3. Monetary Base IV
Part C

Comments on Green Paper

13/8/1980 – 19/9/1980

MCC(80)36 COPY NO. 1

13 August 1980

HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

COMMENTS BY THE ACCEPTING HOUSES COMMITTEE

Note by the Secretaries

The attached comments by the AHC are circulated for information.

M D K W FOOT
M L WILLIAMS

H M Treasury

C

ACCEPTING HOUSES COMMITTEE

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ROMAN WALL HOUSE,
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Our Ref. AHC/550/C.

7th August 1980

The Governor,
The Bank of England,
London, EC2R 8AH.

Dear Mr. Governor,

Monetary Control

You will remember that you wrote to my Chairman on the 5th June, 1980 inviting the Accepting Houses Committee to comment on the Green Paper, "Monetary Control" (Cmnd. 7858).

I subsequently spoke to Mr. Charles Goodhart to obtain an indication as to the timetable within which the considered comments of the Accepting Houses could be collated and communicