purchases; the economic assessment will be able to take account of both this and the possible adverse impact on the company sector.

6. But in spite of these difficulties, the monetary control and other advantages that RIGs offer make it important to see whether a satisfactory scheme can be devised. To avoid an adverse expectational reaction in the markets, and criticism that the security belied the Government's commitment to reduce inflation, it would be important to issue RIGs at a time when they were seen as supporting the Government's policies to reduce inflation; and not, for example, at a time of apparent rapid expansion of money supply growth. Suitable conditions might hold by, say, the end of 1980, and the work is being pressed forward with this in view.

INFLOW CONTROLS AND OTHER OPTIONS FOR REDUCING
THE EXCHANGE RATE

Summary and Conclusions

This paper and the paper of 17 September discuss the following possible ways to seek to reduce the exchange rate in current circumstances without damage to the monetary strategy:

(1) Inflow Controls

(i) A complete package of inflow controls, with a ban on interest payments to non-residents. Whilst such a package probably has a role - as a blunt instrument - in crisis conditions, it seems unattractive as a counter to temporary interest-induced flows. The effect on the exchange rate is uncertain, with a danger of being trapped into further measures; the administrative implications are considerable; and there is an adverse impact on the measured money supply.

(ii) A system with positive but reduced interest rates on non-residents' deposits. To be effective at all this would need to be supported by precisely the same panoply of controls as in (i). It therefore suffers from all the disadvantages of (i), with the additional complication of fixing a defensible interest rate.

(iii) A ban limited to non-resident purchases of gilts. Of limited kinds of inflow controls, this is probably the least unattractive. It could have some appeal as a gesture, though since we would expect the impact on the exchange rate to be very small it might be seen as a rather empty one. Even with so limited a ban the administrative implications are far from negligible; an EC derogation is required; and there could be drawbacks for the operation of the gilts market too.

(2) Influencing market sentiment

Any explicit attempt to "talk the rate down" runs risks either of over-reaction in the market and being blamed for the result; or, if there is no reaction, of being drawn into further measures to validate the original talk. But Ministers cannot say nothing about the exchange rate, and it could help to place more stress on the Government's hands off approach to the exchange rate and rather less on the benefits of a high pound. Some muted Ministerial reference to the temporary nature of some of the factors underlying sterling's current strength could also be considered.

(3) Tactics in the foreign exchange market

Heavy intervention to depress the exchange rate has unacceptable monetary consequences. It would also be interpreted as a change in policy, with a risk of over reaction in the market. There are various much more limited changes in the Bank's day to day intervention tactics that could be tried; but none of them seems at all likely to have a significant impact, and they all run the risk of small but more certain additions to monetary pressure.

(4) Tax Options

The idea of raising revenue at the same time as seeking to reduce the exchange rate has attractions both of substance and presentation - since the extra revenue could in itself provide sufficient justification for the measures. Unfortunately any general imposition, for example, of a withholding tax on interest paid to non-residents would be largely ineffective in regard to the wide range of countries with which we have double tax agreements, would not apply to those Middle East investors subject to sovereign immunity, and in so far as it was effective would simply drive investors into the eurosterling market offshore. There may be some more limited measures in the tax field which could have some marginal impact on inflows and work on these is continuing. But so far we have not identified anything likely either to have any significant effect or to be immediately attractive as a gesture.

INFLOW CONTROLS AND OTHER OPTIONS FOR REDUCING THE EXCHANGE RATE

Introduction

At her meeting on 18 September with the Chancellor and Governor the Prime Minister said she would like to consider again the possibility of a system of inflow controls and differential interest rates, together with any other ways which might be available of getting the exchange rate down without undermining the monetary strategy. This note discusses the advantages and disadvantages of two further variants of inflow controls, and then goes on to consider other possible options.

2. The Treasury paper of 17 September set out a possible package of controls, and identified various difficulties likely to arise were such controls introduced as a counter to temporary interest rate-induced inflows: the uncertain effect on the exchange rate; the danger of being trapped into further measures; the administrative complications; and the adverse impact on the money supply.

3. More generally, any measure that lowers the exchange rate will also raise the demand for money and thus put off the time when interest rates can be safely lowered without undermining the monetary strategy. A lower exchange rate implies a higher demand for money because both the general price level and the level of output are likely to be higher. In the short run bank lending may be reduced because of the favourable impact on profitability in the traded goods sector, but this is likely to be a transient effect which would in practice be accompanied by a reduced incentive to keep wage settlements down. And to offset it a worsening of sentiment in the foreign exchange market may spill over into the gilts market, thus directly adding to the money supply. This is true both of the further variants of inflow controls discussed below, and also of the other options - although some measures would

seem likely to have a larger and more direct impact on £M3 than others.

4. Many of the disadvantages of the complete package of inflow controls would, of course, seem less important were the controls being introduced as a temporary response to some major disruption in the international currency markets. A blunt instrument of this kind might well be an appropriate response, for example, to the effect on sterling of a full scale Middle East war.

Positive but Reduced Interest Rates on Non-Resident Deposits

5. Our earlier note suggested a simple ban on the payment of interest on additional non-resident bank deposits, and explained that to have any effect on the exchange rate it would need to be supported with a panoply of controls to prevent inflows being simply diverted in to different channels. An alternative - though not one ever adopted by the German or Swiss - would be to establish a positive but lower interest rate for non-resident sterling deposits. This would discourage interest-induced inflows to a degree partly depending on the differential chosen. But the restriction would need to be supported by the same panoply of controls (on acquisition of securities, on residents' borrowing abroad and on banks) as an interest ban; and a scheme would still have to be negotiated for banks to make special deposits at an appropriate rate with the Bank of England.

6. Additional problems would arise in deciding precisely how to express the reduced rate (a maximum, or a discount on current market rates?) and in choosing a defensible level at which to pitch it. A possible approach would be to set the level at about that to which the Government hoped interest rates could be brought down - although it would be impossible to be explicit in that respect without appearing to adopt both an interest rate and exchange rate policy. Alternatively it might be possible to justify some rate higher than zero on the basis of the difference between UK and overseas inflation or interest rates.

7. In short, a system of lower but positive interest rates for increases in non-resident deposits would seem to offer no advantage over a simple ban on interest. If anything the effect on the exchange rate would be reduced; precisely the same panoply of supporting controls would be required; and setting a defensible interest rate would raise additional problems.

A Ban limited to Non-Resident Purchases of Gilts

8. We have considered whether there is any mileage at all to be had from any more limited measure of control. Of the possible options the one open to least objection is probably a ban limited to non-resident purchases of gilts. This would at best only catch part of the flows into sterling: non resident flows into gilts are, for example, much less than flows into the banking system (£1.9 billion compared with £3.3 billion respectively over the last year - Annex 1 shows the month by month figures). But such a ban could be presented as a particularly appropriate measure when there was a prospect of a continued fall in UK interest rates, and gilts were likely to be correspondingly attractive because of the prospects of capital gain. If non-residents are free to buy gilts then the effect on the exchange rate of falling interest rates might be somewhat delayed as non-resident purchases of gilts offset to some extent non-resident sales of sterling bank deposits. A ban might help the effect on the exchange rate to feed through quicker, and would prevent non-residents making capital gains at the expense of the Government or of other UK residents. There are no obvious comparable assets into which flows would be diverted: the company debenture market would be too thin to absorb flows on anything like the scale involved. Some flows would no doubt be diverted to monetary assets, but the risk of adding to £M3 is significantly less than with the wider package of controls.

9. We would expect the effects on the exchange rate to be small - much less than the 2% or so we estimated (if the effect on confidence were neutral) for the wider package of controls. Equally we think such a minor measure would carry much less risk of damaging or counter-

productive effects on confidence, and it might be considered small and self contained enough to reduce (but certainly not to eliminate) the danger of the Government being trapped into reinforcing it with further measures. It could be presented as a very specific measure designed to prevent a further rise in the exchange rate following a surge in inflows into gilts in search of capital gains in the expectations of falling interest rates.

10. To set against this, such a measure could have adverse effects on the funding programme. A ban on overseas gilts purchases would, as noted earlier, tend to put upwards pressure on interest rates. We would also lose the benefit to the market of the pressure of foreign purchases which has often operated this year as a catalyst to domestic investors. And the administrative implications, even of so narrow a ban, would be far from insignificant. Even with such a limited scheme we assume it would be important to avoid leaving loopholes so obvious that they would attract immediate and widespread comment - such as non-residents' access to gilts via investment trusts specialising in gilts. We would need a derogation too from our obligations on free capital movements under the EEC Treaty.

11. In short, a ban limited to overseas purchases of gilts might have some very marginal effect on the exchange rate. As a limited gesture to show the Government's concern about the exchange rate it could be thought to have some appeal. But its effect would be seen to be small, and there is a corresponding danger that it would be widely regarded as trivial. Even a narrowly defined measure of this kind has significant administrative implications and other drawbacks.

Influencing Market Sentiment

12. Turning to alternative ways of seeking to reduce the exchange rate without damage to the monetary strategy, one obvious possibility would be to seek to attempt to influence market sentiment by suitable official statements. Experience with such attempts in other countries as well as in the UK is not very encouraging. Their impact tends to

be unpredictable: the market can over-react or ignore them. Much depends on whether a statement is combined with or thought to foreshadow some parallel policy development; and if no substantive policy change emerges the impact can subsequently be reversed, even on occasion giving a result that is counter-productive.

13. But in the right circumstances a suitable Government comment might cause sentiment to crystallise in a particular way sooner than it would otherwise have done, to give a relatively modest adjustment in the desired direction. There are various possible approaches of this kind that could be tried, ranging from the lightest of touches to something more emphatic.

(i) Less emphasis in Ministerial statements on the benefits of a high exchange rate. Although the Government's hands off approach to the exchange rate is generally well understood, there may still be some overseas investors who believe the Government would intervene to support sterling if the rate were to fall, and that there is therefore a floor to the currency risk they are taking. Statements about the benefits of a high exchange rate can be interpreted as support for this belief.

(ii) Some Ministerial musing about whether the market has given sufficient weight to the temporary nature of some of the factors underlying sterling's present strength. A properly working foreign exchange market should discount factors expected only to be temporary. North Sea oil and the Government's resolve to control inflation are not in question but high interest rates are not expected to remain indefinitely, and private sector capital outflows which have been building up steadily following the ending of exchange controls could well accelerate next year - particularly once sterling interest rates fall - as could overseas borrowing in the sterling market. The tone would need to be philosophical and detached to avoid any risk of over-reaction, and the message correspondingly muted.

(iii) A general statement that the Government thinks the £ is over valued.

(iv) A firmer statement, indicating perhaps that the Government would like to see a rate of \$2.20-\$2.30.

14. A statement as strong as (iv) or even perhaps (iii) risks not only over-reaction in the market (for which the Government would get the blame), but also - were there little or no reaction - subsequent pressure to validate it by market intervention. The last would be interpreted as adopting an exchange rate target. On the other hand, with the exchange rate such a focus of current attention, it is not possible simply to say nothing on the subject at all. The Chancellor will be expected to cover the subject, for example, in the Mansion House speech; and when Parliament reassembles it is likely to be a subject of lively interest at question time. While critics clearly have to be reminded that a high exchange rate does bring benefits as well as costs, it might be best for the time being to stress as well that the Government has no exchange rate target and is not in the business of intervening either to depress or support the rate. Something on the lines of (ii) might also be considered on an appropriate occasion. Very careful drafting would be needed for it to be noticed yet not interpreted as a change in policy.

Tactics in the foreign exchange market

15. Any acquisition in the market of foreign currency for the reserves or for repaying official foreign currency debt risks adding to the money supply. Substantial intervention to depress the rate is clearly unacceptable. But there is no golden rule that so much intervention is required to achieve so much shift in the exchange rate.

16. As with talking the rate down it would be important, but not necessarily easy, to steer a course between action that would be widely interpreted as a change in policy - possibly leading to over-reaction in the market - and action not picked up at all by the market, and therefore having little impact on the rate either. Sterling's fall from $\$2.00$ at the beginning of March 1976 to $\$1.91$ by the end of the same month - the beginning of the slide to $\$1.56$ - was sparked by positive intervention on 4 March which the market interpreted as a signal that the Government wanted to see a depreciation.

17. In recent months we have been "smoothing" the upward pressure on sterling by taking in to the reserves on average around $\$200$ million a month. Outside commentators have some difficulty in interpreting the monthly reserves figures, and even if this "smoothing" were stepped up a bit it would be unlikely to be interpreted widely as a change in policy. We have therefore considered whether it might be possible by some very limited change of tactics to give a low key signal to the technicians in the market that had a modest but not over-large effect on the rate. Possible tactical changes include the following.

(a) Some further asymmetry in day to day intervention, with less or no support for the \pounds on days when the rate comes down than positive intervention when the rate is rising.

(b) Greater use of off-market purchases of foreign currencies. In recent months the Bank have been channelling some requests from their customers (other central banks) to purchase sterling into the market, rather than taking the deals themselves, because of our concern that these transactions were adding to pressures on the money supply. We could temporarily suspend this policy.

(c) Greater use of forward purchases of foreign currency. Their main advantage is that they can be used to disguise the total amount of intervention undertaken since the size of the Exchange Equalisation Account's forward book is not published. But arbitrage will ensure that such operations do not significantly delay the monetary impact of the intervention.

(d) A more radical option would be an explicit statement that intervention was to be increased temporarily, and some small consequential addition to the money supply accepted, while interest rates remained high and before private sector outflows picked up further - with both the intervention and its effect on the money supply to be reversed once interest rates have come down.

18. While (d) might be an option in a period when the money supply was running well within the Government's target, it is clearly not acceptable in present circumstances. As to (b) and (c), partly because their essence is to operate in a disguised way we think that substantial amounts would have to be spent - with corresponding implications for the monetary strategy - to have any noticeable impact on the exchange rate. The first of the four options is perhaps the least unattractive; but even in that case we could not confidently predict a noticeable impact on the exchange rate, while the monetary effect of any net increase in intervention, however limited, would be more certain.

Tax Options

19. Finally, we have given some thought to whether the tax system could be used to discourage inflows (or encourage outflows). The idea of raising extra revenue at the same time as discouraging inflows has obvious advantages, including the presentational one that the measure could be justified in terms of extra revenue generated rather than any expected actual fall in the exchange rate.

20. Unfortunately major difficulties would be involved, for example, in imposing a withholding tax on interest paid to overseas investors. First, many such investors reside in, or could direct their investments through, countries with which we have Double Taxation Agreements which specifically require interest to be paid gross (or in some cases impose a ceiling on withholding taxes at a very low rate). Secondly,

the major inflows from Middle Eastern investors tend in any case to be subject to sovereign immunity from tax under international law. Thirdly, even if we could get round such difficulties, the effect of imposing such a tax would simply be to divert inflows into the eurosterling market offshore. The chances of raising any significant revenue by such means are therefore slight.

21. There may be some much more limited tax changes that could and perhaps should be made. An Inland Revenue chaired working party has been looking at various changes that may need to be made following the ending of exchange controls, both in the anti-avoidance field and more generally. One possible option, for example, would be to repeal the special corporation tax relief to UK companies for interest on foreign currency borrowing from abroad which was introduced in 1969 specifically to attract inflows. But this would be a very minor change indeed, unlikely to raise any significant revenue or to affect the exchange rate, and open to the obvious objection in current circumstances that it would directly harm UK companies and be subject to criticism on that score. We will however continue to work on this, and to search for any other similar minor changes that might make sense following the ending of exchange controls, now that it is no part of Government policy to seek to attract inflows.

ANNEX 1

				<u>£m</u>
	Banking Months	Total Net Official Sales of Gilts	Net Gilt Sales to Overseas Holders	Overseas flows into Banking Sector
1979	July	1160	225	207
	August	618	109	275
	Sept	925	195	70
	October	-18	123	164
	November	818	-32	395
	December	1346	232	342
1980	January	1731	332	402
	February	-175	-11	127
	March	-8	-112	204
	April	755	141	376
	May	477	257	394
	June	1972	290	144
	July	1542	304	769
	August	1611	189	7

① C.W.S. → Parrot's - Parent 22: 5 techniques
② G.H. - where we are → ① Morel
Pres. Sec. - SECRET Techniques

J.3

TELEPHONE
01 - 601 4444

BANK OF ENGLAND
LONDON EC2R 8AH

10 October 1980

The Rt Hon Margaret Thatcher MP
10 Downing Street
London
SW1

MB

My dear Prime Minister

In the hope that it would be useful ahead of the meeting you are holding on Monday afternoon, I enclose a memorandum prepared in the Bank. This begins by briefly reviewing recent experience with monetary policy and the money supply and indicates the lessons we feel can be drawn from this experience. It goes on to consider, in the light of an annex on the Bank's current forecast for the economy, the problems now facing us in the implementation of monetary policy in the coming months. The memorandum concludes with a discussion, drawing on our own analysis and the recent consultations, of the possibilities of changing our techniques of monetary control.

We have taken the questions in this order because, whatever may be the attractions of some form of monetary base control, its adoption would necessarily involve a long transitional period before we knew enough about the way in which the new system worked to be able to exert meaningful control.

On the other hand, I believe that the immediate situation faces us with policy dilemmas of a particularly acute and urgent kind which we shall need to resolve.

Yours sincerely

Gordon Richardson

MONETARY POLICY: THE MAIN ISSUES

1 Recent developments.

Both Bank and Treasury officials have carried the analysis of recent monetary statistics as far as is possible with the data at present available. They have reached broadly similar conclusions as follows:

- (a) The corset seriously distorted the monetary statistics, both while it was in effect in the two years to June, and following its removal. One form of distortion - the commercial bill leak - could be directly observed and more or less precisely measured; other distortions could not be quantified at the time, nor can they be now. The Chancellor, of course, drew attention to the problem of these distortions in announcing the ending of the corset.

- (b) But making such allowance as we can for corset effects, the "underlying" rate of growth of £M3 accelerated sharply in the late spring and summer to well outside the target range. (It will be recalled that this followed a period in which monetary growth had moderated for a time around the turn of the year, when the PSBR temporarily improved while heavy funding continued.)

- (c) The acceleration in underlying monetary growth in the spring resulted largely from a resurgence in the PSBR. In the first half of the financial year this is thought to have been running at an annual rate of over £15 bn., which was not only much greater than had been expected but larger than could be financed outside the banking system from the capital market despite continuing heavy gilt sales to domestic non-banks (at an average annual rate of nearly £9 bn.). At the same time net external outflows from the private sector - which exercise a contractionary effect on monetary growth - tended to diminish as the current account went into surplus.

- (d) These factors were superimposed upon persistently very strong demand for bank credit from the private sector. The vast bulk of private sector borrowing has been undertaken by industrial and commercial companies, reflecting the size of the continuing company sector deficit and the effective absence of alternative sources of finance. Increasingly, since the recession really began to bite in April, a proportion of this borrowing has been undertaken simply to maintain the substance of the business intact. Personal sector borrowing for consumption has been only just over 10% of total private sector borrowing over the year to mid-August, and - taking account of seasonal influences - showed no acceleration in the latest three months.

As a result of these developments the recorded increase in £M3 from mid-February (the beginning of the target period) to mid-September was some 13%. Our best estimate is that underlying £M3 during this period may have risen by about 10%. It should be remarked that this latter figure, taken together with the present forecast (which may of course be highly fallible) of monetary growth to next April, could mean an annual rate over the present target period as a whole of around 12% in underlying £M3, compared with the 7-11% target.

Most of the available evidence apart from £M3 - the performance of the exchange rate and the current account, the improvement in inflation, the stability in housing and other asset prices, the sharp decline in company profits, in output and in employment, and the fact that M1 has risen at a rate of only 8 1/2% since February or 6 1/2% since June last year - strongly suggests that policy has been and remains very restrictive. In particular, interest rates have now become substantially positive in real terms, because of the slow-down in the current and prospective rate of inflation, where, even with 17% MLR, they were negative earlier in the year. The current tax position of many companies will also add to the real burden of interest rates.

Taking all the evidence, we conclude that monetary policy has indeed been severe. The money supply target was originally chosen on the basis of assumptions that in certain crucial respects turned out to be wrong. The PSBR has persistently tended to exceed the forecasts. Wage increases last winter were much higher - in both public and private sectors - than was forecast. Despite the recent overshoot of £M3, the pressure on the company sector and the rise in unemployment indicate that these wage increases have not been validated by monetary policy. The exchange rate and interest rates have also been higher for longer than expected. The effect of these developments has been to put industry, and particularly that large part of manufacturing industry which is exposed to foreign competition, under disproportionate financial pressure. More generally, these developments have added to the financial imbalances within the economy, with large deficits in both public and corporate sectors matched by a massive personal sector surplus.

It was against these tensions, involving in particular the intermediation of the banking system between the corporate and personal sectors, that £M3 overshoot during the spring and summer. Given the plight of the corporate sector, bank lending has been more than usually insensitive to the level of interest rates; and the recent size and volatility of the PSBR would have been difficult to handle in any circumstances.

One lesson from this might be that £M3 is not the appropriate target aggregate, and certainly in the light of the recent experience a number of outside commentators have re-raised this question. £M3 has its advantages: the ability to analyse it in terms of its credit counterparts is helpful to understanding the factors that underlie monetary growth; but £M3 is very difficult to control in the short run. However, all the alternative aggregates have their own drawbacks; and in any case we see no practical possibility of abandoning £M3 in the present circumstances. The real lessons - which both the outside commentators and we ourselves have repeatedly stressed in the past - are that we need to avoid focussing too narrowly on any single aggregate and that we cannot hope for precise control over £M3 - or any other aggregate - over short periods.

A further general lesson from the recent experience of the corset, and from our earlier experience with quantitative lending ceilings, is that we need to be deeply sceptical of the value of direct controls of any kind.

Against that background the questions we now need to concern ourselves with are:

- (i) what steps need to be taken to manage the immediate situation; and
- (ii) should our system of monetary control be changed?

2 Management of the immediate situation

(i) General considerations

The monetary figures for banking September, which suggest in particular that private sector loan demand may be beginning to ease, are reasonably encouraging, and there is a possibility that £M3 will grow more slowly for a time, especially after the turn of the year. The Bank's recent forecast suggests an annual rate of growth of 8% in the next six months. This however depends upon an expectation that the PSBR will be substantially lower than so far in this financial year (though it would still then be over £10 1/2 bn. for the financial year as a whole). But in the following year the PSBR rises in the forecast to £11 1/4 bn. so that the possibility of continuing moderate £M3 growth would depend upon sustaining a high level of debt sales and upon a further decline in the rate of bank lending to the private sector. At the same time the prospects for the economy are for a continuing decline in output, particularly manufacturing output, with unemployment rising close to 3 mn. by end 1982. Inflation falls to some 12 1/2% next year but only slowly thereafter. This forecast is described more fully in a separate paper.

All forecasts are hazardous and how much one should make of them is of course a matter of judgment. Nevertheless the general picture suggested for the development of the real economy may be realistic, bearing in mind the huge and continuing erosion of competitiveness in manufacturing, which will limit the extent to which we benefit from any upturn in the world economy. On the monetary side, provided the expected slowdown in the PSBR in the rest of this financial year occurs, and with the help of the new National Savings from November and of some falling off in the private sector's demand for bank credit, it seems possible that - as last year - £M3 growth will moderate into the spring. But we cannot be at all confident that we will be able to avoid a renewed acceleration as the PSBR picks up, just as there has been this year.

The problem for policy against this prospect is to preserve the effectiveness of the monetary strategy at a time when it is urgently necessary to ease the disproportionate pressure on manufacturing industry.

(ii) The roll-over

The dilemma crystallises first in the decision that must shortly be taken on the roll-over of the monetary target. There are three broad approaches:

- (a) To attempt to claw back over the next 6-12 months the whole of the ground lost during the summer, including the effect of post-corset reintermediation. This would involve £M3 growth from now on at well below what is suggested by the forecasts and would certainly imply a sharp tightening of policy;
- (b) The other extreme would be to start afresh with a new target for a 7-11% or perhaps 6-10% rate. This would impair credibility. At the same time some in the financial markets, and some economic commentators more generally, are impressed by the other evidence of monetary stringency and, although there would no doubt be criticism, the blow to credibility need not be fatal. Even this course would allow little scope for any significant easing of the pressures on manufacturing companies without a shift in the balance of policy within the monetary target.

- (c) In between we might allow only that part of the base drift which can be attributed to the unwinding of distortions that occurred before February (ie outside the present target period) or before some earlier date eg last October. Such a calculation would be necessarily somewhat arbitrary because of the measurement problem referred to earlier; nevertheless, given the expectation among some commentators that we may adopt the approach in (b), it might be seen as a substantial effort to recover lost ground. This approach could allow £M3 growth of at most 8-9% a year over the coming 6-12 months

Public credibility of the strategy will depend only partly on the target chosen: it will depend at least as much on the conviction that the target can be achieved without imposing intolerable strains on the economy. This again poses a dilemma for policy. Avoidance of such strains would seem to require an early and substantial reduction in interest rates both to ease directly the pressures on the corporate sector and as probably the most effective means of moderating the strength of the exchange rate. We are not confident that there would be much room for a shift in this direction even with the most liberal of the options for the monetary target mentioned above.

(iii) The PSBR

Action to reduce the PSBR could help to square this circle if ways can be found of doing so that do not add too directly to the recession. At this stage it is more important to agree upon the outline of the strategy than its detail. But it is clearly important to hold down public expenditure which is not directly induced by the recession - and, within this, public sector wages in particular. Beyond this, the scope for raising revenue from those sectors of the economy that have been least affected by the squeeze (ie primarily the personal sector, but perhaps also from North Sea oil companies if ways could found which had a meaningful impact on monetary

growth) needs to be closely considered. The more that can be done in these areas the greater the scope for attaining a tight money target with lower nominal interest rates.

(iv) Corporate sector financing and the Bank's assistance to the banking system

The problems of monetary management are also being aggravated by the persistent strong demand from the company sector for bank credit. We cannot rely upon a sufficient decline in such credit demand - so long as the company sector deficit continues at its recent level and so long as there are no effective alternative sources of finance available to companies. If, in this situation, monetary policy were tightened and interest rates allowed to rise, this would add to the upward pressure on the exchange rate, and intensify company cutbacks and liquidations. Banks themselves could then become increasingly concerned over the security of their lending and its implications for their own position. The overall effect would be to steepen, perhaps abruptly, the fall in output and employment. At present levels of real interest rates borrowing by the corporate sector is in some large part borrowing to sustain the business. The pattern of financing of the public and corporate sectors has drained reserve assets from the banking system thereby generating upward pressure on interest rates. This the Bank has relieved by giving special assistance in various forms, including up to £1 1/4 bn. through its gilt purchase and resale operations - an amount that remains outstanding. If interest rates are to be prevented from rising we have no alternative but to continue to provide such relief - and we may well need to increase the amount outstanding during the revenue quarter early next year.

The difficulty could be eased if it were possible by fiscal means to reduce the company sector deficit. But the PSBR constraint clearly limits what can be done in this way. An alternative is to seek to divert some of the company sector borrowing from the banks into the capital market. It would also help to achieve this if

the demands on the gilt market can be reduced by containing the PSBR, and by financing more of it through National Savings, so that downward pressure can be brought on long-term interest rates. It may also help if the company debenture market could be stimulated by the temporary offer of an interest subsidy to the borrowers: the Bank have put detailed proposals to the Treasury for a scheme of this kind which we believe could be worth trying. A further possibility is to encourage companies worried about a future fall in long-term rates to issue indexed debt. This would not suffer some of the drawbacks of the government itself issuing marketable indexed stock: for example, because of the difference in credit standing, and in size, company borrowing would not risk attracting a mass of OPEC funds which would push the exchange rate up further. A merchant bank has recently approached us about the possibility of issuing indexed corporate debt and we have indicated that we would have no objection in principle to such issues. A major deterrent at present, however, is the Corporation Tax treatment of the write-up in the nominal value of the debt: we would hope that this deterrent could be removed. Again, the more that could be achieved in these ways the easier it will become to combine a restrictive £M3 target with significantly lower short-term interest rates.

To sum up the Bank's views on immediate policy:

- We are acutely conscious of the present and prospective strains imposed on the manufacturing sector by monetary policy. To ease those strains would require a cut in short-term interest rates both for its own sake and as the most likely means of moderating the exchange rate. But the dilemma is how a meaningful move can be made unless the other constraints on policy can be eased through appropriate additional action on the PSBR and the adoption of a less rather than more restrictive monetary target within the limits described earlier.
- We think that greater attempts should be made to stimulate the private capital market by further initiatives on National Savings as soon as this can sensibly be done and by interest subsidies and tax changes to encourage long-term company borrowing.

3 The system of monetary control

The far-reaching changes that have been suggested in our system of monetary control could not be implemented sufficiently quickly to affect decisions on the immediate policy issues, but we need now to resolve the broad lines of approach to the system of control.

Both before and after publication of the Green Paper the monetary base debate has produced a welter of often diametrically opposed views, often obscured by complex points of detail. Cutting this tangled undergrowth aside some fairly clear conclusions have emerged.

Two general points are perhaps worth making at the outset. First, it was generally agreed in the consultations that any of the arrangements discussed below would involve moving away from £M3 to some other monetary target. Secondly, at least for an initial period - which might be prolonged - there would be much larger fluctuations in interest rates, which would be difficult to present and explain to the general public. It should be noted in passing also that the proposed arrangements would not be compatible with our membership of EMS, if that is to remain a policy option.

There are only two sets of monetary base proposals that have real coherence or substantial support.

(i) A non-mandatory monetary base system

The first is the pure, non-mandatory, system put forward by Brunner, Meltzer and Pierce at the recent seminar with foreign academics and supported in this country by Griffiths and Minford. It rests on the propositions that:

- (a) the one thing a central bank can control with tolerable precision in the short run is the quantity of its own liabilities which form the base;
- (b) if free to choose the amount of base money which they hold, banks will establish a desired relationship between their holdings of base and their total liabilities, which will be reasonably stable in the medium-term (say over 2-3 years).

They specifically do not argue that controlling the base will provide shorter-run control over any particular monetary aggregate and are not concerned that it should: their view is that by holding on to the base a central bank can be sure that none of the monetary aggregates - or inflation itself - can run seriously out of control (at least for any length of time).

This approach has intellectual attraction. Provided it is accepted that short-term interest rates should be allowed to fluctuate freely, without any restrictions, we would broadly accept the proposition at (a) - though in practice the degree of precision with which the base could be controlled is certainly rather less than some of the academics would allow. We simply do not know, however, whether the proposition in (b) is true, or would become true after the system had been allowed to evolve: it is untried in a financial system as complex as ours and in this sense it is a leap in the dark. But, if it were true then targetting and controlling the base would have advantages over targetting and controlling any particular monetary aggregate, given the real conceptual difficulty of selecting an appropriate single aggregate, and the practical difficulties of controlling it necessarily indirectly.

What did emerge fairly clearly from the consultations in relation to (b) is that, if a reasonably stable medium-term relationship between base asset holdings and the money supply (however defined) did emerge, it would not be because banks' behaviour would change dramatically so that they rationed their lending to the available base. Banks individually would be likely to take the view that they could obtain the base assets they required simply by bidding for deposits. In a sophisticated, competitive and necessarily decentralised banking system it is unrealistic to suppose that individual banks would be constrained in their lending activity by the prospect of a higher cost of funds which they would be able to pass on to their borrowers. If such a relationship emerged, therefore, it would be essentially because the banks - in bidding for deposits to finance their loans and to maintain their desired holding of base assets - would bid up interest

rates to the point where the demand for credit was curtailed. This clearly has implications for the degree of interest rate volatility that must be expected of the system.

A major difficulty with the proposal, acknowledged by most of the academic proponents, is that it would require a long transition before we could tell if a sufficiently stable demand for base or a sufficiently stable relationship between the base and either the money supply or nominal income had emerged. Initially we would know little about the banks' desired holdings of base assets or about how to interpret what evolved. We would not therefore know how to target the base. If meanwhile we sought to operate base control in these circumstances we should lose control over both interest rates and £M3.

If we wanted to move towards this kind of system, we should have to continue during the transition to rely essentially upon discretionary choice of short-term interest rates and debt sales designed to achieve a £M3 target, but providing steadily increasing scope for flexibility around the chosen general level of rates. This might allow the banks' voluntary demand for base assets gradually to be revealed, and, if it proved to be sufficiently stable, the base could then increasingly be used to guide the choice of the level of interest rates. Ultimately, then, one might hope to be in a position to leave interest rates to market forces.

From the outset, there would be substantial institutional change, involving the techniques for financing government, the clearing bank overdraft system, the rates charged by Building Societies and the role of the discount market.

Whatever the merits or demerits of such changes, they could not be carried through quickly, nor yield effective results for a number of years.

(ii) A mandatory monetary base system

The second main approach to monetary base control is that which has been advocated mainly by Pepper in the UK, and which would have some practical resemblance to present arrangements in the US. Under this proposal the Bank would again operate on the base which would however, in this case, be related by means of a mandatory minimum reserve requirement to certain categories of liabilities of the banking system. These liabilities, it was generally accepted in the consultations, would have to be those included in M1 (or possibly a different, retail deposit, aggregate M2), for which there would be a target as we now have for £M3.

The main disadvantage of such arrangements is that the mandatory reserve requirement would constrain the banks' freedom to manage their asset structure - with some inevitable earnings penalty. The banks would therefore have an incentive to avoid these constraints by channelling business outside the controlled aggregate. This would result in distortions of the kind we have experienced with the corset, and which the Americans have experienced in the growth of the euro-dollar market.

The main advantage claimed for the system is that it would leave short-term interest rates to be determined by market forces. In practice this would be more apparent

than real. With a system of mandatory reserves the Bank would in the final analysis have to provide the base that was required, and market interest rates would, as now, reflect the price at which the Bank chose to provide it - which could of course be allowed to vary more than at present in response to the movement in M1(M2) and the associated base requirement. Recent US experience, which is not yet decisive, suggests that there could be greater volatility not only of short-term interest rates but also of the money supply.

The institutional changes required would be similar to those under a non-mandatory base scheme.

The Bank would see little merit in arrangements of this sort as a final objective; nor would we see it - as some have argued - as a transitional step to a non-mandatory system since we would learn nothing in the meantime about the stability of demand for reserves under a non-mandatory system.

To sum up this section:

- we see the theoretical attraction attributed to a pure, non-mandatory, monetary base system as proposed by Brunner and other academics;
- there would be a long transitional period before we could operate it, during which we should have to continue much as now, although with increasing interest rate flexibility which would involve major institutional change;
- we remain sceptical as to whether even when it was fully in force it would work satisfactorily in practice.

THE STATE OF THE ECONOMY

1. This note assesses developments in the real economy as background to discussion of monetary policy. Recession has hit manufacturing disproportionately hard, which sharpens complaints about the level of interest rates and the exchange rate. Prospects for manufacturing companies have to be assessed in the light of prospects for the economy as a whole.

Developments this year (Table 1)

2. Compared with other industrial countries, the decline in output this year has already been fairly steep. After a small fall in the first quarter, total output (GDP) fell a further 2% in the second quarter, taking it down to 2½% below the average for last year. Though there has been some decline in service sector output, most of the fall was concentrated on manufacturing which has fallen heavily this year and in July was over 7% below the 1979 average.

3. Adult unemployment, seasonally adjusted, was nearly 1,800,000 in September (7.4%), up 520,000 on a year ago. The brunt was borne by manufacturing (where employment by July had fallen by 6¼% since July last year.)

TABLE 1: DEVELOPMENTS IN 1980

	1980 so far			Bank forecast for 1980
OUTPUT				
% change from 1979 average	(Q1)	(Q2)		(Average 1980)
Total (GDP - output)	-0.7	-2.5		-2.5
	(March)	(June)	(July)	(Average 1980)
Manufacturing	-5.7	-6.6	-7.1	-7.5
UNEMPLOYMENT*				
Thousands	(March)	(June)	(Sept.)	(1980 Q4)
	1,413.9	1,535.1	1,784.0	1,867.0
%	5.9	6.4	7.4	7.8
RETAIL PRICES				
% change over 12 months	(March)	(June)	(August)	(1980 Q4)
	19.8	21.0	16.3	16.5

*Excluding school leavers, seasonally adjusted

4. The whole of the fall in output this year is accounted for by the turnround in stockbuilding. The run-down in stocks appears far from completed: traders have probably been unable to reduce stocks of finished goods as quickly as they would have liked. Exports have been fairly steady: we have lost shares in export markets through growing uncompetitiveness, but this was masked because export markets continued to grow briskly in the early part of the year - but are now likely to turn down as recession abroad spreads. Imports (at any rate of manufactured goods) tend to be affected more rapidly by worsening competitiveness: in fact, however, this has been overlaid by the fall in demand at home. Foreign competition has also contributed to the squeeze of profit margins both on exports and probably in home markets; many firms appear to be faced with a question whether to abandon export markets in which they have so far managed to keep a footing.

5. Lower output and lower margins have reduced the already low level of industrial and commercial companies' profits. This in turn is forcing them to accentuate retrenchment - in stocks, investment, overheads and labour - which would probably anyhow have taken place; and this seems bound to continue. Because of the difficulty of and possible disadvantage of raising finance on the long-term capital market, and because of low profits, companies have been exceptionally dependent on finance from the banks.

6. Table 1 also shows the declining rate of price inflation. The year-on-year figures shown understate the fall-off in inflation: over the last four months the annual rate of rise in retail prices has been 9%. Prospects for inflation next year (and, to degree, for output), depend on wage settlements in the coming round.

7. Overall developments so far this year have been more or less in line with earlier Bank forecasts. Present Bank forecasts for 1980 - not greatly revised - are also shown in Table 1.

Prospects for 1981 and 1982

8. It seems more likely than not that output will fall further next year, and, quite possibly, again in 1982. The reasons for suggesting a pessimistic view - notwithstanding the uncertainty of forecasts - are broadly as follows.

9. Developments could be significantly affected, among other things, both by the course of wages and by the exchange rate. It is possible to be relatively optimistic about wages. Reports from the Bank's Agents suggest an increasingly widespread view in industry itself that settlements may be moderate - i.e. below the present year-on-year increases in the RPI (16%) and in many cases perhaps well under 10%. In services, the prospect is more difficult to gauge, and much may depend on the level of settlements in the public sector. Even with considerable moderation, however, the increase in wages in this country is unlikely to be smaller than the average of our main competitors - which would not enable us to catch up lost ground.

10. The competitive position of industry undoubtedly suffered a large decline over the last two years. Thus, on the measure used by the IMF¹, it has declined by 35% since the second half of 1978. Half of that could be ascribed to wage costs here rising more rapidly than in other countries; half to the rise in the exchange rate over that period. The exchange rate might fall as and when interest rates can be reduced. But clearly no such adjustment is likely to reverse more than a part of the competitive deterioration that has occurred. The full effects of the latter have still to show up.

11. Thus, while the movement of exports and imports has not been a depressing factor on the economy this year, next year it could reduce output by 1 or 2%; and it could continue to operate in this direction in the next one or two years.

¹The so-called normalised unit labour cost measure.

12. It is also likely that business expenditure will fall, but the pattern will change. Though stocks are likely to continue to be run down, this influence was already large this year and may not depress output further. But as a result of financial pressures, companies are likely to be forced to cut back on investment. That, also, might reduce output by 1 or 2% next year, and continue to be a factor on a smaller scale in 1982.

13. There could, then, be several factors operating together, all tending to pull output down, with nothing very powerful operating in the contrary direction. The sort of picture the present Bank forecasts suggest is shown in Table 2. This is somewhat worse than earlier Bank forecasts because wage increases have been higher than allowed for and the exchange rate has risen so much. The impact on manufacturing industry next year, though continuing, should be relatively less severe than it has been this year.

TABLE 2: MAIN FACTORS CONTRIBUTING TO FALL IN OUTPUT

	<u>1980</u>	<u>1981</u>	<u>1982</u>
Stockbuilding	-3%	0	(+)
Investment	$-\frac{1}{4}\%$	-1 or 2%	(-)
Exports and imports	$+\frac{1}{2}\%$	-1 or 2%	(-)
All other factors	$+\frac{3}{4}\%$	$-\frac{1}{2}\%$	
Total output (GDP)	-2%	-3 or 4%	-1%
Manufacturing output	$-7\frac{1}{2}\%$	-5%	-2%

14. No mechanical forecast of price changes can have a high degree of validity or credibility. But unless expectational elements and general monetary and financial pressures induce extremely marked moderation in wage settlements this round and the next, it is difficult to see the rate of price inflation getting down below the 10% level over this period.

15. If the decline in output continues, unemployment could be expected to go on rising through the next two years. The exact rate of increase is difficult to predict, but could be as in the Bank forecast - $2\frac{1}{2}$ million adult unemployed at end-1981 and nearly 3 million at end-1982.

Conclusion

16. Though no credence can be attached to the precise numbers, the forecasts strongly suggest the possibility that recession will continue through next year and, on a diminishing scale, into 1982. The outturn could be affected both by policy changes and by many unpredictable elements. Thus the forecast makes what could be over-pessimistic assumptions about wages, and assumes little change in the exchange rate. A somewhat lower exchange rate, in particular, could temper the recession and bring forward the date of the eventual upturn.

Bank of England
10th October 1980.



21

Original on:
Public Expenditure

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

PUBLIC EXPENDITURE

This minute is to give you warning of further serious problems over our future public expenditure plans, especially for 1981-82. These will have to be brought out in the paper which John Biffen and I will be putting to the Cabinet planned at the end of the month. We urgently need to discuss the issues, both because of their intrinsic difficulty and because they are relevant to our discussion on Monday of monetary policy. Hence this interim note.

2. The main reasons why the prospects looks worse than in July are:

(i) Discussions with the nationalised industries about their external financial limits for next year show that their financial prospects have worsened further. Clearly we must do all we reasonably can to get the industries themselves to take measures to offset their increased bids. John Biffen has made some proposals to this end. We may have to insist on further cuts in investment. The position will not be clear for a few more days. At the moment we cannot be sure whether the increase in the provision for nationalised industries can be held to the £½ bn envisaged in July or will have to be increased, perhaps to £1 bn (at late 1979 prices).

/(ii). Meanwhile



(ii) Meanwhile changes in the prospects for unemployment, inflation and interest rates call for increased spending for unemployment and other social security benefits, housing subsidies and export credit subsidies. Other recent developments also point to further adverse changes.

3. In addition, Keith Joseph and Jim Prior are formulating proposals for industrial support and employment measures which could come to £0.4 bn.

4. In July we decided that public expenditure plans for 1981-82 and the subsequent years should be held within the totals published in our March White Paper, adjusted downwards for the EC settlement, which would make the planning total for 1981-82 about 1½ per cent lower in volume terms than the plans for the current year. I regard it as critical to the credibility of our public spending policies that we hold to this decision, keeping the figures within our own published planning totals.

5. It would be helpful if we could get it lower. For now there is a further reason for a tough line. The latest Treasury forecast points to a public sector borrowing requirement approaching £11 bn (in cash) in 1981-82, which would be incompatible with our objectives for reducing monetary growth and getting interest rates down. So we have to find ways of bringing it down. We can in theory, do so in 3 broad ways: higher taxes; reductions in the cost of given spending volumes; or lower expenditure volumes. In practice the cost is, of course, largely the pay element.

6. I am examining what contributions might come from the tax side, including further revenue from the North Sea, employees' national insurance contributions, and

/perhaps



perhaps not revalorising to the full extent the personal tax allowances. It is neither desirable nor easily conceivable to look to this source for a major contribution. Public expenditure must contribute in one way or another.

7. Pay is a critical element. Each 1 per cent more, or less, on public services pay is about £½ bn on the PSBR. We are considering in E the provision to be made for public services pay next year. A draft paper is coming to you separately. All I need say here is that the lower we set that provision and - the real imperative - achieve pay settlements within it, the less the cuts in services forced upon us.

8. But we do have to consider cuts in services in any event - as we foresaw in July and as I indicated in my minute to Cabinet last month. If we were to close the gap by further reductions in volume the implications look like being as follows.

9. Even if there were no net increase on employment and industry measures, in order to achieve the target agreed in July we should probably need cuts of between £1½ bn and £2½ bn (at late 1979 prices) on programmes other than the nationalised industries. John Biffen and I will be considering further over the next few days what proposals we must make. I should say now that I have sympathy with what Michal Heseltine has been saying about spreading the cuts widely and doing enough to minimise the risk of having to come back yet again for more late.

10. We shall certainly need most of the £0.9 bn specific cuts which John Biffen has so far been discussing in bilaterla with our colleagues. But those discussions show that many of the proposals already on the table

/are



are difficult and will be strongly resisted. This has more important implications for how we might proceed now.

11. These are the kinds of proposals we shall have to consider if we are to do more on volume. I am looking at the possibility of trying for a further reduction in local authority current expenditure beyond what was announced in August. I am also considering adding to the specific cuts a general 2 per cent cut in all cash controlled programmes. This would in effect carry forward into next and subsequent years the benefit from the current year's cash limits squeeze, which in the plans so far was carried forward only in civil service numbers.

12. All of this involves political difficulties. In particular the further volume cuts would mean moving away from commitments made previously, for example in looking for significant savings in the very large programmes for health, defence and social security.

13. I fear cuts would be needed in gross spending on health, which we have hitherto sought to protect.

14. We would also have to look for a further contribution from defence, while respecting Francis Pym's concern both about national security and about relations with our NATO allies. I understand his wish to be able to say that we have at least stopped the decline in defence spending which occurred under our predecessors, even though I think significant increases may now need to be deferred until later in our period of office.

15. Social security accounts for a quarter of total public expenditure, and by far the largest single element within that is retirement pensions. I regard it ^{as} essential

/to effect a



to effect a step change here in the light of our exceptional problems, in order to put the programme on a more realistic basis. Such a change would only be defensible in a year when the increase in incomes generally has to fall behind that in prices, as has to happen next year. We should have to think extremely carefully about presentation in the light of our pledges. Were we to proceed the kind of change needed would be to abate the increase in retirement pensions and other benefits in November 1981 to, say, 3 per cent less than the expected increase in RPI. The same would apply to public service index-linked pensions.

16. This is a forbidding menu. But the overall arithmetic will persuade you, as it has persuaded me, that we have to think in this kind of way. I hope we may have a chance of talking together about the central problems, quite briefly - perhaps on Sunday evening, at any rate separately from the meeting on Monday about monetary matters.

A handwritten signature in dark ink, consisting of a stylized, cursive 'G' followed by a horizontal line and a small flourish.

(G.H.)

10 October 1980

Also at Flag T is a
long paper from
the Governor
R.



10 DOWNING STREET

Prime Minister

This is a mass of
paper on a whole complex
of interrelated issues. (I haven't
yet seen several of them). But I
think you ^{should} / try to read through
them - starting with the

background note attached to
this minute, and then working
your way through from Flays A
(You don't need to read F on nationalised ^{leadership} ^{policy} ^{issues})
to the I. L I will be at home
if you want to discuss, and
we have the briefing meeting at
7pm on Sunday. R 10/60

SECRET

Prime Minister

Ref. A03202

MR. LANKESTER

Monetary Policy

Prime Minister's Meeting on 13th October

There is a formidable volume of paper for this meeting. What follows is an attempt to suggest how the Prime Minister might set about organising the discussion of it.

2. I think that there are three main issues, which should be separated for the purposes of the discussion:

(1) History

What went wrong with the money supply this summer; why we failed to prevent it in time to consider correcting it.

(2) Economic and monetary prospects and policies

What is the prospect for the money supply in the rest of this financial year and next? If it looks as if it will not come back into line with the path of the MTFs, should action be taken to bring it back? If so, what action?

(3) Techniques of monetary control

Should we stick to the existing principles of control and try to improve it, by improved forecasting and the adoption of different techniques for the management of open market debt sales? Or should we move to a system of monetary base control?

3. I suggest that the issues should be taken in this order, because, even if we decided in principle to change to a monetary base control, the control could not be in place in time to help us with the immediate problems of confronting the money supply. And it can be argued that differences of technique are marginal in relation to the problem of management which we face.

SECRET

History

4. The Treasury papers make the case that the path of money supply was seen but not the magnitudes. In particular the rates of increases in wages and prices and the level of the exchange rate were considerably higher than those forecast. Great efforts are being made to improve the forecasting system; but the papers warn that it will never be easy to forecast the month-by-month movement of the monetary aggregates. I suggest that the meeting should not spend too much time on this, but should move fairly quickly to the second and main item of business.

Economic and monetary prospects and policies

5. Here the questions seem to be:

- (1) What are the prospects for £M3 and the PSBR over the coming months?
- (2) If it looks as if they are not going to come back within the MTFS path, do we accept failure to reach the target, on the ground that further tightening would deepen the recession and strangle the corporate sector? Or do we take action to bring £M3 and the PSBR back nearer to the MTFS path, by such means as will least damage the corporate sector?
- (3) If so, what action?
 - (a) Monetary action - in effect, pushing sales of public sector debt harder (possibly with new techniques)? What would be the effects of that upon interest rates and the exchange rate? Would those effects be acceptable, given the underlying economic and industrial situation?
 - (b) Fiscal action:
 - (i) Public expenditure - public sector pay is an important element here, but can we expect to get more out of that than keeping it in line with the rate of increase of £M3 predicated in the MTFS? Is there any possibility of reducing public expenditure sufficiently to affect the PSBR by the amount we need to effect it in the necessary timescale?
 - (ii) Taxation - presumably no increase in corporate taxation or in VAT. It would not be possible to increase direct taxation until next April, but an increase from next April could be

The Chancellor is considering the increasing the 'health stamp' as an alternative to raising income tax

It.

announced ahead of the Budget (Mr. Healey did that once). But would such an increase make economic sense or be politically practicable? The remaining possibility is increased indirect taxation on alcohol, tobacco and petrol; these would have an unwelcome effect on the RPI, but perhaps less effect on pay settlements in present circumstances than might have been the case at earlier times.

- (c) Direct controls on bank credit to non-manufacturing borrowers - only tolerable as a temporary measure in a near-emergency, because it would tend to increase disintermediation, and would be likely to add to problems of small businesses; but a possible source of temporary relief to the pressure on interest rates at the centre of the system?
- (d) Do we want to be able to finance a given PSBR at lower interest rates, in order to diminish the pressures keeping the exchange rate and ease the squeeze on the corporate sector? If so, do we need to consider a system of two-tier interest rates, even if that means introducing inflow controls (two-tier interest rates would not be sustainable without them), either on their own or in addition to other monetary or fiscal action? If that is not thought likely to be practicable or effective, do we have to consider monetary or fiscal action for this purpose, even if it is not required to bring £M3 and the PSBR down?

or should we try to talk the rate down, and would joining the EMS help?

It..

6. All these questions have to be considered in the context of the prospects for and the effects of possible measures on the underlying level of economic activity. What are those prospects? Earlier forecasts suggested that we might begin to move out of recession by the end of 1981. Is it the case that recent forecasts are more pessimistic, and see the recession continuing and even deepening into 1982? The output of manufacturing industry is expected to fall by about 7½ per cent in 1980 and a further 5 per cent in 1981. This must imply rising unemployment and liquidations. Can we afford to risk intensifying these tendencies?

Techniques of monetary control

7. The papers tell us that several months' more work would be needed before it would be possible to start to introduce a system of monetary base control (MBC), and that its introduction would have to be gradual thereafter. So the introduction would presumably be phased over the second half of 1981 and 1982. The papers seem to favour a mandatory system.

8. A final decision to move to MBC does not need to be taken yet. But it may be possible to begin to define attitudes on it, as a basis for further work.

9. The fundamental point that seems to me to emerge from these papers is that whatever technique we adopt for smoothing the growth of money supply - whether new techniques of debt sales within the existing system, or moving to a system of MBC - implies greater volatility of interest rates. Using debt sales would imply greater volatility at the medium and long-term end; MBC would mean greater volatility at the short end. The ability of the authorities to enforce a judgment about the appropriate level of interest rates at any given time would be impaired. Are we prepared to give up, or at least significantly diminish, the capacity to manage interest rates?

10. An MBC system would involve institutional changes: changes to, probably the end of, the overdraft system in favour of fixed loans, the loss of the discount market's present role. The first would be a loss of flexibility for borrowers, and people would believe that it meant higher costs of borrowing, because they would have to pay interest on the full amount of the loan incurred, not on a day-to-day balance (they might be wrong, but it would never be possible to prove it). The loss of the discount market's present role would not matter much; but the discount houses would be looking for other business, and that brings me to the risk of disintermediation.

11. What is the risk of disintermediation with an MBC? At the extreme end of the spectrum, one could imagine the financial system developing forms of "para-money" which were not dependent upon or much affected by the monetary base. How real is that risk? What would be its consequences for monetary control, for the monetary system, and for the economy? What part would Eurocurrencies play in defeating the objectives of MBC? Are there exchange rate implications?

SECRET

12. If the decision were eventually to go against MBC, what improvements can be made in existing techniques, particularly techniques of market management? The papers do not carry us much further forward on this. Should the Bank of England now be asked to do a thorough study, and report with recommendations by Christmas?

Conclusions

13. It seems unlikely that the meeting will lead to definite or final decisions. It may, however, help to narrow the choice of options, and lead to at least provisional judgments which will

- (i) enable further work, both on monetary policies and on techniques, to be concentrated on the most likely starters;
- (ii) colour the discussion of cash limits, EFLs and public expenditure which will dominate the meetings of the Cabinet and the Ministerial Committee on Economic Strategy in the next few weeks.

9th October, 1980

SECRET

BA
ROBERT ARMSTRONG

CONFIDENTIAL



Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

9th October 1980

T. Lankester Esq.
10 Downing Street
LONDON
SW1

mt.

R 10/10

Dear Tim,

SHORT-TERM PROSPECTS FOR THE CGBR AND PSBR

The Chancellor undertook to provide the Prime Minister (his minute of 7 October entitled Money Supply, Interest Rates, the PSBR and the Exchange Rate) regularly with a note taking a three month forward look at the CGBR and the forecast path on a quarterly basis for the PSBR over the rest of the financial year.

... I have sent a copy of the first of these notes to the Chancellor in Brighton and he is intending to show it directly to the Prime Minister. I am however also enclosing a copy with this letter for your own purpose. There are a number of points of background and detail to which the Chancellor wanted to draw the Prime Minister's attention.

The note shows an increase in the PSBR forecast for 1980-81 to a point estimate of £10½ billion. This is unwelcome.

The new assessment is a product of the thorough reappraisal always made in September-October of the economy as a whole. At this time, the forecasters take on board the new estimates of the past prepared for the annual national income Blue Book as well as the evidence that has accumulated since the full Budget forecasts.

There has been a progressive upward revision to the expected borrowing of both local authorities and nationalised industries - despite the actions taken to curb their needs

/for external

CONFIDENTIAL



Faint, illegible text, possibly a header or address line.

COMPLIANCE



9 OCT 1980

CONFIDENTIAL



for external finance. At the same time, the persistence of the under-collection of VAT since April suggests that it cannot be interpreted (as seemed possible earlier) as a short-term wobble in the flow that would correct itself.

Even now, forecasts for the PSBR this year are still very uncertain: the note suggests a range of £8 $\frac{3}{4}$ - 12 $\frac{3}{4}$ billion as a reasonable interpretation of the point estimate. There is no completely up to date outside forecast at the moment: recent publications have varied between £9 billion and £11 billion, and this is influencing current attitudes in the markets.

Yours ever,

Ronald Tolkien

R.I. TOLKIEN
Private Secretary

THE PROFILES OF THE CENTRAL GOVERNMENT BORROWING REQUIREMENT (CGBR)
AND PUBLIC SECTOR BORROWING REQUIREMENT (PSBR) IN THE REMAINDER OF
1980-81: NOTE OF OCTOBER 1980

A. Outturn of the CGBR in September

The provisional estimate of the CGBR in September is £800 million. This will be published on 9 October. The outturn may later be increased a little by further information. The result is within the margin of error of a one month ahead forecast: the rolling forecast made at the beginning of the month had been £650 million. Tax receipts were nearly £400 million below forecast with shortfall on receipts from both Inland Revenue and Customs and Excise. In earlier months the tendency had been for the former to run above forecast. Net issues to finance departments' expenditure were some £300 million more than forecast. In the absence of special knowledge, some reaction from the relatively high August figure had been expected. No large special factor in the outturn has been identified. There were offsets elsewhere in the accounts, including an increase in departments' end-month balances. Table 1 compares the outturn with the figures forecast in Table 1 of last month's note.

2. The CGBR this September was much smaller (largely because of PRT receipts) than it had been a year ago. So the cumulative excess of the CGBR this year so far over the corresponding part of 1979-80 has fallen from £2.1 billion at the end of August to only £1.2 billion at the end of September. Table 2 summarises the figures and also the new forecasts for the remainder of the financial year.

3. The CGBR counterpart relevant to the money figures for banking September was £749 million (compared with £650 million forecast). The equivalent figure seasonally adjusted was £1,145 million.

B. Rolling forecast for CGBR in banking October

4. The banks' mid-month make-up day in October is 15 October. So the October banking month is 18 September-15 October. From 18-30 September the CGBR was £690 million and the current figure for the banking month as a whole is £830 million, in both cases before seasonal adjustment.

C. Rolling forecast for CGBR in October-December

5. The new working figures for the CGBR in the next three calendar months were compiled alongside work on the new forecasts for the PSBR as a whole (see next section). They are:

	<u>£ million</u>
October	100
November	1,800
December	1,300

As noted in the recent paper "Money Supply, Interest Rates, the PSBR and the Exchange Rate" such forecasts can deviate by around plus or minus £500 million for the first month and plus or minus £750 million for the third month.

6. The composition of the rolling forecast is summarised in Table 3. Receipts into the Consolidated and National Loans Fund are forecast to be relatively high in October: this is the quarterly peak for receipts of both VAT and advance corporation tax.

7. In total, expenditure from the Consolidated and National Loans Fund (including net lending) is more evenly spread over the quarter, though lending is forecast to be heaviest in October and debt interest payments are always large in November. Main borrowers which have signified intentions are the Electricity Council, the Steel Corporation. Relatively high net borrowing by local authorities from PwLB is usual in October.

D. PSBR in 1980-81

8. A fresh assessment of the PSBR is produced by the new economic forecasts. For the current financial year the figures by quarters, not seasonally adjusted, are as follows:

	<u>£ billion</u>	
	<u>1979-80 outturn</u>	<u>1980-81</u>
April - June	3.3	4.9 Provisional outturn
July - September	3.8	3.0 Estimated and forecast
October - December	3.9	3 $\frac{1}{4}$ Forecast
January - March	-1.2	- $\frac{1}{2}$ Forecast
Year	9.9	10 $\frac{1}{2}$

A minus sign denotes a net repayment.

9. The new forecast reflects a thorough reappraisal of all elements. A realistic margin or error, on each side of the new forecast for the year is some £2 billion: hence the forecast may best be expressed as a range £8 $\frac{1}{2}$ -12 $\frac{1}{2}$ billion. The chance of going outside this range is assessed, subjectively, as one in five. The estimate of the error margin is derived from an analysis of the Industry Act forecasts published in the autumn of the years 1976-79: in 1976 and 1977, the year's PSBR was overestimated in the autumn forecast and in 1978 and 1979 it was underestimated (though by less). Even though much is already known about borrowing in the first half of the current financial year, there are still major uncertainties:

(i) Although the borrowing of the central government over the period April-September 1980 is known to within a small margin, there is less information about the borrowing of the rest of the public sector;

(ii) The need for borrowing arises because of an excess of expenditure over income, and that is the way forecasts of borrowing requirements are constructed. Knowledge of

expenditure and income for the period April-September is weaker than knowledge of what has been borrowed; and, for example, unexpectedly high borrowing thus far in the year may suggest either a continued extra excess of expenditure over income in the rest of the year; or only a temporary excess, with much lower borrowing in the second half of the year. In building up the new forecast some items have been interpreted one way and some the other;

(iii) Government income and expenditure flows for the rest of 1980-81 depend on the development of the economy - on output, inflation, unemployment etc. Errors in these forecasts for the next six months, and in the uncertain estimates for the July-September quarter, will contribute to errors in the PSBR forecasts.

10. The main elements in the net increase of £2½ billion in the forecast PSBR since the Budget are:

<u>Factors increasing the forecast PSBR</u>	<u>£ billion</u>
Extra borrowing by local authorities	0.9
Extra borrowing by public corporations ¹⁾	0.7
<u>Shortfall on VAT receipts</u>	<u>0.7</u>
Shortfall on other Customs receipts	<u>0.4</u>
Shortfall on expected special sales of assets	0.2
Extra social security benefits because of higher unemployment	0.3
Increase in defence cash limit	0.2
Total	<u>3.4</u>

1) The latest forecast for public corporations' borrowing is £3.1 billion. The FSEBR showed only £1.4 billion, but included a hidden allowance of about £1 billion.

Factors reducing the forecast PSBR

£ billion

Extra receipts from EC as a result of 30 May agreement ²⁾	0.4
Extra receipts of income tax and national insurance contributions	0.6
	<hr/>
Total	1.0
	<hr/>

2) This is the difference between the refunds forecast to result from the 30 May agreement and the refunds expected at PSBR time under the old financial mechanism. The latest forecast, unlike the figures being used in the public expenditure survey, assumes some slippage of cash refunds out of 1980-81 into the following year.

Total identified changes, net	+2.4
Others, net	-0.2
Total change in the forecast PSBR	+2.2

11. Outside forecasts for the PSBR in 1980-81, published in August or September, range from £9-11 billion.

TABLE 1

CENTRAL GOVERNMENT BORROWING REQUIREMENT

CGBR IN SEPTEMBER

	<u>Forecast</u>	<u>Outturn</u>	<u>£ million</u> <u>Effect on</u> <u>CGBR</u>
RECEIPTS			
<u>Consolidated Fund</u>			
Inland Revenue	3200	3050	-150
Customs and Excise	1730	1507	-223
Other	600	605	+5
<u>National Loans Fund</u>			
Interest etc receipts	300	618	+318
Total receipts	5830	5780	-50
EXPENDITURE			
<u>Consolidated Fund</u>			
Supply services and Contingencies Fund	5300	5603	-303
Other	250	244	+6
<u>National Loans Fund</u>			
Services of the national debt	800	884	-84
Net lending	280	335	-55
Total expenditure	6630	7066	-436
Other Funds and Accounts	+150	+486	+336
CGBR	650	800	-150

TABLE 2

Central Government Borrowing Requirement

£ billion

			Cumulative		Difference
	1979-80	1980-81	1979-80	1980-81	
April	1.3	0.9	1.3	0.9	-0.4
May	1.5	2.3	2.8	3.3	+0.4
June	1.0	1.3	3.8	4.6	+0.8
July	-	0.8	3.8	5.4	+1.5
August	1.1	1.6	4.9	7.0	+2.1
September	1.7	0.8	6.6	7.8	+1.1
October	0.1	(0.1)	6.7	(7.9)	(+1.2)
November	1.8	(1.8)	8.5	(9.7)	(+1.2)
December	1.6	(1.3)	10.2	(11.0)	(+0.8)
January	-2.5	} (-1.3)	7.7
February	0.4		8.0
March	0.2		8.2	(9.7*)	(+1.5)

* Latest forecast

Note: Some rows may not cross add because of rounding. Each column is correctly rounded.

TABLE 3

CENTRAL GOVERNMENT BORROWING REQUIREMENT

£ million and %

	(1) April- September	(2) October forecast	(3) November forecast	(4) December forecast	(5) Year to end December	(6) % change of col (5) on year earlier	(7) Budget forecast for whole year % change
<u>Receipts</u>							
<u>Consolidated Fund</u>							
Inland Revenue	14,510	2,850	2,100	2,250	21,700	+20	+17
Customs and Excise	10,371	2,600	1,950	1,700	16,650	+34	+33
Other	3,746	700	750	750	5,900	+14	+5
<u>National Loans Fund</u>							
Interest etc receipts	1,971	400	300	300	2,590	-	+19
Total receipts	30,592	6,550	5,100	5,000	47,200	+22	+20
<u>Expenditure</u>							
<u>Consolidated Fund</u>							
Supply services	31,726	5,700	5,400	5,500	48,300	+24	+20
Other	1,535	250	250	250	2,250	-	+12
<u>National Loans Fund</u>							
Service of the national debt	4,788	350	1,200	450	6,850	+19	+19
Net lending	1,766	550	250	150	2,700	+12	+27
Total expenditure	39,825	6,850	7,100	6,350	60,100	+22	+20
Other Funds and Accounts	+1,465	+200	+200	+50	+1,900		(1,350)¹⁾
CGBR	-7,768	-100	-1,800	-1,300	-11,000		

1) £ million.



**THE CITY
UNIVERSITY**

Northampton Square London EC1V 0HB
telephone: 01-253 4399 telex: 263896

Centre for Banking and International Finance
Director Professor Brian Griffiths

PERSONAL AND CONFIDENTIAL

8 October 1980

The Rt. Hon. Margaret Thatcher, MP
Prime Minister
10 Downing Street
London SW1

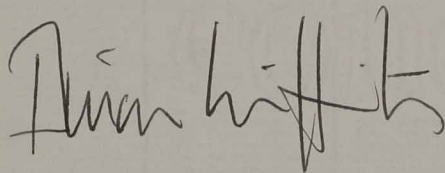
RW/WS

Dear Prime Minister,

After talking to Tim Lancaster, I am sending you a note on a subject about which I feel rather strongly.

With every good wish for the future.

Yours sincerely



Brian Griffiths

MONETARY CONTROL

1. I am delighted that you are taking a personal interest in this subject. Although it is frequently presented as a rather narrow and technical appendage of the government's overall policy, I believe it is absolutely vital for ensuring that the medium-term targets are met. It is very interesting to observe the number of occasions in the 1970's when it became an important matter for the then Prime Minister.

The danger at present is that two or three months of good money supply figures, plus important new problems arising elsewhere, will lead the bureaucracy to urge you to put the matter in your pending tray - so that once again it will not be dealt with at a fundamental level.

2. Why have short term monetary control?

If the investing public were assured that the government would stick, come what may to their annual money supply targets strict month to month control of the money supply would be unnecessary. The problem arises, however, because in the past published monetary targets have not been met, so that the public find it difficult to know if a sudden spurt in money supply growth is a new trend or a short term deviation from an announced trend which will be corrected in a few months. On the basis of past experience it is not surprising that they tend to be cautious and sceptical if not downright cynical about future trends when bad

money supply figures are announced. The only way this can be overcome is by ensuring that monetary growth targets are met in the short as well as in the medium term.

3. The primary reason for both the variability and the extent of money supply growth over the 1970's is a system of monetary control which requires the Bank of England to make judgements about such things as the appropriate level of interest rates which, quite frankly they are incapable of doing.

4. In view of the record of the Bank of England over the 1970's in designing mechanisms of monetary control, I have little confidence in their ability to come up with an appropriate system now.

In 1971, they designed Competition and Credit Control. I remember attending a conference at the Bank in July 1971 and, along with Harry Johnson, David Laidler and Michael Perkin, pointing out that the system suffered from crucial defects. My remarks are on record in popular and academic journals. The major criticism was the definition of reserve assets and the Bank of England's inability to control their supply. The experiment proved a disaster, partly because Mr Heath misused the system, but partly because it was in any case a very defective system.

When this was realised, the Bank tried to remedy the weaknesses of Competition and Credit Control by introducing the 'corset'. We now

have conclusive evidence that the major effects of the corset were:-

- (i) to reduce measured money supply growth without reducing underlying money supply growth.
- (ii) to distort relative interest rates, and
- (iii) to render the money supply statistics meaningless.

5. The disturbing fact is that those in the Bank responsible for these innovations - John Fforde, Charles Goodhart and Kit McMahon - are still there and that they show very little signs of dispensing with the intellectual framework which produced such schemes.

6. In the recent seminar (September 29th 1980) held at Church House I was impressed by the way in which Bank of England officials seemed to be looking for a "half-way house". In fact one of the questions for discussion was precisely as to whether it was possible to construct some 'half-way house' to a monetary base system.

My fear is that the Bank will put forward proposals which have the appearance of monetary base control (much as Competition and Credit had the appearance of controlling the monetary aggregates) whereas in reality they allow themselves sufficient loopholes to do what they want so that it will be business as usual.

{ Fin in Week
have. →

- 4 -

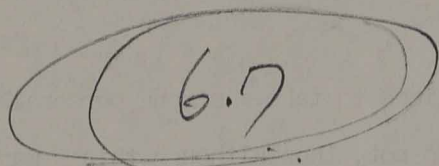
① M₃ - controlled?
or just not controlled.

7. In my judgement a proper system of monetary control will not be proposed by the Bank of England but will have to be imposed on them. Given our system it is inevitable that it will come from the Treasury. But in this area the Treasury is very weak staffed compared to the Bank and with one honourable exception, namely Peter Middleton, many of the staff, whom I know, seem far too agnostic to propose anything approaching a good workable system.
8. I believe it is of vital importance that you, as Prime Minister, are able to assess the Treasury proposals before they are published as a joint Treasury and Bank scheme, and that you seek the written advice of Brunner, Meltzer, et al at this stage.
9. When the proposals are published the critical points to watch are:-
- (a) the extent to which the Bank changes its lender-of-last-resort function; →
 - (b) whether or not MLR is tied to a market rate of interest;
 - (c) the extent to which the Bank are prepared to target the monetary base on a short run basis - so that effectively they reduce the options available to themselves in the conduct of policy.

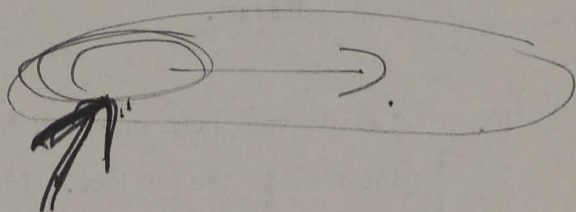
(d) the transitional arrangements - the City is an exceptionally innovative place and such reform could easily be introduced in a 3-6 month period: all this talk of years is sheer humbug.

10. I would very much urge you to continue to take a strong personal interest in the subject. If you do not, then although things may improve in the next few months I have no doubt that because money supply growth is pro-cyclical similar problems will emerge in the recovery from the present recession.

Brian Griffiths
8 October 1980



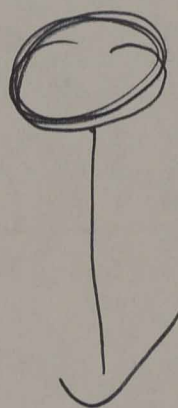
5.5



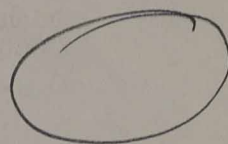
7.7

276 276

25 220b



| 223



•••

1 1/2

8-9

13 13

✓ Mr. Duquill.
Mr. Vereker.



Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

MB

PRIME MINISTER

MONEY SUPPLY, INTEREST RATES, THE PSBR AND THE EXCHANGE RATE

We shall be providing 4 notes for our meeting on 13 October, dealing with:

Flag A

(a) the underlying monetary situation after the abolition of the corset

Flag B

(b) the roll forward of the £M3 target

Flag C

(c) monetary control

Flag D

(d) the exchange rate

Flag E

2. I shall also be letting you have a note summarising the present state of play on the public expenditure exercise, and the options and dilemmas to which it gives rise. There will be further separate notes on nationalised industry pricing and public sector pay.

Flags F, G

Flag H

3. To complete the list, the Treasury are also preparing, in accordance with the agreed work programme the first 3 monthly forward look at the CGBR and the forecast path on a quarterly basis for the PSBR over the rest of the year.

Flag I

Also a note on Treasury's latest short-term forecast.

....

4. Meanwhile, I attach a note prepared by officials which gives the background to recent events. It is not intended to cover the ground in other papers, but to explain the background to monetary control decisions and to offer some pointers for the future. There is

/one point



one point which is worth emphasising at this early stage. We shall have to be careful not to take precipitate action which may increase uncertainty or make the attainment of the medium term strategy more difficult; this will involve paying great attention to the speed of change, particularly if fundamental changes in our financial institutions - affecting lender of last resort, the discount market, the overdraft system and leasing - are at issue. None of this, of course, reduces my conviction of the need to improve upon the present system.

A handwritten signature in black ink, appearing to be "G.H." with a flourish.

(G.H.)

7 October 1980

MONEY SUPPLY, INTEREST RATES, THE PSBR AND THE EXCHANGE RATE

This note covers recent developments, the current procedures and policy approach, and work now in hand on these major and inter-related aspects of the economy. The note is largely factual and does not attempt to anticipate the conclusions of the full papers being prepared for the meeting with the Prime Minister on 13 October which will cover the monetary situation following the abolition of the corset, the rollover of the monetary target in the context of the forecast and of economic strategy generally, and the methods of monetary control.

2. The note has the following parts:

- A. Money Supply Growth: Present Situation
- B. Present Methods of Monetary Control: General
- C. Control of the Money Supply: The PSBR
- D. Control of the Money Supply: Bank Lending
- E. Control of the Money Supply: External Factors
- F. Exchange Rate

There is a separate Annex on monitoring the PSBR.

A. MONEY SUPPLY GROWTH: THE PRESENT SITUATION

Impact of the SSD Scheme

3. A detailed note has been prepared for the Prime Minister's meeting; what follows is a brief summary of some of the main points.

4. The money supply, £M3, grew at an annual rate of over 26% in the 6 months between banking February and August of this year, compared with the current target range of 7-11% pa. There was exceptional growth in banking July and August, after the end of the Supplementary Special Deposits scheme (the "corset") in June. The corset, which had been in place for 2 years, had given rise to substantial disintermediation as the private sector increased its holdings of "near-money" (assets not liable to corset penalties). With the end of the corset, the banks have been able to restructure their balance sheets; and there has been a surge in money supply growth as business that had been forced into non-bank channels returned to the banking sector.

5. The authorities have long been aware of the incentive which the SSD scheme gave to disintermediation. The problems

were spelt out in Chapter 2 of the Green Paper on Monetary Control. Distortions resulting from the corset were inevitably increased by the abolition of exchange control last October*. This gave residents access to the euro-sterling market. Though we have details of non-bank holdings of acceptances (the bill leak) we have very little timely information about residents' holdings of euro-sterling deposits. Most countries, without exchange controls, face exactly the same problem of determining, on the basis of evidence drawn from third countries, shifts between the domestic and overseas banking systems.

6. The SSD scheme also acted as a restriction on banks setting out to seek new forms of business. We have taken action to restrict their moving into the housing finance market in competition with the building societies. But there is still a question about how they will behave following the abolition of the corset and the effect of this on the money supply, which is to be dealt with in a separate paper by the Bank.

7. Our best central estimates for the underlying growth in £M3, allowing for corset distortions, is the "adjusted M3" series in Table 1. But these are still subject to substantial revision; the last 3 months figures are insufficient to enable us to estimate precisely the growth of residents' holdings of money and money-like assets. It is however clear that over the last 6 banking months it has been substantially above the 7-11% target.

8. Table 1 also shows movements in other measures of money and liquidity. The wider measures of private sector liquidity, which are less distorted than £M3 by the corset, have moved in a broadly similar way to adjusted £M3. M1, on the other hand, has grown much more slowly, being more sensitive to high interest rates.

9. It should be added that though the SSD scheme - especially since the abolition of exchange controls - has meant that we did not know exactly what the underlying rate of growth was, and made it difficult to know whether corrective action was necessary, we did know by the summer that it was outside the target range. What we did not guess was the extent to which it is currently exceeding it.

*This was pointed out in the Chancellor's minute of 11 October to the Prime Minister.

The Pattern of Recent Money Supply Growth

10. The greater than expected acceleration in "adjusted £M3" in recent months followed modest growth during the winter. This in turn followed a period of higher growth until the increase in MLR last November. Table 2 illustrates these three phases, and also shows the profile of the main counterparts of £M3 growth. Apart from the effect of the MLR increase itself, on gilt sales in the first instance and less distinctly on bank lending, the main feature which stands out is the similarity between the path of adjusted £M3 and that of the CGBR; the other counterparts were, in comparative terms, fairly steady. Although there are always interactions between the separate counterparts, it is reasonable to infer that the profile of the CGBR (and indeed the PSBR as a whole) has been a strong influence on the profile (if not the actual rate of growth) of £M3 over the period. At the same time bank lending has remained surprisingly buoyant. Section C discusses the PSBR and Section D bank lending.

B. MONETARY CONTROL: PRESENT METHODS

11. The Green Paper on Monetary Control (Cmd 7858) was published in March 1980 with the aim of completing discussions in 6 months time. The Bank of England has published a number of parallel consultative papers including one on measures of liquidity for prudential purposes. The Green Paper argued that, with the basic instruments of fiscal policy and interest rates, money supply growth could be controlled over the medium term, say, over a year or more. But it recognised that they could not ensure a smooth monthly growth path, it spelt out the advantages of shortening the period within which it was possible to exercise control, and discussed possible changes in methods of control. Many comments have been received from financial institutions, commentators and academics. Seminars with interested people from the UK and abroad were held on 29 and 30 September. A separate paper is being prepared for the Prime Minister's meeting.

The Discretionary Determination of Interest Rates

12. The present system depends on whether the authorities can judge the appropriate level of interest rates to meet the money supply target and whether Ministers are willing to sanction the necessary changes.

The authorities are able to virtually determine the level of short term rates through changes in MLR, and money market operations.

13. This technique is independent of the banks' reserve asset position. Throughout this year the banks have been short of liquid and reserve assets. But since the general level of interest rates has been judged appropriate the authorities have relieved this pressure on the banks and so maintained short term interest rates at the desired level.

14. The process of control works as follows. The quarterly economic forecast generates the interest rate path thought necessary to achieve the money supply target taking account of the forecast of the PSBR described in Section C. That gives the authorities some idea of the likely direction in which interest rates might be expected to move over the year and indicates the likely quarterly profile of the demand for money and hence interest rates. In practice, decisions on interest rates and gilt sales have to be made on a shorter time scale. To assist in this, the Bank and the Treasury each month look ahead over the next 3 months, taking a view on movements in the main counterparts of money supply growth, the PSBR in the light of the latest monitoring information (see Section C and Annex A), public sector debt sales, bank lending and external factors.

15. Thus, in principle, if, for example because of a fluctuation in central government borrowing as a result of the pattern of expenditure or revenue flows, unusually high money supply growth is expected, interest rates or debt sales can be changed accordingly. But existing gilt market techniques are based on securing gilt sales when they can be obtained rather than when they would be needed to smooth monetary growth. Something can be achieved by part payment if forecasts are accurate. But the present system does not allow us to smooth out unforeseen changes in monetary growth by selling stock when needed and thereby letting long rates of interest adjust.

16. Moreover:

- a. the counterparts to money supply growth can fluctuate very substantially and unpredictably from month to month, and the profile of money supply growth over a quarter is extremely

uncertain;

b. it takes some months for it to become clear that there has been a divergence from the target path, rather than simply fluctuations about it, and it is very difficult for the Government to move interest rates up unless it is sure that the move is justified. This carries the risk that unforeseen events like a surge in the PSBR become firmly embedded in the money supply.

c. Because of the uncertain impact of interest rate changes over the short term, it is difficult to be sure that the chosen level will be appropriate.

17. Swings in monetary growth have been substantial, not only from month to month, but from quarter to quarter. In the 12 months to banking June 1980, the increase in £M3 (after seasonal adjustment) was as high as £1,250 million (2.2%) and as low as £42 million (0.1%). In the eight quarters to Q1 1980, the increase in £M3 varied between £2.2 billion and £1.1 billion. The swings in the main counterparts have been even larger*. Chart I attached illustrates this.

18. Experience shows that swings cannot be foreseen at all reliably even over a period of 3 months. Our record in forecasting periods three months ahead during the first half of this year shows deviations averaging about 1/3% per month on the money supply. Just one month ahead, the differences between forecast and actual can on occasion be much worse. In individual months these differences soemtimes approached 2% of £M3. There was, however, no discernible bias towards either over or under forecasting on a one month ahead basis in the period preceding the abolition of the corset. Charts 2 and 3 show how the CGBR and £M3 banking month forecasts compare with what actually happened.

*The range of the main counterparts over the 12 months to banking June 1980 was:

CGBR	+ £1.4 bn to - £0.6 bn
Other public sector (net)	+ £0.3 bn to - £0.6 bn
Central Govt debt sales	+ £1.4 bn to - £0.1 bn
Bank lending to private sector	+ £1.5 bn to - £0.2 bn
External factors	+ £0.8 bn to - £0.7 bn

The Movement of Interest Rates

19. Table 3 shows the movement of MLR and selected interest rates since May 1979. MLR moved up three points last November in response to rapid monetary growth - following a high PSBR and gilts pause. It was followed by an increase in the mortgage rate. The subsequent fall in the rate of growth of £M3 (and absolute fall in M1) suggested that the system of control was working as intended. But bank lending stayed high and the PSBR expanded again. Thereafter for a few months it looked as if the level of MLR was adequate - at least if the prospect of recession was taken into consideration. In banking May and June, £M3 seemed to be accelerating again. The one point reduction in MLR in July was therefore a calculated risk; it was not justified by the monetary situation to date but by the prospects of slower money supply growth in the future. Chart 4 shows the movement of the money supply as it looked when the decisions were taken.

Further Work

20. Apart from reintermediation following the corset there have been two basic problems of monetary control:

a. The Path of the PSBR

Though it can never be even throughout the year, the PSBR path over the last two years has been so extreme as to make smooth monetary growth a virtual impossibility. It is intended to examine, as a matter of great urgency, what can be done to smooth the path of the CGBR as soon as the new forecast is available. (This forecast is to be sent to the Prime Minister as set out in the work programme). There is no doubt however, that this will be a formidable task - the revenue, expenditure and lending components are not controllable with precision and there will be limits on how much further present procedures can be changed to give a better path.

b. The Method of Determining Interest Rates

The paper on monetary control for the Prime Minister's meeting will deal with techniques for adjusting interest rates both short term and for the range of debt instruments - so that less weight has to be put on tax and public expenditure decisions which are largely taken annually and which produce an uncertain path for the CGBR. The timely, and

appropriate adjustment to interest rates is crucial to monetary control.

C CONTROL OF THE MONEY SUPPLY: FORECASTING AND MONITORING THE PSBR

21. The relationship between the PSBR and changes in money supply, is not at all direct or close in the short term. But the PSBR is potentially so important a counterpart that forecasts of it are important in managing the control of the money supply.

22. Forecasts of the PSBR are one output of the economic forecasts prepared in the Treasury. This means that the forecast for the PSBR is consistent with the simultaneous forecasts of output, unemployment, inflation and so on for the economy as a whole.

23. The preparation of the forecasts thus provides a regular clearing house for views about the economy and also for the judgements of those directly involved in the control and monitoring of public expenditure and the monitoring of revenues and borrowing. The PSBR forecasts incorporate, for example, up-to-date judgements on how fully cash limits will be spent (including a view on the chances of any breaches), how local authority employment will change, what nationalised industries will have to borrow, and how tax revenues will turn out.

24. The forecasts are constructed on a quarterly basis and so generate a quarterly forecast for the PSBR. The forecast for the PSBR is built up from all the income and expenditure components. In many of these areas, the raw material for the forecasts - expenditure plans, cash limits, EFLs, tax liabilities - relate to complete years and not to individual quarters. Where there is information about the path during a year - the pattern of wage settlements, the timing of asset sales, EEC contributions, tax payments, and so on - efforts are made to embody that information in the quarterly path. But for many items there is no such information and a smooth path is forecast. Thus the quarterly path of the PSBR combines items which are forecast with a smooth path and items with knowable irregularities.

25. The difficulties of foreseeing many of these irregularities,

and the large, and varying, seasonality of many of the series, has resulted in the focus of attention in the forecasts being concentrated much more on the financial year total as a whole than on the quarterly path.

26. In practice, the profile of the PSBR during a financial year is important for considering the rolling forward of money supply targets, and for monitoring the actual PSBR in order to judge whether deviations are a warning signal or not significant. Hence if, in fact, the PSBR is going to turn out very unevenly, but is not forecast to do so, then strategic judgements about the trend of interest rates and funding policy (eg the timing of initiatives on National Savings) will be based on wrong signals. Day-to-day tactical decisions, however, will be affected less since, as noted in Section B they are based on the rolling monthly forecasts of the central government borrowing requirement (CGBR) and such other short term forward indicators as can be found.

27. At the beginning of each month a new forecast of the major components of the CGBR is made covering the period to three months ahead. This rolling forecast forms the basis of the Bank of England's assessment of the money market's position in the short term and also provides the basic material for monitoring daily inflows and outflows. The rolling 3 monthly forecast takes account of factors, identified at the monitoring stage, which are thought to have affected the trends. The forecast for the first month can deviate by around plus or minus £500 million and for the third month plus or minus £750 million. Banking month forecasting of the CGBR for monetary control purposes is subject to wide and erratic fluctuations resulting from slight changes in the timing of receipts and payments, around the third Wednesday of the month. Chart 3 illustrates these divergences for the first half of the year. A further effort is currently under way to improve this forecast and relate it more closely to the quarterly forecasts.

28. The forecast at Budget time of the PSBR path in 1980-81 turned out to be seriously wrong. In the April-June quarter the PSBR was £4.5 billion compared with the forecast at Budget time for the

quarter of £2 $\frac{1}{2}$ billion. The quarter showed exceptionally high levels of defence spending; unusually high borrowing by local authorities; and shortfall on tax receipts; very high borrowing by public corporations and other factors. Even with the benefit of hindsight it is hard to see how much of this could have been foreseen: some - such as the defence spending and the high local authority borrowing - could not have been.

29. That the PSBR was running high in April-June was known by June, through the rolling CGBR forecast and the monitoring procedures described in the annex. They relate to key elements of the accounts and are most timely in relation to the central government transactions which account normally for the bulk of the PSBR.

30. Much greater attention is now being paid to forecasting the quarterly path of the PSBR by ensuring that we take full account of all sources of information on the timing of transactions. This will improve our forecasting performance. But given that the margin of error on an annual forecast is plus or minus £3 billion, it is possible that quarterly forecasts would each have average errors of at least plus or minus £1 billion. Such a margin is not large, given that the PSBR is the balance between flows in excess of £100 billion a year on each side of the account.

D CONTROL OF THE MONEY SUPPLY: BANK LENDING

31. Bank lending has grown very rapidly in the last 2 years. In the year to mid 1980, the total stock of bank loans to the private sector grew by nearly 23%, following growth of 21% in the previous year. Table 4 attached gives greater detail on bank lending in recent years.

32. There are a number of possible explanations. The acceleration in inflation is the most obvious, though the present methods of monetary control may also play a part. Until the last few months inflationary expectations had probably been rising steadily since about mid-1977, and this will have offset the impact of rising nominal interest rates. The company sector has been in substantial deficit since late 1978, and this would be expected to increase the demand for bank finance. With the current high level of long term

interest rates the long term capital markets are not making a significant contribution.

33. But our understanding of bank lending, particularly in the short term, is far from good in spite of considerable research in both the Bank and the Treasury and a search of outside literature. The failure of research to yield robust results reflects distortions of the corset and earlier controls. But in any event, it is quite unrealistic to expect understanding of quarter by quarter movements to be anything other than sketchy.

34. The quarterly financial forecasts examine the path of bank lending with care in view of the implications for monetary growth or interest rates. The forecast for the 1980 Budget foresaw no significant falling off in the growth of bank lending until the fourth quarter, but it did not foresee the acceleration which actually took place in the first half of the year. The main difficulty at this stage of the economic cycle concerns the timing of companies' reaction to the recession (which has been greater than foreseen at the Budget) and in particular the speed with which they run down stocks and adjust their labour force. In the first stages of a recession the companies' need for finance may well rise rather than fall if adjustment is slow, or the recession too steep. There may well have been an element of the latter underlying recent behaviour, although interpretation is made rather difficult by the conflicting stories told by different indicators of the company sector's financial position.

35. There are large monthly fluctuations in bank lending. In the year up to June, when the corset was taken off, the seasonally adjusted monthly increase varied from £170 million in December to over £1.5 billion in April. Nevertheless the acceleration this year had been clearly noted by April and incorporated into the 3 month forecasts.

36. A further problem has been the difficulty of assessing the banks' position under the corset, which was increased by the abolition of exchange controls in November as new forms of finance become available to companies. That this additional difficulty would arise was clearly understood at the time of the exchange control

decision and also when the decision was taken in November not to abolish the corset then.

37. Once the distortions induced by the corset are fully unwound, the underlying features of bank lending should become clearer. But it would be misleading to suggest that very great strides can be made in our understanding. Given the overdraft system, under which even the clearing banks cannot forecast, and do not try to control, their own lending accurately from month to month, there is bound to be volatility. The Bank have regular discussions with the clearing bankers and it is clear that their analysts have much the same sort of problems in interpreting current behaviour as we do. The Bank of England are providing a paper assessing how the banking system is likely to develop post-corset.

E CONTROL OF THE MONEY SUPPLY: EXTERNAL FACTORS

38. The external adjustments to the money supply can be a particularly volatile element and one not susceptible to forecasting with precision on a monthly basis. Within the last year they have fluctuated between a positive value of £250 m and a negative one of over £300 m. Even in the absence of any net intervention in the foreign exchange market by the authorities, they can still be strongly influenced by movements in the current account of the balance of payments and by the structure of the capital account.

39. Forecasts for the external adjustments are based on projections of the current account and a complex set of developments and interactions on capital account. Because the exchange rate is determined by market forces, it is necessary to identify the net effect of a variety of flows in both directions across the exchanges. The abolition of exchange controls has made this difficult. Similarly, large inflows to pay PRT are a fairly new development and have probably given rise to very large monthly fluctuations of the externals.

40. There has been no systematic bias during this year in the forecast of the externals one month ahead, but some slight tendency to overpredict them (ie forecast too positive an influence on SM3)

looking three months ahead. But errors in any one month can amount to as much as 1% of £M3.

F THE EXCHANGE RATE

41. Although the pattern has been erratic, the effective sterling rate has risen since the beginning of 1979 from 64 to 76.5, almost 20%. This has taken place at a time when cost inflation has been much more rapid in the UK than in other countries. Consequently the loss of cost competitiveness has been much greater - of the order of 40%.
42. The rise in the exchange rate has been the result of a variety of factors. The rise in the price of oil and the uncertainties about future supplies have made sterling attractive to non-residents. Higher interest rates in the UK than in other countries have also been a factor. Some of the current strength of sterling may be reversed when UK interest rates come down, and if the outlook for oil supplies becomes more settled. But our possession of oil will almost inevitably produce an exchange rate higher than it otherwise would have been.
43. The high exchange rate has brought with it benefits to inflation: import prices for goods other than oil have been falling this year. But it has intensified the squeeze on manufacturing industry.
44. The removal of outward exchange controls was completed in October 1979. This has generated substantial outflows (of around £1 billion a quarter), though these have been more than matched by overseas inflows into sterling. The possibility of introducing controls on inflows was discussed with the Prime Minister on 18 September, and further work on this and other means of influencing the exchange rate is in hand.
45. Any such action, however, runs the risk of increasing both inflation and the pressure on the money supply targets. For example a 10% fall (to \$2.15) could directly add around 2% to the rate of inflation in the course of a year. Significant market intervention would require a large increase in sales of gilts or other debt or a cut in the PSBR if it was to be contained within the present monetary target. The Bank of England's activity in smoothing upward

pressure over the past 18 months has probably itself cumulatively involved some addition to the money supply, even though total external influences on £M3 have been negative over this period.

G SUMMARY AND CONCLUSION

This note has brought out the following points:

- a. £M3 cannot be controlled in the short run, and its counterparts are too variable to be predicted with precision month by month.
- b. A great effort is already put into forecasting and monitoring monetary growth and the PSBR. An upsurge in the PSBR and monetary growth was foreseen. But the extent of the surge in adjusted £M3 since February was neither foreseen by us or anyone else. The PSBR for the first half of 1980-81 was underpredicted. So was the growth of bank lending. The fall in activity in manufacturing and the rise in the exchange rate have also been greater than was foreseen at the time of the Budget.
- c. More work needs to be done - and is being done - to improve forecasting performance, particularly with regard to the short term movements in the PSBR. But the average error is likely to remain large.
- d. Forecasts are not policy. The essence of monetary targets is that adjustments have to take place in response to unforeseen changes in order to prevent them causing an increase in the money supply over a period of time. This indicates two areas for further work on techniques:
 - i. a major effort is in hand to see whether the PSBR path can be made smoother and to see whether excessively skew paths of the sort we have seen this year can be avoided.
 - ii. This may help monetary control but it will be impossible to adjust the PSBR in order to achieve the desired rate and pattern of monetary growth. So techniques of control, including funding methods, are also being re-examined.
- e. Events in the summer suggest the following considerations:
 - i. we must avoid new methods which like the corset operate by causing large scale disintermediation.

- ii. more timely changes in interest rates would be a necessary feature of either improvements in existing techniques or completely new methods. This means changes both up and down in all interest rates, including base rates and mortgage rates, in response to blips in monetary growth.
- iii. if possible new techniques should provide greater constraints on the banks.
- iv. it is unlikely to be possible to combine improvements of this sort with an exchange rate objective.

HM Treasury
6 October 1980

TABLE 1

<u>Banking months</u>	% at annual rate seasonally adjusted				
	<u>M1</u>	<u>£M3</u>	<u>PSL1</u>	<u>PSL2</u>	<u>adjusted £M3 approximately</u>
June 1978--June 1979	12.8	11.5	16.1	14.2	13
June 1979--June 1980	3.2	11.7	13.5	11.8	17
February--June 1980 (4 months)	0.2	12.1	18.1	15.4	22
February--August 1980 (6 months)	7.9	26.2	21.9	18.2	22

PSL1 = 'Money' plus other money market instruments (including bank bills) plus certificates of tax deposit.

PSL2 = PSL1 plus other savings deposits and securities (including building society deposits).

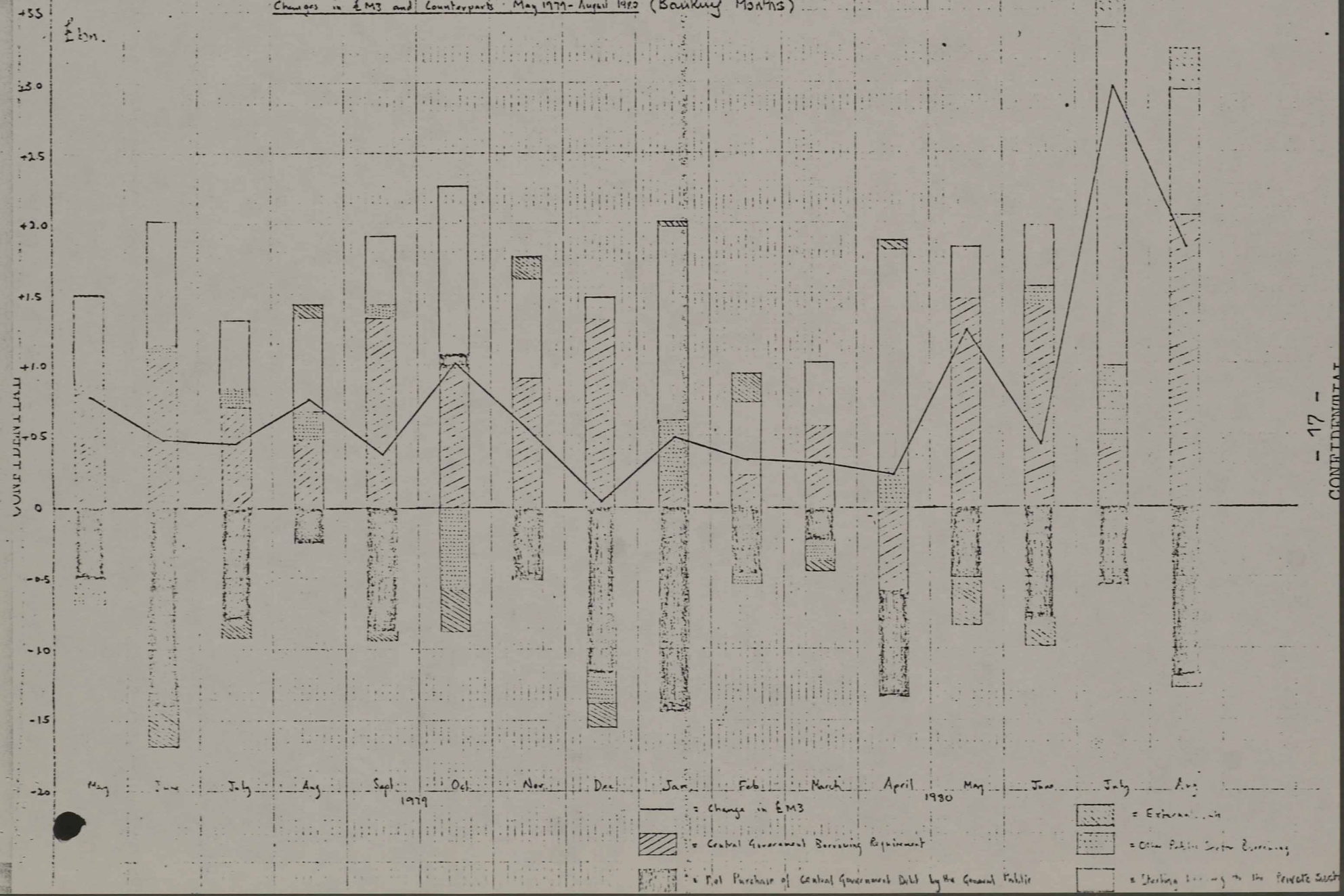
TABLE 2

banking months, £ million
seasonally adjusted

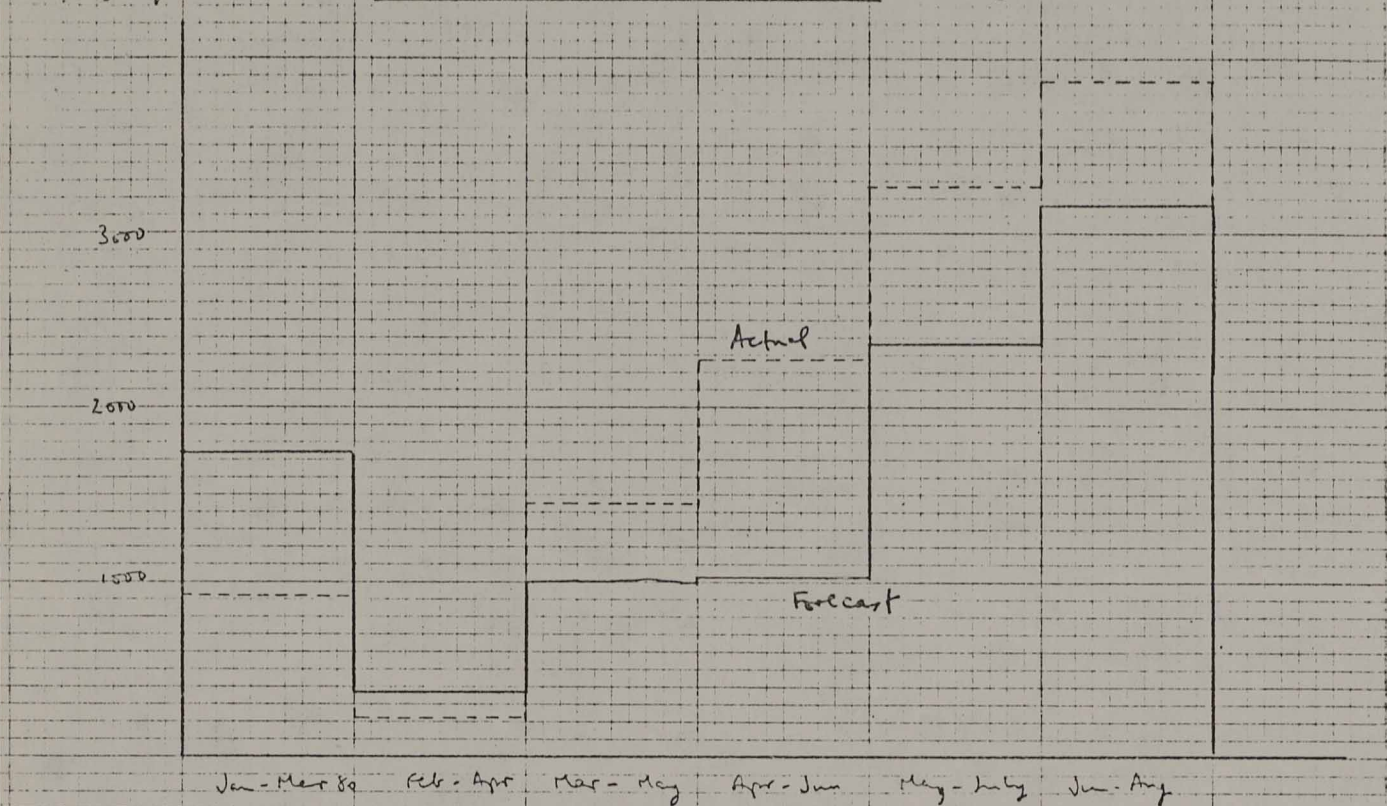
Banking Months	Adjusted £M3		CGBR £m	CG debt sales to non-bank private sector £m	"Adjusted"* Other Public Sector Borrowing (ie contribution to DCE) £m	"Adjusted"* Bank Lending to the private sector	
	£m	(% annual rate)				£m	(% annual rate)
June 1978- June 1979	6290	(13%)	8900	- 9720	780	7090	(21%)
June 1979- November 1979 (5 months)	3910	(19%)	4420	- 2310	- 80	4210	(26%)
November 1979- April 1980 (5 months)	2270	(10%)	1650	- 4070	470	4580	(27%)
April 1980- August 1980 (4 months)	4990	(27%)	5340	- 3210	260	3130	(21%)

* These figures have been adjusted for the estimated effects on the recorded figures of disintermediation induced by the imposition and subsequent removal of the corset.

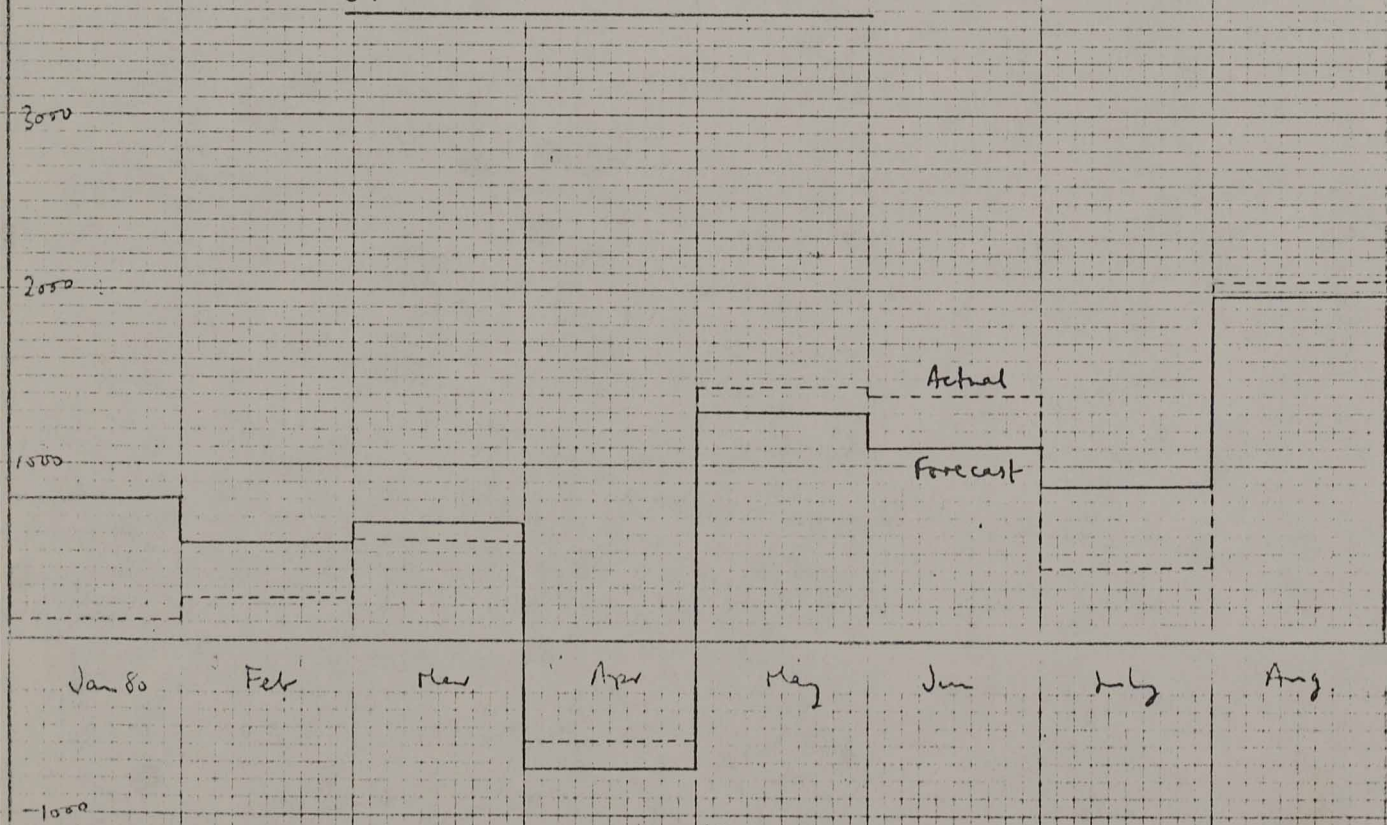
Changes in £M3 and Counterparts May 1979 - August 1980 (Banking Months)



(i) Forecasts 3 months ahead (banking months)

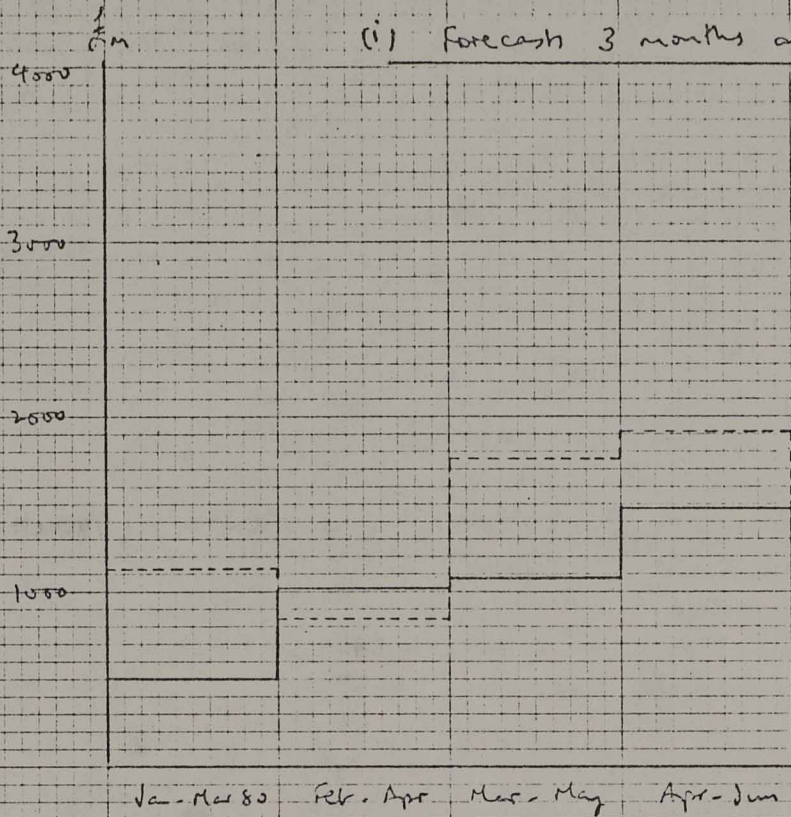


(ii) Forecasts 1 month ahead.



Jan - June 1980

(i) Forecast 3 months ahead (banking months)



(ii) Forecast 1 month ahead (banking months)

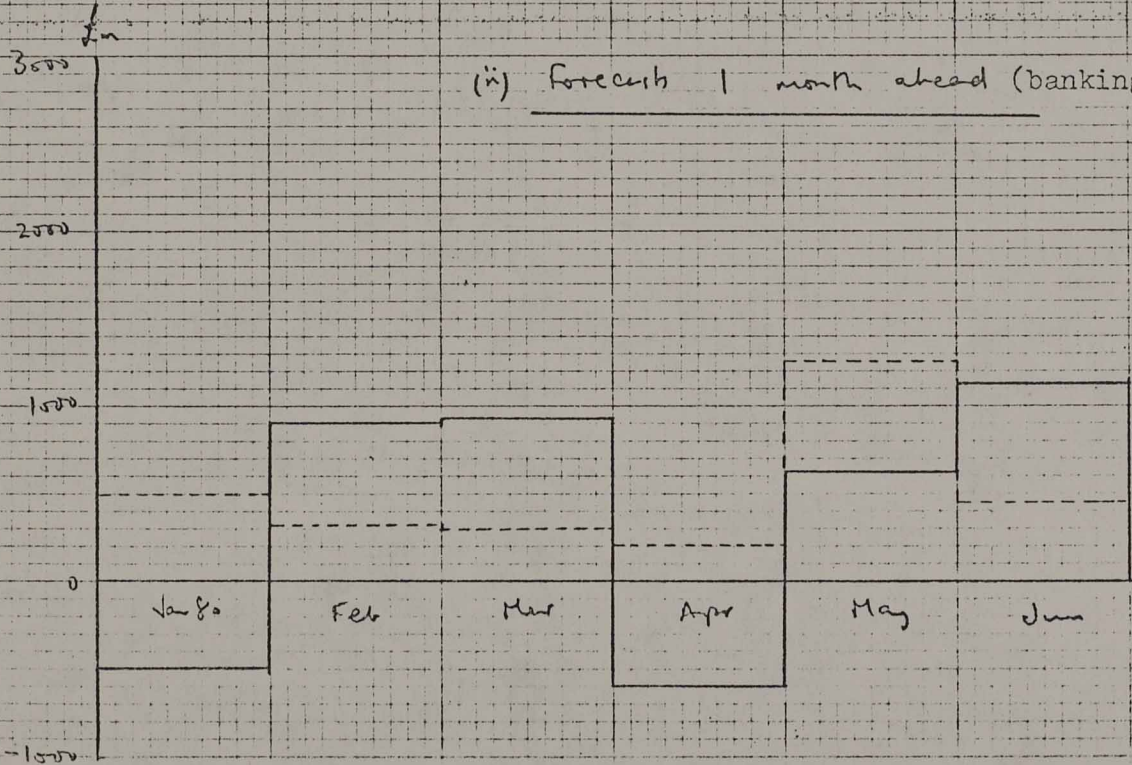
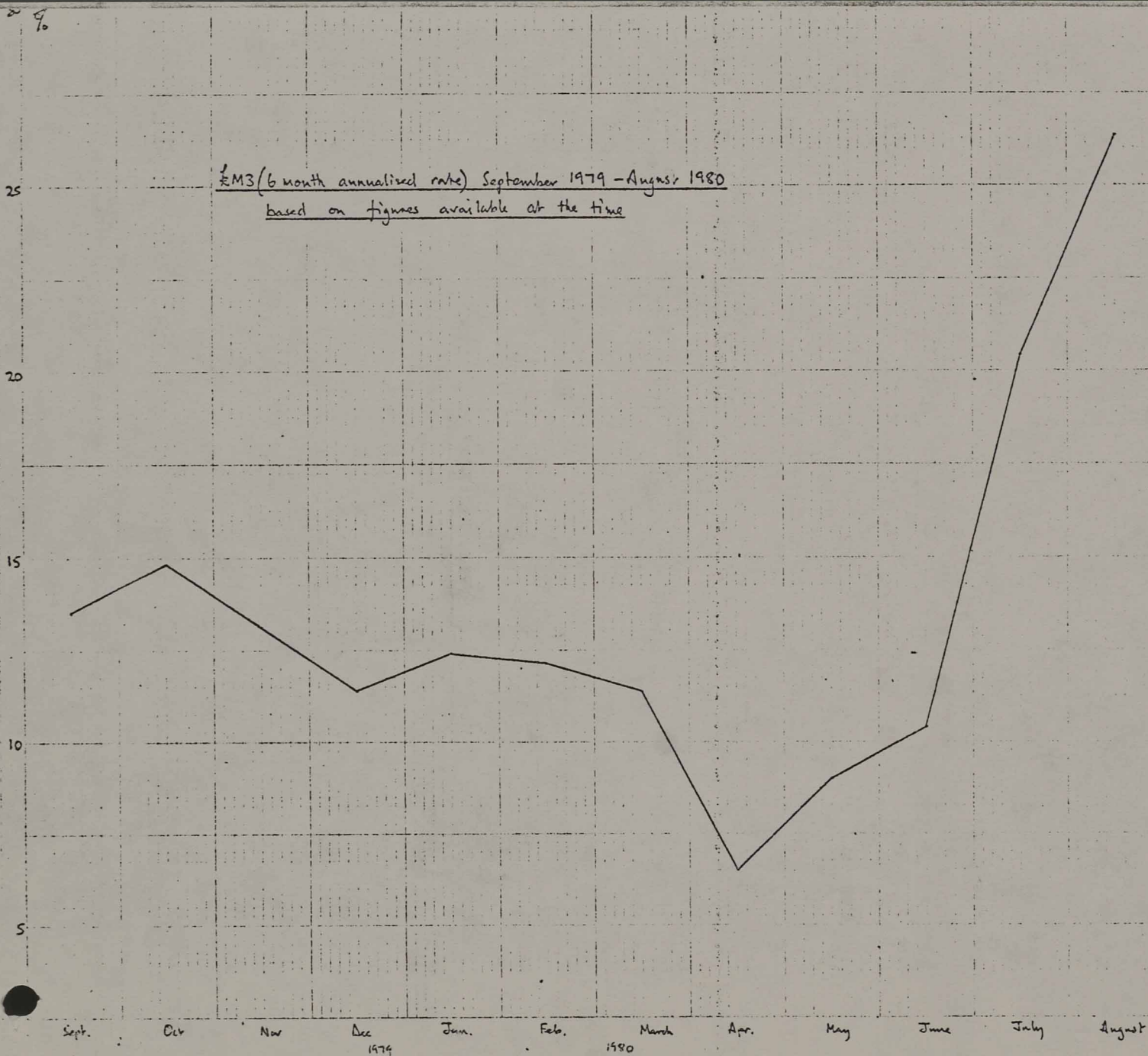


Chart 4

£M3 (6 month annualized rate) September 1979 - August 1980
based on figures available at the time



CONFIDENTIAL

20
CONFIDENTIAL

TABLE 3

RELATIVE INTEREST RATES - MAY 1979-SEPTEMBER 1980

		Government Stock Redemption Yield**					
		<u>MLR</u> ^o	<u>3-month inter-bank rate</u> *	<u>Mortgage Rate</u> [†]	<u>5 years</u>	<u>20 years</u>	
1979	MAY	12	11.88	11.75	11.29	12.24	
	JUNE	14	14.07	11.75	12.34	12.80	
	JULY	14	14.03	11.75	12.48	12.56	
	AUGUST	14	14.25	11.75	12.17	12.41	
	SEPTEMBER	14	14.16	11.75	12.24	12.57	
	OCTOBER	14	14.75	11.75	13.31	13.45	
	NOVEMBER	17	16.88	11.75	15.66	14.79	
	DECEMBER	17	17.00	15.00	15.10	14.67	
	1980	JANUARY	17	17.32	15.00	14.99	14.07
		FEBRUARY	17	18.19	15.00	15.33	14.60
		MARCH	17	18.19	15.00	15.10	14.64
		APRIL	17	17.35	15.00	14.14	14.09
MAY		17	17.07	15.00	14.08	14.01	
JUNE		17	16.88	15.00	13.09	13.75	
JULY		16	15.44	15.00	13.00	13.11	
AUGUST		16	16.88	15.00	13.95	13.92	
SEPTEMBER	16	15.75 ^{††}	15.00	13.02 ^{††}	13.33 ^{††}		

^o At end month.

* Mean of the lowest bid and highest offer rates on the last Friday of the month.

[†] Rate recommended by the Building Societies Association. Calculated at end month.

** Calculated on the last working days of the month.

^{††} Most recent figure available.

RECENT BANK LENDING BEHAVIOUR

TABLE 4

	Increase in bank lending (%)					Percentage increase in:					
	Personal sector	Industrial & commercial companies	Other financial institutions	Total private sector	Total including bill leak	Real GDP	RPDI	RPI	Book value of stocks	ICC's financial deficit	Short term interest rates
<u>.2 months to</u>											
mid-1977	13.4	14.7	5.4	13.5	13.4	2.4	-3.6	17.4	24.0	-168	8.05
mid-1978	19.3	9.8	21.6	13.4	12.6	3.8	10.0	7.6	10.2	295	9.02
mid-1979	24.4	19.8	21.0	21.2	23.6	3.2	5.8	10.6	16.5	-133	12.22
mid-1980	28.9	17.4	37.9	22.6	24.2	-4.3	2.0	21.5	15.5	-1250	17.16
<u>Quarterly change</u>											
1979 Q3	7.3	3.4	11.5	5.3	6.5	-5.2	-0.1	6.7	4.5	-695	14.09
Q4	6.0	2.4	9.8	4.2	4.5	3.8	3.9	2.8	5.0	-1478	15.69
1980 Q1	6.3	5.4	2.6	5.4	5.0	-0.8	-1.5	4.8	3.2	-503	17.68
Q2	6.6	5.2	9.8	6.1	6.3	-1.9	-0.3	5.8	2.0	-1250	17.16

CONFIDENTIAL

CONFIDENTIAL

MONITORING THE PSBR

A "monthly note on the borrowing requirement" is circulated to Ministers and senior management in Treasury. Copies also go to the Bank of England. This note is a round up of events to date and may include an appraisal of the prospect for the year in months when there is not an up to date national income forecast, containing a forecast of the PSBR. This note draws on the regular assessments of detailed aspects of public sector transactions that are produced in various parts of the Treasury.

2. Of central government transactions, tax collections by Inland Revenue and Customs and Excise and expenditure from votes by government departments are all monitored monthly against monthly or quarterly profiles prepared early in the financial year.

3. At budget time, detailed monthly profiles for each category of tax are obtained from the revenue departments. These profiles are consistent with the budget forecast for the year. These profiles are used to determine variance from forecast when the monthly actuals are received. Any deviations which is expected to lead to a change in trend is reported in the "monthly note on the borrowing requirement" which is circulated to Ministers and senior management.

4. Detailed quarterly profiles of expenditure from each Vote are obtained from departments four to six weeks after Budget day. Actual expenditure is compared with profiles each month by the Treasury and variations are examined. For cash limited expenditure explanations are sought from departments for any excess expenditure so that corrective action, if necessary, can be taken to ensure that the cash limits are not breached. For non-cash limited expenditure the Estimates and profiles depend on economic assumptions - unemployment, prices, interest rates etc. If these assumptions turn out wrong then this is an important reason for differences between

actual and budgetted expenditure. All variations from profile are reported to senior management.

5. Other central government transactions and the central government borrowing requirement are examined monthly, mainly by reference to the Budget forecast for the year as a whole, and to corresponding transactions in previous years.

6. Monitoring of borrowing by local authorities and public corporations is maintained, also using Budget forecasts and previous years as main reference points. In addition, attempts are made to assess quarterly local authority current expenditure, mainly from trends in employment, and also local authority capital expenditure, and to relate both to plans and controls for the year as a whole.

-7 OCT 1980



Recon. 11.

1 October, 1980

I enclose my note of the meeting which the Prime Minister had with Professor Karl Brunner and others yesterday on Monetary Base Control.

J. P. LANKESTER

A J Wiggins, Esq
HM Treasury

AW

Blind cc:- Mr Hoskyns, Mr Wolfson
 Mr Ingham, Sir R Armstrong
Copied to Master set

NOTE OF A MEETING BETWEEN THE PRIME MINISTER AND FOREIGN
 PARTICIPANTS IN A SEMINAR ON MONETARY BASE CONTROL: 1430 HOURS
 30 SEPTEMBER AT 10 DOWNING STREET

Present

Prime Minister
 Mr. P. Middleton
 Mr. T. Lankester

Professor Karl Brunner
 Professor Allan Meltzer
 Dr. Hermann-Josef Dudler
 Dr. Kurt Schiltnknecht
 Professor Mario Monti
 Professor James Pierce

* * * * *

Mr. Middleton summarised very briefly the discussion in the Seminar on MBC which had been held for UK participants the previous day. They had first discussed the period over which it was possible and desirable to control the monetary base, and had concluded that the shortest period possible was three months. They had then discussed how the clearers would react to an MBC system. They had concluded that the overdraft system in its present form would have to go. In addition, it was clear that the discount houses would no longer function as they did at present. Finally, they had discussed the issue of mandatory versus non-mandatory forms of MBC. There would be problems with both forms: for example, with a non-mandatory system, there would be a tendency to disintermediation; with a mandatory system, there was great uncertainty as to what would happen. But although there would be problems with both methods, the distinction between them was less important than

/the decision

Dr. Schiltknecht said that in Switzerland the authorities had dispensed with any targetting of the exchange rate or interest rates, and instead they simply had a target for the monetary base. By experience, they knew that inflation would not break out if the monetary base was controlled.

Professor Meltzer said that the UK Government was on target for meeting its inflation objective. But the recent jump in sterling M3, even though some of it was due to the end of the corset, underlined the difficulties which the authorities had in controlling the money supply. Under the present control arrangements, there was a tendency to "procyclicality": the Bank was slow to respond to changes in monetary conditions in its manipulation of interest rates, and this simply made the cycle worse. The Government should free interest rates right away, and move over to controlling the monetary base. The M3 target should be dispensed with, and replaced by a new target. For M_0 it was particularly important to move quickly so as to get the monetary aggregates under control before the recovery appeared. He admitted, however, that there would be a problem of political credibility in moving from one target definition to another: somehow it would have to be explained that the new target was a continuation of existing strategy.

Dr. Dudler said that he was less confident than some about the speed with which economic agents would respond to monetary targets, even if they were achieved. For example, in Germany after a monetary base target was adopted in 1974, wage settlements had continued at an excessive rate. But over time tight control of the monetary base did seem to have the desired effect: and agents were likely to respond more quickly with the penalties which were implicit in an MBC system than under the UK's present arrangements.

Professor Monti said that he too would support a move by the UK authorities to MBC. The Italian authorities had used MBC for some time. Although Italy's monetary performance had been less than satisfactory this was not because of inadequate instruments; rather, it was because the Government had not been prepared to take

/interest rate

the decision of whether or not to adopt MBC in any form.

As for the second Seminar with the foreign experts earlier that day, there had been a general consensus that the existing instruments were inadequate to control the monetary aggregates in the way the Government desired, and that reforms were needed. Most of the participants were strong advocates of MBC, but they were concerned about the transitional arrangements in moving from the present system. It was clear that it was not possible to combine control of the monetary base with short-term control of sterling M3. This posed a political problem insofar as the Government was committed to a M3 target. But from an economic standpoint, the majority view was that controlling the monetary base was more important in the fight against inflation than controlling M3, and therefore converting to a monetary base target would be desirable.

Dr. Brunner said that the issue was essentially simple. Either, the Bank would continue with its present instruments, and M3 would continue to be out of control, or we should move over to MBC. In designing the present monetary strategy, the authorities had virtually made it certain that the strategy would fail. The only viable way forward was for the authorities to set a target for the monetary base; he was confident that over a period the other monetary aggregates would follow a similar path. In any case, he believed that there was a good relationship between M_0 and inflation. Having announced a target for M_0 , the Bank would have the job of both achieving it - that should not be difficult, given the will - but also of communicating to the public what it was trying to do. By influencing expectations, the cost of getting inflation down in terms of lost output and jobs would be that much less.

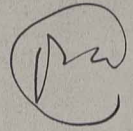
Dr. Pierce said that at present M3 was planned by the authorities by fixing interest rates, and too often the interest rate judgement was wrong. To the extent that errors occurred, they lost control of the money supply. By contrast, if they were to control the monetary base, they would have effective control over credit creation.

interest rate consequences of the monetary base targets. In other words, they had the right levers but not the political will.

R.

1 October, 1980

Is monetary base control just interest rate control in disguise?



Mervyn Lewis

University of Adelaide and visiting scholar, economics department, Bank of England*

The debate about monetary base control concerns the first principles of monetary economics. The growth of the wholesale banking markets raises vital issues

Is monetary base control merely 'a means for the markets to generate the *interest rates* necessary to bring the rate of growth of the money supply back towards the desired path' (green paper on *Monetary Control*, our emphasis), or is it something more? If the former, most of the participants in the flagging monetary control debate could eventually reach some form of accommodation, in which interest rates are left more to market forces. Many of the critics of present monetary policies really wanted no more than this in the first place. For their part, the Treasury and the Bank of England would like to see interest rates at some remove from direct political interference.

The idea that control of the money supply via the monetary base is different from interest rate control was stated forcibly by Milton Friedman to the House of Commons Select Committee (as reported in *The Observer*, July 6):

Direct control of the monetary base is an alternative to . . . interest rates as a means of controlling monetary growth. Of course, direct control of the monetary base will affect interest rates, but that is a very different thing from controlling monetary growth through interest rates.

If monetary base control is different, we must ask how it works and provide a frame of reference for evaluating its costs and benefits vis-à-vis interest rate control. Our concern is with the behaviour of the banking system, for this is where the money supply problem currently exists.

Base money (alias high-powered money or simply cash) is important to the banking system because it is the ultimate means of payment. Convertibility into cash is one of the characteristics expected of deposits which are treated as 'money', while transferability in the settlement of debts and to make payments is a distinguishing feature of banking services. In an overdraft system, transfers can also be made from accounts in debit, so that liquidity services are provided on both sides of the balance sheet. Banks can be visualised as purchasing

primary securities, pooling them to eliminate risks and combining them with capital, labour, materials and high-powered money to create 'liquidity'. High-powered money has the role of an input into banks' production function.

How much high-powered money is required by the banks depends on the nature of the production process and on institutional arrangements. Banks providing liquidity services face uncertain demand for cash from deposits and from loans where there are undrawn facilities or open credit lines. They are able to employ the law of large numbers to keep cash at low levels, but cannot eliminate the need for cash completely.

Base money

Control of the money supply is exercised by restricting the quantity of the factor of production, base money, to the banking industry. Since the monetary authorities have a monopoly over the production of this factor input, they can make it available in less than perfectly elastic supply: in the limit, the supply could be made perfectly inelastic. Banks are then in the same position as firms in any industry for which the inputs required for production are available only at sharply increasing cost.

One immediate difference from the interest rate mechanism presently operated is the involvement of the banks. Following the removal of the corset, the banks are now almost passive spectators in the process of monetary control. In response to an increase in minimum lending rate (MLR), their 'job' is to raise base rates in line (which they have done), but that is about all. The Bank of England, as it were, appeals directly over their heads to the public's demand for credit. In the meantime, the banks can continue to push out facilities with relative impunity. If borrowers are not daunted by the higher interest rates, the banks could conceive their job to include bidding for deposits and reserves to sustain any expansion of advances. Monetary base control, by contrast, impinges directly upon banks' decision-making and provides

*The views expressed are the author's own and should not be interpreted as those of the Bank of England.

a pecuniary incentive for them to participate in the process of adjusting their balance sheets to the dictates of monetary policy.

A second difference concerns the adjustment mechanism which, under monetary base control, would be chosen by the banks on profit-maximising grounds. At present, the form of the adjustment (eg interest rates operating upon credit demand) is chosen by the authorities. If that fails, the authorities must either raise rates further, or wait for credit demands to subside. Until the latter eventuates, banks are supplied with cash to prevent them running out of reserves. Left to themselves, banks could well choose to respond to a reserve shortage in the same way—by raising deposit and loan rates. Should interest rates fail to restrain the demand for money or credit, this could not be the end of the matter. A reserve deficiency would still exist and the banks would be forced to try something else. Some assurance would exist that the adjustments would proceed until monetary growth came into line.

Liability management

The idea that there is some new breed of banker who will always eschew asset management for liability management is patently false. If interbank rates are bid up high enough, it would pay some banks to sell bills and bonds to the private sector in order to obtain funds for lending out in the interbank market. Liability management is allowed to succeed because the Bank provides the reserves needed to validate deposit expansion.

Perhaps the most important difference is in terms of the implications for behaviour next time round. Once banks are forced to make up reserve shortages by borrowing interbank at 'penalty cost' or by selling securities at a loss, they are likely to exercise much greater care in future when granting facilities and open credit lines. Unused facilities are a valuable source of liquidity to customers, and banks might, in different circumstances, be expected to vary the 'price' for this service.

In this description, monetary base control is qualitatively different from interest rate control. At the aggregate level it operates by imposing a quantitative restriction upon banks' intermediation. This is translated directly into individual banks' profit calculus. Both the initial response and subsequent adjustments are determined by market forces. The system of rewards and punishments given to bank behaviour would be a very considerable benefit indeed. Unfortunately, it is not as easy to be clear about the possible costs.

For restraint upon cash to be an effective control device, it is not enough that its supply be inelastic, as is witnessed by the idea of using negotiable licences to control banks' deposit expansion. As with base money, the supply of negotiable licences would be monopolised by the authorities. As banks expand beyond allowable limits, variations in the

market price would raise costs against individual banks. Yet it is generally agreed that such a scheme would encourage banking to be done outside the controlled area—particularly in offshore markets. Would the same consequences follow from monetary base control? If banks' holdings of base money were involuntary, as under a reserve requirement, this might well be the case. But we have argued that banks' demand is a voluntary one based on a production function for liquidity services, not an arbitrary restriction upon an institution designated to be a 'bank'.

Institutions in the Eurosterling market (which is still relatively undeveloped) providing substitute liquidity services would require inputs of high-powered money, just as is the case in domestic markets. What competitive advantages would they have over domestic banks to be able to attract the deposits and reserves needed for liquidity production? Much the same question must be asked of the idea that non-banking intermediaries in domestic markets would provide substitute liquidity services.

But are liquidity services the distinguishing characteristic of money? If they are, then perhaps one-third of £M3 should be excluded from the definition. This is a conservative estimate of the amount that represents wholesale funds of the non-bank private sector, much of which is held in banks which specialise in wholesale banking. This type of banking differs substantially from retail banking, which is the model outlined earlier. Retail banks exist by producing liquidity services; they endow claims with attributes of capital certainty, convertibility and transferability. The economic basis of wholesale banking is to lower transactions costs in markets for corporate borrowing and lending and to intermediate within the term structure of interest rates.

Wholesale deposits

In contrast with retail banking, in which virtually all deposits are in sterling and withdrawable on demand (or at very short notice), wholesale deposits are for various maturities and in a variety of currencies. Unlike retail deposits, where each bank may have millions of small accounts, to which the law of large numbers can be applied, each bank in wholesale business may have only a few hundred large accounts and is not large enough, relative to the total market for wholesale funds, to apply the same principles.

Because the economic basis of wholesale banking is different and the balance sheet structure differs, a different 'production process' applies. A substantial degree of matching of currency and maturity is the rule, even when, with non-bank business, substantial maturity transformation occurs. (Maturity transformation in sterling wholesale banking is only slightly less than that which now occurs in Eurocurrency business.) A critical role is played by the interbank market in 'reconciling' the public's

preferences with those of the banks. Funds are channelled from ultimate lenders to ultimate borrowers through several banks. What begin as short-term deposits finish up as rollover loans of several years' duration. Each bank is mismatched, but not to any great extent, and no one bank is left with a large share of the transformation. This is in marked contrast to retail operations, in which the transformation is undertaken fully by the bank.

It follows that the Bank's proposals about prudential liquidity, with the higher requirements on interbank funds, strike at the heart of wholesale banking, and indicate a failure to understand this type of intermediation. Our immediate concern, however, is that for wholesale banking activities there is no demand for base money. In this sense, much of the British banking system has already progressed to a cashless society. Even the concept of a reserve ratio has little meaning, for the demand for marketable securities (bills, CDs) to cover an open position depends on the mismatching, maturity by maturity, not upon any scale measure of the total balance sheet.

Helpful analogies

Restraint upon the supply of base money will curtail retail banking and those substitutes for retail banking which involve the production of liquidity services using inputs of high-powered money (or, in a pyramid of credit, claims against retail banks). If, as we have argued, wholesale banking involves different services and different production processes, it is unlikely to be constrained directly by monetary base control. The vital question, then, is should it?

Analogies are helpful, but which is the correct one? At one extreme, we could, as Friedman does, liken the production of money to that of motor cars, with high-powered money like steel. Steel is a vital and irreplaceable input to the production of motor cars, at least in the short run. By restricting the supply of steel, control could be exercised over the production of motor cars, even though there are different brands and different models. Alternatively, we could envisage money to be like containers. There are several different types of container (steel cans, glass, aluminium, plastic) and many different production processes involving quite different inputs. Each type of container, and its associated input, has its distinctive merits, but all can be substituted at a price. Is the same true of different forms of banking and finance more generally?

Thus the monetary control debate is really a debate about the first principles of monetary economics. Is the aim of monetary policy to control something special called money, or is it to control all borrowings and lendings and all forms of financing in the economy? In the latter case, the Bank's interest rate policies are clearly appropriate. But if money does have a special place, it is unnecessary and inefficient for the Bank to control all borrow-

ings and lendings when a more direct means of controlling the relevant money supply is available. Monetary base control will involve interest rate variations as a by-product or as a means to an end, but it may not prove necessary to deflate all borrowings and lendings and alter all credit conditions in the economy on the way. Altering all financing demands in order to change one particular form of financing is a blunt instrument.

Different environment

There is something to be said for both views. Proponents of monetary base control have, somewhat slavishly, applied a theory developed in the United States, with its preponderance of retail banking, to the quite different environment of the British banking system. On the other hand, it is surely the case that those bank and non-bank claims which are backed (directly or indirectly) by base money are more liquid than a lot of wholesale money, some of which differs little in character from commercial paper. By ignoring the importance of base money to liquidity production, the Bank has overemphasised wholesale banking and failed to distinguish money from credit.

This distinction between money and credit is central for how we interpret the 're-intermediation' expanding the money supply in July 1980 following the removal of the corset. On the credit view, it is the total of borrowing and lending which matters, not the distribution of this total between bank and non-bank markets. Consequently, however unfortunate it is, the bill leak has already occurred, and the replacement of bank acceptances by bank lending does not alter this fact. This view rests critically upon assumptions about the extent of maturity transformation undertaken by the banking system. If 6-month bank acceptances become 6-month bills discounted by the banks, financed by 6-month CDs, the credit view can be sustained—although we must ask why re-intermediation takes place.

Re-intermediation

More typically, the 6-month bank acceptance would become a medium-term loan at variable interest rates with the lender holding a short-term deposit. (Even in the case of wholesale deposits, nearly half have a maturity of 7 days or less.) In this particular instance, the extent of liquidity production appears substantial; most of the lending appears to be by deposit banks and a substantial amount of the deposit increase is of sight deposits.

It follows that the re-intermediation is not innocuous and the reason is the liquidity creation implied by bank intermediation, especially that by deposit banks. How many more examples will be needed before the authorities realise that interest rate control upon deposit banks' intermediation needs to be supplemented by constraint upon the availability of cash?



Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

26th September 1980

T. Lankester Esq.
10 Downing Street
LONDON
SW1

Dear Tim,

SWISS MONETARY POLICY

Switzerland is one of the countries whose experience and practice is particularly relevant to our concern about methods of monetary control. You might therefore like to have the attached note describing briefly their conduct of monetary policy in recent years. You will see that the Swiss record in sticking to their monetary targets is a good deal less than perfect; indeed they are one of the few countries to have abandoned their monetary targets in recent years. Furthermore there are features of the Swiss system which make it a less than perfect model for us - especially the absence of a sophisticated money market.

This does not mean that we are in any way reluctant to learn from the Swiss. One of their leading experts is among the group of distinguished foreigners who will be discussing the improvement of monetary control techniques with the Treasury and the Bank on Tuesday of next week, and whom the Prime Minister will be seeing later in the day.

*Yours ever,
Peter*

P.S. JENKINS
Private Secretary

MONETARY POLICY IN SWITZERLAND

1. The Swiss were early converts to monetary targets. The advent of floating exchange rates provided the opportunity for setting independent monetary objectives as part of a policy of ensuring price stability. Monetary targets were first set in 1975. These were expressed in terms of the annual average rate of growth of M1. In 1975 and 1976, a target for the growth in monetary base was published alongside the M1 target but it was dropped in 1977 and 1978. For the first 3 years, the outturn was quite close to the target, though there was a small overshoot in 1976 as a result of a shift from time deposits to sight deposits associated with lower interest rates on savings.
2. In 1978, however, the Swiss franc came under intense pressure despite very low interest rates and the introduction of a number of inflow controls. In effective terms the exchange rate appreciated by 20% between December 1977 and September 1978. In October 1978, the Swiss National Bank (SNB) announced a major change of policy. No further appreciation against the DM would be permitted and the SNB would intervene to achieve a rate of at least SF80 per DM100. (Germany accounts for about 1/5th of Swiss exports). This decision, which was related to the SNB's participation in the central bank arrangements to stabilise the dollar, implied the abandonment of the monetary target. During 1978 M1 rose by 22%, December to December, or 16% on average for the year, against a target of 5%.
3. No monetary target was set for 1979. During the course of the year monetary conditions gradually returned to "normal", and the exchange rate fell back from its peak. The excess of liquidity was gradually reabsorbed. M1 fell back from SF66 billion at the end of 1978 to SF62 billion by the middle of 1979 and it remained at that level for the rest of the year. By the end of the year, the SNB was able to unwind a number of measures aimed at discouraging capital inflows and in December the negative interest rate on foreign bank deposits was abolished.
4. At the end of 1979, the SNB decided once more to announce a monetary target. This was set at 4% for the period November to November 1980 and it was expressed in terms of the growth in the monetary base rather than M1. By mid 1980, the monetary base had

shown no increase over a year earlier and M1 had fallen about 8% below the level of a year earlier.

5. In response to the questionnaire sent by the Treasury and Civil Service Committee, the SNB reaffirmed its belief in the use of monetary targets but it was prepared to be pragmatic. Its memorandum stated:

"On the whole, we believe that the benefits exceed the costs of a money stock target. However, as far as the Swiss approach is concerned, we do not apply monetary targets in a rigid manner. Normally, we attempt to stick to the target as closely as we can, but are also prepared to depart from the target if major unforeseen events should occur. Even though our approach to targeting the money stock is not rigid, we do not consider it to be ineffective. An unforeseen event really must have a major detrimental impact on the Swiss economy if the money stock target is to be abandoned temporarily".

6. Prior to 1978, when the monetary target was expressed in terms of M1, there was thought to have been a fairly stable money multiplier ie the ratio between the monetary base and M1. Developments in 1978 and 1979 have called that into question. The SNB now believes that the demand for money is subject to shifts induced by exchange rate expectations. At times when the Swiss franc is expected to appreciate, investors alter the currency composition of their portfolios pushing up the demand for Swiss money and other Swiss franc assets.

7. With a target set in terms of M1 there was a danger of the authorities responding inappropriately if the money stock began to expand rapidly. The central bank would not know whether this was because monetary policy was too lax or because exchange rate expectations had changed. If it were wrongly interpreted as the former, the authorities would contract the monetary base and add to the deflationary pressures caused by the strong exchange rate.

8. To counter these problems, the SNB decided to set its target for 1980 only in terms of monetary base. In an interview last May, when the latest statistics for M1 were showing a fall of 12% on a year earlier, Dr Leutwiler, the SNB President, stated that the

decision to fix the target in terms of monetary base has been the correct one. If the target had been set for M1, it would have allowed the monetary base to expand too fast, further weakening the Swiss franc, ie the converse of para 7.

9. The SNB memorandum to the TCSC described the short run volatility of the money stock and the monetary base as "considerable", but this is not thought to weaken the impact of targets if public confidence that they will ultimately be met is retained. It warned that an attempt to eliminate the short run volatility of the monetary aggregates would be liable to increase interest rate and exchange rate volatility.

10. Irrespective of the aggregate for which the target has been set, monetary base has always been the instrument of control. There are several reasons for this stemming from features of the Swiss financial system. Swiss banks are normally willing to hold significant balances with the central bank even in the absence of monetary cash requirements. This reflects the fact that there is not a well developed domestic money market in Switzerland and that banks have thus no alternative source to the central bank for primary liquidity. The absence of a money market, which makes it difficult to conduct open-market operations in short term domestic securities, rules out a strategy of monetary control based on short term interest rates as an instrument of policy.

11. The conduct of monetary policy has been aided by the small size of the public sector. In 1977 tax revenue was equivalent to 31.5% of GDP, compared with the OECD average of 36.2%, and the average for OECD Europe of 38%. The public sector deficits have also been small by international standards. Over the last 3 years the general government borrowing requirement has averaged around 1%.

12. It is dangerous to generalise from Swiss experience as it is an economy sui generis. Certainly, the experience of 1978 seems to have had little permanent effect on inflation which accelerated from 1% in 1978 to about 5% by December 1979. This was still the best performance in the OECD area. By June 1980 inflation had dropped to 3%.

13. By contrast, its growth performance has been the worst in the OECD area. Virtually alone among industrial countries, the level of

GNP in 1980 will still be below (2%) the 1973 level. This has, however, been consistent with the maintenance of an unemployment rate of less than $\frac{1}{2}$ %. The burden has fallen on foreign workers. Between 1974 and 1977 the total labour force contracted by 270,000 (10%) of which 210,000 was accounted for by foreign workers.

IG3 Division
HM Treasury
26 September 1980

SWITZERLAND: BASIC DATA

	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>
GNP growth	1.5	7.3	1.4	2.4	0.2	0.8	1.6
Inflation	9.8	6.7	1.7	1.3	1.0	3.6	3.2
Current Balance \$bn	0.2	2.6	3.5	3.4	4.4	2.8	1.0
Interest Rates (3 months, end period)	6.0	2.5	1.5	1.1	0.1	4.4	4.7
General Government Borrowing Requirement (% of GNP)	-1.6	-1.6	-1.8	-1.0	-0.3	-1.3	-1.3

Comparison of Target and Actual
Growth in M1

%

	Target	Actual
1975	6	5.9
1976	6	8.0
1977	5	5.4
1978	5	16.2



B

H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-233 3000

Direct Dialling 01-233 5627

P E Middleton
Deputy
Under Secretary

26 September 1980

T Lankester Esq
10 Downing Street

Dear Tim,

MONETARY CONTROL *(prepared by Peter Middleton)*

I attach a list of those attending our seminar on Tuesday 30 September. I will bring them along to see the Prime Minister at 4.30 pm.

2. The Chancellor's office have sent over a note on monetary policy in Switzerland. But the Prime Minister might also like to know a little about monetary control in the other countries represented.

The United States

3. In October last year the Fed went over to a system of reserve targeting. It announced that it would place "greater emphasis in day-to-day operations on the supply of bank reserves and less emphasis on confining short term fluctuations in the Federal funds rate". The change has always been presented by the Fed as one of emphasis. Targets for the main monetary aggregates are translated into weekly targets for reserves, and open market operations then aim to add or drain reserves from the system as necessary.

4. The Fed funds rate is allowed to fluctuate freely within a band of four percentage points: only if it comes up against the four point limit does the open market manager (in the New York Fed) have to ask for supplementary instructions. Moreover, the interest rate constraint applies only to a week's average: on individual days, rates may go beyond the four point range. The current policy thus allows more strain to be borne by interest rates than was the case between 1972 and 1976, when the permitted variation in the Fed funds rate was only 1 - 1½%.

5. The Fed has been at pains to acknowledge that the link between reserves and the target monetary aggregates is "complicated and variable", changing "with shifts in the currency and deposit mix, with changes in bank demands for excess reserves and borrowing, and with timing problems related to lagged reserve accounting". Indeed, the Fed's evidence to the Treasury and Civil Service Committee, from which these quotations are taken, makes it clear that a great number of assumptions have to be made to derive the reserve target. Each is a matter of judgement, and

subject to a large margin of error. In practice, the reserve target has been only the most short term of intermediate objectives, adjusted almost on a weekly basis in the light of outturns for the monetary aggregates.

6. The American system is thus not a fully fledged monetary base system like the Swiss. Brunner and Meltzer criticise it severely on this account. But it has freed interest rates and has succeeded in restoring confidence in monetary control when it was falling into disrepute. In my view the most promising course for the UK is to move in the direction of monetary base control rather like the Americans have in order to get flexible interest rates while avoiding rigidly fixing the system before all the consequences of the new arrangements are known.

7. Since October, the growth of the monetary aggregates in the United States has not, on average, been too far out of line with the targets. But it is also true that the change in operating methods has by no means yielded a smooth path for the target monetary aggregates. M1A and M1B actually fell in the second quarter of the year. That has been sharply reversed in the third quarter, in which M1A has so far been expanding at about twice the target rate of $6\frac{1}{2}\%$ a year.

8. Moreover, the month-to-month changes have been still more volatile. At the "annual rate" in which American statistics are usually given, the growth of M1A has bounced around from - 17.7% in April to + 11.4% in June. The estimate for August is + 18%. M1B varied between - 14.1% in April and + 14.9% in June.

9. In terms of monthly averages, the Fed funds rate has varied between 9% and over $17\frac{1}{2}\%$ in the space of only 4 months. Mortgagors are protected because US mortgages are traditionally at fixed rates - though the supply of mortgages virtually dried up when rates rose sharply in the spring. I should perhaps add that in America, as here, monetary policy has been beset with vast numbers of uncertainties. Quite apart from the real shocks to the system, the institutional structure has been changing extraordinarily rapidly. There has, for example, been a fast expansion of interest-bearing chequing accounts in banks and savings and loans, an explosion and then a contraction of "money market funds" outside the established financial intermediaries, and a growth of innumerable other devices to get round Regulation Q (which limited the interest rate which banks and savings and loans could pay on savings accounts). The monetary aggregates have had to be redefined more than once on this account. The public's preferences seem also to have been volatile, with the demand for transactions balances falling more sharply in mid-year than previous relationships would have suggested. The outlook is now considered to be so uncertain that the Fed has been reluctant to roll forward its quantitative targets into 1981, and has only done so under considerable pressure from Congress.

Western Germany

10. Germany does not have a monetary base system. But it sets targets for a peculiar aggregate, central bank money (CBM) which consists of the banks' reserve requirements at given reserve ratios and notes and coin in circulation with the public. It is chosen because it is thought

to be within the central banks control while closely approximating to M3 - a rather wider concept of liquidity than our £M3 but not all that different.

11. The Bundesbank does not really use CBM as an instrument - otherwise it would in effect be a MBC system. It controls money market conditions which have an indirect influence on CBM by a combination of discretionary changes in interest rates, open market operations and rediscount quotas together with variations in reserve requirements. It is in respect of this last instrument that we are interested in their views in the present context. By varying the terms on which it satisfies the demand for cash and bankers balances, the Bundesbank gradually brings CBM in line with the target and exerts a broad influence over £M3.

Italy

12. The Italians have a complicated system and their record of control in relation to their targets is far from brilliant. They have targets for monetary base and various aggregates related to the domestic creation of money - domestic credit expansion (widely defined) and bank lending. The Bank has an internal target for the growth of the base each month - designed to be compatible with the credit aggregates, but it adjusts this judgementally for special factors.

13. The base itself is controlled by open market operations in Treasury bills so that the desired level of bank reserves is maintained. But it is not a free market system: there are direct controls on bank lending which play a major part in restraining monetary growth. And monetary base has been allowed to fluctuate far more than would have been possible if it had been the main instrument of control.

*Yours ever,
Peter.*

P E MIDDLETON

mb

Mario Monti

The notes attached on US, W. German, Britain and Swiss experience with various of monetary base control are worth reading if you can spare the time.

MBC: SEMINAR WITH FOREIGNERS

Professor Karl Brunner:

Rochester University, NY and University of Berne, Switzerland

Professor Allan Meltzer:

Carnegie-Mellon University, Pittsburgh (has worked closely with Professor Brunner)

Dr Hermann-Josef Dudler:

Bundesbank: departmental chief responsible for money and capital markets

Dr Kurt Schiltnknecht:

Swiss National Bank (chief economic adviser to the Governor, with responsibility for advising and operating the Swiss monetary control system)

Professor Mario Monti:

Bocconi University, Milan (also advises Bank of Italy; written extensively on banking behaviour)

Professor James Pierce:

University of California, Berkeley (formerly senior adviser to Arthur Burns at the Fed)

March

CONFIDENTIAL

*Domestic
Monetary Policy*

2

Econ Pd

PRIME MINISTER

SEPTEMBER BANKING FIGURES

I received from the Treasury this evening provisional figures for banking in September, which will be published the Tuesday after next. Sterling M3 went up by about 3%; bank lending to the private sector fell back to about £500 million; and the GGBR was about £1.1 billion (which is more or less in line with the forecast which the Treasury gave you in their last note after adjustment for seasonal factors and conversion from calendar to banking month). The M3 figure must have included some continued re-intermediation, so that the underlying growth must have been lower. The broader aggregate known as PSL1, which excludes the bill leak distortion, went up by only 0.1%.

This is better, and it should mean that we will not be driven into any "crisis action" before the Party Conference; it will also make your speech for the Conference easier.

But the position - taking the first six months of the financial year - still remains very difficult; and important decisions will be needed in October. First, there is the monetary base question; second, the possibility of raising more from the personal sector by extending "granny bonds" and by other possible instruments; and third, the rolling forward of the monetary target and the possible need for further public expenditure cuts and/or tax changes.

The Treasury are working flat out on all this; on monetary base, for example, they have set up a special task force, bringing in people from other Divisions, and from conversations I have had with Peter Middleton and Terry Burns, I think they are determined to get some changes in the way the Bank controls the clearers. The worry is that the Bank dig their heels in; if they do, we will be faced with the difficult decision of whether to insist on changes, given that they have to operate the system.

CONFIDENTIAL /The Treasury

CONFIDENTIAL

- 2 -

The Treasury are preparing papers on the three issues mentioned; also a paper on the underlying economic situation and further notes on the draft exchange rate and the PSBR as a follow up to your last meeting.

It seems best if we consider all this at one long meeting - since the issues are all inter-related. Clive is suggesting in the Business Note that we set aside the whole afternoon of Monday, 13 October.

You are seeing the foreign participants in the monetary base seminar on Tuesday afternoon. Attached at Flag A is a useful summary article on the monetary base issue; at Flags B and C are notes on monetary policy in the countries represented by the foreign participants, including Switzerland.

*T. Conroy
Duty Clerk
PP TL*

c. Mr. Whitmore
Mr. Wolfson
Mr. Hoskyns
Mr. Vereker

26 September 1980

CONFIDENTIAL

Chancellor of the Exchequer

cc Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr Ryrie

for inf:

Mr Williams
Mr Culpin

MONETARY CONTROL SEMINAR

1. You might like to see the agenda and list of participants for the seminar which Mr Fforde and I will be directing on 29 September. The attached article by Mervyn Lewis is a good one which you might like to read.

2. This is of course only part of the process of consultation. We are having a discussion with a number of distinguished foreign pundits - who include Karl Brunner - on Tuesday 30 September. And we have of course got official representations from the main institutions in the UK which are being summarised and analysed.

P E MIDDLETON
18 September 1980

Enc

Mr Lamkesh,

we spoke. The Prime Minister might also like to read the article by Mervyn Lewis.

19/9

LIST OF PARTICIPANTS (EXCLUDING BANK OF ENGLAND AND HM TREASURY)

Professor R Alford	LSE
Professor Artis	Manchester University
J Atkins	Citibank
Professor A Bain	University of Strathclyde
Professor W Buitter	Bristol University
A Courakis	Oxford University
D Currie	London University
T Congdon	Leeds University
G E Gilchrist	Union Discount
D Gowland	York University
Professor B Griffiths	City University
M Hall	Loughborough University
C Johnson	Lloyds Bank
D Kern	National Westminster Bank
T Laugharne	Grieverson, Grant
S Lewis	Phillips & Drew
Professor C Foster	Coopers & Lybrand Assoc Ltd
Professor M Miller	University of Warwick
Professor P Minford	Liverpool University
Professor V Morgan	Reading University
I Morison	Inter-Bank Research Organisation
Professor W Newlyn	Leeds University
G Pepper	Greenwells
R J Petherbridge	Union Discount
G C Powell	Jersey, States Office
B Riley	Guernsey, States Office
Professor H B Rose	Barclays Bank
Professor T Rybzyński	Lazard Bros
D Savage	NIESR
Professor J R Sargent	Midland Bank
A Smithers	Warburgs
M Stewart	University College London
Professor B Tew	Nottingham University
P Turner	James Capel
B Williamson	Gerrard & National Discount
H Wills	LSE
G Wood	City University
P Wood	Barclays International Bank

G. Forsyth

Morgan Grenfell

(A) A

THE MONETARY CONTROL SEMINAR

Introduction

1 There is no fixed timetable for the day's proceedings; we would, however, hope to cover most of the subjects raised in paras 2-9 below (ie to discuss various aspects of the debate on monetary base control (MBC) in theory and in practice) in the morning sessions.

The time horizon for monetary control

2 The first issue is the period over which control is sought. Is there general agreement with the view expressed in the Green Paper that month-by-month control is not essential and that it is doubtful in any case whether any form of control could act with such precision?

3 We would then like to discuss the way in which MBC works and to clarify the implications of MBC for the behaviour of banks. In particular would MBC affect the volume of funds that banks were willing to provide at any given price? In this context, the Group might consider the views put forward by Dr Mervyn Lewis in the attached paper (to be published shortly in The Banker). Is the distinction he draws between retail and wholesale banking a valid one? Would the banks respond to control of the base in the way he suggests?

4 This naturally leads into questions about the implications of MBC for interest rates. We would welcome views on the implications of achieving a given monetary target by MBC rather than the present methods. Would interest rates on average be higher or lower; and would the volatility of interest rates be increased or reduced?

Mandatory forms of MBC

5 The discussion might then move on to mandatory forms of MBC. Having set a mandatory minimum then (except in a system of lead accounting) it is argued in the Green Paper that the authorities

would have to ensure that sufficient base was in fact available at the time when the requirement was to be met. Is this agreed? If so, the main issues then concern the methods by which it would be made available and the interest rate at which assistance was given. What would be the role of the authorities' judgment and what the role of the market in setting interest rates under such a system?

6 A mandatory system has been criticised as inequitable, implying a discriminatory tax on banking. It has also been suggested that disintermediation could occur in response to mandatory MBC as it did in response to the corset. Do these arguments point towards a non-mandatory form of MBC, at least as the better option to consider for the long term, if some form of MBC is favoured?

Non-mandatory MBC

7 A non-mandatory MBC would probably involve more fundamental changes in the structure of financial markets. We would welcome discussion of the nature and the extent of these changes.

8 A non-mandatory control works only if the demand for base has a predictable relationship to the money supply over an operationally relevant time period. But varying degrees of liquidity would also be offered by Treasury bills, etc, even if these assets were no longer rediscountable at the Bank of England. Would the existence and variability of the stock of such assets complicate any relationship between the base and money? If so, does it carry implications for debt management policy under a non-mandatory regime, either because of the implications for banks' likely demand for base or because we should take account of the size of the stock of near-money assets created by central government and other borrowers in assessing monetary conditions?

9 Most forms of MBC would involve to some degree a modification of the lender of last resort facility. It has been suggested that some form of 'half-way house' could be devised, which might limit rather than abolish lender of last resort facilities (and so preserve many of the characteristics of the present system) while still moving towards the principle of non-mandatory MBC - that cash

is a distinctive asset which banks will feel the need to hold in some predictable relationship to their deposits. Is such a half-way house possible on either a theoretical or practical basis? What would be the implications for the structure of financial markets and for the main borrowers and lenders?

Broader issues

10 We would like then to broaden the scope of the discussions and to consider briefly some of the general issues in the debate over rules versus discretion in the conduct of monetary policy.

11 In this context, we might consider the system of automatic interest rate adjustments outlined in Chapter 5 of the Green Paper.

12 There will also be an opportunity for members of the Group to raise other issues relevant to the debate over monetary control. We do not expect clear conclusions to emerge but we do hope for some indication of the range of views on the direction in which monetary control methods should develop.

IS MONETARY BASE CONTROL JUST INTEREST RATE CONTROL IN DISGUISE?

Is monetary base control merely "a means for the markets to generate the interest rates necessary to bring the rate of growth of the money supply back towards the desired path" (Green Paper - our emphasis), or is it something more? If the former, most of the participants to the flagging monetary control debate could eventually reach some form of accommodation, in which interest rates are left more to market forces. Many of the critics of present monetary policies really wanted no more than this in the first place.

The idea that control of the money supply via the monetary base is different from interest rate control was stated forcibly by Milton Friedman to the House of Commons Select Committee (as reported in The Observer, July 6):

"Direct control of the monetary base is an alternative to interest rates as a means of controlling monetary growth. Of course, direct control of the monetary base will affect interest rates, but that is a very different thing from controlling monetary growth through interest rates."

If monetary base control is different, we must ask how it works and provide a frame of reference for evaluating its costs and benefits vis-a-vis interest rate control. Our concern is with the behaviour of the banking system, for this is where the money supply problem currently exists.

Base money (alias high-powered money or simply cash) is important to the banking system because it is the ultimate means of payment. Convertibility into cash is one of the characteristics expected of deposits which are treated as 'money', while transferability in the settlement of debts and to make payments is a distinguishing feature of banking services. In an overdraft system, transfers can also be made from accounts in debit, so that liquidity services are provided on both sides of the balance sheet. Banks can be

visualised as purchasing primary securities, pooling them to eliminate risks and combining them with capital, labour, materials and high-powered money to create 'liquidity'. High-powered money has the role as an input into banks' production function.

How much high-powered money is required by the banks depends on the nature of the production process and on institutional arrangements. Banks providing liquidity services face uncertain demand for cash from deposits and from loans where there are undrawn facilities or open credit lines. They are able to employ the law of large numbers to keep cash at low levels, but cannot eliminate the need for cash completely. As a bank lends or invests, the loss of cash puts it in a position where any subsequent deposit withdrawals or loan demands may necessitate sales of securities at a loss or interbank borrowings at unknown rates. These possible costs must be balanced against the benefits of increased income. In this way, the availability of cash limits banks' acquisition of non-cash assets.

Control of the money supply is exercised by restricting the quantity of the factor of production, base money, to the banking industry. Since the monetary authorities have a monopoly over the production of this factor input, they can make it available in less than perfectly elastic supply: in the limit, the supply could be made perfectly inelastic. Banks are then in the same position as firms in any industry for which the inputs required for production are available only at sharply increasing cost. For an individual bank, the restriction of the supply of base money imposes an external cost as banks in the system expand deposits and bid for reserves. (Each bank's supply response is a mixture of a movement along a short-run cost curve and a shift of that cost curve as rising factor prices impose an external pecuniary diseconomy.) An individual bank can react in a variety of ways: by bidding for inter-bank funds, raising deposit (and loan) rates, improving services, cutting back on new facilities, cancelling or reducing existing facilities, selling CDs, disposing of bills or bonds. The route actually chosen will be the one most profitable to the bank.

One immediate difference from the interest rate mechanism presently operated is the involvement of the banks. Following the removal of the corset, the banks are now almost passive spectators in the process of monetary control. In response to an increase in MLR, their 'job' is to raise base rates in line (which they have done), but that is about all. The Bank of England, as it were, appeals directly over their head to the public's demand for credit. In the meantime, the banks can continue to push out facilities with relative impunity. If borrowers are not daunted by the higher interest rates, the banks could conceive their job to include bidding for deposits and reserves to sustain any expansion of advances. Monetary base control, by contrast, impinges directly upon banks' decision-making and provides a pecuniary incentive for them to participate in the process of adjusting their balance sheets to the dictates of monetary policy.

A second difference concerns the adjustment mechanism, which, under monetary base control, would be chosen by the banks on profit-maximising grounds. At present, the form of the adjustment (eg interest rates operating upon credit demand) is chosen by the authorities. If that fails, the authorities must either raise rates further, or wait for credit demands to subside. Until the latter eventuates, banks are supplied with cash to prevent them running out of reserves. Left to themselves, banks could well choose to respond to a reserve shortage in the same way - by raising deposit and loan rates. Should interest rates fail to restrain the demand for money or credit, this could not be the end of the matter. A reserve deficiency would still exist and banks would be forced to try something else. Some assurance would exist that the adjustments would proceed until monetary growth came into line. The idea that there is some new breed of banker who will always eschew asset management for liability management is patently false. If interbank rates are bid up high enough, it would pay some banks to sell bills and bonds to the private sector in order to obtain funds for lending out in the interbank market. Liability management is allowed to succeed because the Bank provides the reserves needed to validate deposit expansion.

Perhaps the most important difference is in terms of the implications for behaviour next time round. Once banks are forced to make up reserve shortages by borrowing interbank at 'penalty cost' or by

selling securities at a loss, they are likely to exercise much greater care in future when granting facilities and open credit lines. Unused facilities are a valuable source of liquidity to customers, and banks might, in different circumstances, be expected to vary the 'price' for this service. There would also be an incentive for banks to refrain from lending and build up reserves when reserve shortages are anticipated. Accordingly, surges in monetary growth may be less likely to occur.

In this description, monetary base control is qualitatively different from interest rate control. At the aggregate level it operates by imposing a quantitative restriction upon banks' intermediation. This is translated directly into individual banks' profit calculus. Both the initial response and subsequent adjustments are determined by market forces, and the rewards and punishments these forces give to banks would seem very considerable benefits indeed. Unfortunately, it is not as easy to be clear about the possible costs.

For restraint upon cash to be an effective control device, it is not enough that its supply be inelastic, as is witnessed by the idea of using negotiable licences to control banks' deposit expansion. As with base money, the supply of negotiable licences would be monopolised by the authorities. As banks expand beyond allowable limits, variations in the market price would raise costs against individual banks. Yet it is generally agreed that such a scheme would encourage banking to be done outside the controlled area - particularly in offshore markets. Would the same consequences follow from monetary base control? If banks' holdings of base money were involuntary, as under a reserve requirement, this might well be the case. But we have argued that banks' demand is a voluntary one based on a production function for liquidity services, not an arbitrary restriction upon an institution designated to be a 'bank'. Institutions in the Eurosterling market (not that such a market can really be said to exist, thanks to the Bank of England) which provided substitute liquidity services, would require inputs of high-powered money, just as is the case in domestic markets. What competitive advantages would they have over domestic banks to be able to attract the deposits and reserves needed for liquidity production? Much the same question must be asked of the idea that non-banking intermediaries in domestic markets would provide substitute liquidity services.

But are liquidity services the distinguishing characteristic of money? If they are, then perhaps one-third of £M3 should be excluded from the definition. This is a conservative estimate of the amount that represents wholesale funds of the non-bank private sector, much of which is held in banks which specialise in wholesale banking. This type of banking differs substantially from retail banking, which is the model outlined earlier. Retail banks exist by producing liquidity services; they endow claims with attributes of capital certainty, convertibility and transferability. The economic basis of wholesale banking is to lower transactions costs in markets for corporate borrowing and lending and to intermediate within the term structure of interest rates. In contrast with retail banking, in which virtually all deposits are in sterling and withdrawable on demand (or at very short notice), wholesale deposits are for various maturities and in a variety of currencies. Unlike retail deposits, where each bank may have millions of small accounts, to which the law of large numbers can be applied, each bank in wholesale business may have only a few hundred large accounts and is not large enough, relative to the total market for wholesale funds, to apply the same principles.

Because the economic basis of wholesale banking is different and the balance sheet structure differs, a different 'production process' applies. A substantial degree of matching of currency and maturity is the rule, even when, with non-bank business, substantial maturity transformation occurs. (Maturity transformation in sterling wholesale banking is only slightly less than that which now occurs in Euro-currency business.) A critical role is played by the interbank market in 'reconciling' the public's preferences with those of the banks. Funds are channelled from ultimate lenders to ultimate borrowers through several banks. What begin as short-term deposits finish up as rollover loans of several years' duration. Each bank is mismatched, but not to any great extent, and no one bank is left with a large share of the transformation. This is in marked contrast to retail operations, in which the transformation is undertaken fully by the bank accepting the deposits. It follows that the Bank's proposals about prudential liquidity, with the higher requirements in interbank funds, strikes at the heart of wholesale banking, and indicates a failure to understand this type of intermediation.

Our immediate concern, however, is that, for wholesale banking activities, there is no demand for base money. In this sense, much of the British banking system has already progressed to a cashless society. Even the concept of a reserve ratio has little meaning, for the demand for marketable securities (bills, CDs) to cover an open position depends on the mismatching, maturity by maturity, not upon any scale measure of the total balance sheet.

Restraint upon the supply of base money will curtail retail banking and those substitutes for retail banking which involve the production of liquidity services using inputs of high-powered money (or, in a pyramid of credit, claims against retail banks). If, as we have argued, wholesale banking involves different services and different production processes, it is unlikely to be constrained directly by monetary base control. The vital question, then, is, should it?

Analogies are helpful, but which is the correct one? At one extreme, we could, as Friedman does, liken the production of money to that of motor cars, with high-powered money like steel. Steel is a vital and irreplaceable input to the production of motor cars, at least in the short run. By restricting the supply of steel, control could be exercised over the production of motor cars, even though there are different brands and different models. Alternatively, we could envisage money to be like containers. There are several different types of container (steel cans, glass, aluminium, plastic) and many different production processes involving quite different inputs. Each type of container, and its associated input, has its distinctive merits, but all can be substituted at a price. Is the same true of different forms of banking and finance more generally?

Thus the monetary control debate is really a debate about the first principles of monetary economics. Is the aim of monetary policy to control something special called money, or is it to control all borrowings and lendings and all forms of financing in the economy? In the latter case, the Bank's interest rate policies are clearly appropriate. But if money does have a special place, it is unnecessary and inefficient for the Bank to control all borrowings and lendings

when a more direct means of controlling the relevant money supply is available. Monetary base control will involve interest rate variations as a by-product or as a means to an end, but it may not prove necessary to deflate all borrowings and lendings and alter all credit conditions in the economy on the way. Altering all financing demands in order to change one particular form of financing is a blunt instrument.

There is something to be said for both views. Proponents of monetary base control have, somewhat slavishly, applied a theory developed in the United States, with its preponderance of retail banking, to the quite different environment of the British banking system. On the other hand, it is surely the case that those bank and non-bank claims which are backed (directly or indirectly) by base money are more liquid than much of wholesale money, which differs little in character from commercial paper. By ignoring the importance of base money to liquidity production, the Bank has overemphasised wholesale banking and failed to distinguish money from credit.

24 July 1980
M K Lewis

Econ Pol



MR MIDDLETON

- CC Principal Private Secretary
- Sir D Wass
- Mr Ryrie
- Mr Monck
- Mr Britton
- Mr Riley
- Mr M L Williams
- Mr Culpin
- Mr Grice

~~Mr Lankester - No. 10~~

B

B/E

- (Mr Clark - Deputy Governor's Office
- (Mr Goodhart

MONETARY CONTROL SEMINAR WITH FOREIGNERS

The Financial Secretary has seen your minute to the Chancellor of 19 September. He will be attending the lunch to which you refer in your paragraph 4, and we have told the Deputy Governor's office of this.

The Financial Secretary agrees that the Mervyn Lewis paper is good and indeed important. In this context, he would be grateful for a short note on how easy it would be to devise a £M3 statistic which excluded the wholesale components - effectively, the old M2. He would also like to see what the growth of a so adjusted £M3 has been over the past 6 months.

He would be grateful if Mr Riley could arrange for a short piece covering these two points.

SAL

S A J LOCKE

24 September 1980

24 SEP 1980



ing Governor of the Bank of England

is a mug's game . . . ?

FERDINAND MOUNT



ON THE whole, to be the director of a London merchant bank sounds rather agreeable. There is the farmhouse in Wiltshire, the cottage on Lesbos, the eyrie in Knightsbridge. Every now and then, you help some enormous company to take over some other enormous company in what is called "a takeover battle" — although your fee and your bank are quite safe, whoever else may be a casualty.

And if all else fails you can let off steam in a spectacular public row with your second cousin once removed about whether he is entitled to call his bank J.R. Smithers & Co when your bank has been called Smithers and Smithers since 1793.

At the peak of your career, you may even receive an invitation to join the Court of the Bank of England. You might even become Governor—but that, dear reader, is the moment at which you ought to think twice. If I were you, I would take up breeding orchids or tinkering with power boats instead.

For being Governor of the Bank of England is a mug's game. There is one simple reason for this: the job brings you into contact with politicians. And you will soon find out that when politicians cannot blame the Press, they always blame the bankers. No Labour conference is complete without a sneering reference to the latest "bankers' ramp" — some new conspiracy against the working class masterminded by the Gnomes of Zurich, the IMF or, best of all, the Governor of the Bank of England.

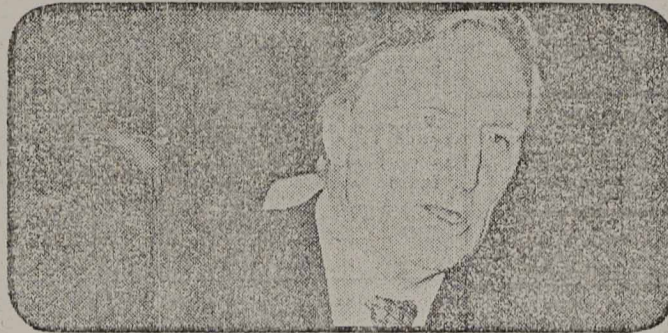
Bigger mess

In the 1930s, the blood of good socialists was trained to run cold at the mention of Sir Montagu Norman, the then Governor, Nationalising the Bank of England after the war made no difference. The Crossman diaries are full of Sir Harold Wilson's plots to "fix" Lord Cromer who, in the event, fixed Sir Harold by commenting on the eve of the 1970 election that the Labour government was leaving a bigger mess behind than it had inherited.

And now we have Mrs Thatcher buttonholing all and sundry to proclaim that "it's all the Bank's fault." Any passing Swiss banker or Cabinet sub-committee is treated to a lecture on the incompetence of the present Governor, Mr Gordon Richardson. He has, she claims, totally messed up the money supply; he never tells her a thing; how can you run a country with a central bank which does not understand the simplest thing and so on, and so on.

Now this may surprise the unwary. Don't Tories like bankers? Dash it all, aren't half of them merchant bankers anyway? Surely all those not-so-young men in pin-stripe suits have served their time in the galleys of Slater Walker or Kleinwort Benson. But at the risk of stating the obvious, I must repeat that Tories are politicians like other politicians; and what politicians do not like are laws of nature — such laws as "what goes up must come down" and "two and two make four."

Gordon Richardson is easily the sharpest Governor we have had since the War (no, that wasn't me saying



HARASSED . . . Gordon Richardson

Don't shoot the butler

that that wouldn't be hard; this is a kindly sort of column). He is well aware that getting the money supply under control is a tricky business and that the method used to control lending to the banks—the "corset" — was by no means foolproof; excess flesh was bound to bulge over the whale-bone—I know this is a distasteful metaphor, but it wasn't me that chose it.

The Government and indeed the select committees of the House of Commons were warned that there was a strong possibility that the banks would find ways round the restrictions and that, when exchange controls were lifted, the possibility would become a certainty.

The net result is that there is more money sloshing around in the system than there was supposed to be; and hence there is still more pent-up inflation to come. Terrible, terrible, let's jump up and down on the Governor's prone form until he says he's sorry.

Cheap money

Here one feels a bit like the Doctor interrupting a ghastly roasting being given to Tom Brown by Flashman. The truth is that this bullying of the Governor is unfair. If things have gone wrong, the responsibility should stay where it originates—with the Prime Minister herself. It is she who was so sticky and tardy about putting up interest rates to a level high enough to discourage people from borrowing money; if she had done what she ought to have done in the first place, the money supply would now be under better control and interest rates might already be starting to come down. But those economic ministers, from Sir Geoffrey Howe downwards, who have been trying to persuade the Prime Minister of this have met the politician in her—and politicians like cheap money.

If she had managed to make a much earlier start on the control of

Thatcher would have done if the slump had not, in a grisly way, come to her rescue. It has, and it is doing much of her work for her: price rises are coming down, so are wage settlements. Unemployment is terrible and will get worse before it gets better, but that was always implicit in her policy anyway. The one thing not to do is to take the advice of Mr Denis Healey, the well-known photographer, in this space last week. To start printing a great deal more money at this stage in the transition from slump to recovery would be disastrous; we know this, because that was what the Great Photographer did himself in 1974-5.

As much by luck as by judgment, the Tory Government happens to be facing the right way at the moment, and Mrs Thatcher has an opportunity to defeat inflation that will not come again.

One cannot expect any Prime Minister to refrain from claiming credit when things go right, but she might have the grace to refrain from blaming her past errors on Mr Richardson, whose role is only that of a harassed butler trying to clean up after her—Donald Sinden to her Elaine Stritch.

public spending, industry would not now be short of cash. The Bank of England is estimated to have spent a couple of billion this year on bailing industry out by keeping interest rates down and extending credit. It was open to the Government—which, after all, is supposed to have ultimate control over the Bank of England—to forbid this and to pursue a genuinely tough policy. But the Government, it seems, did not wish to be quite that unpopular. Those seers who keep on looking for the crucial moment when the wets will "speak up" and "come out" have really missed it. From the start, Mrs Thatcher has acquiesced in a Bank of England policy to soften both the pressure of her own squeeze and the impact of the world slump.

It is pointless to ask what Mrs.

Prime Minister

I think not you should

be aware of her whole

last Thursday's Evening

Standard

26ix

PART 4 ends:-

PM to Brunner 22.9.80

PART 5 begins:-

Evening Standards extract 23.9.80

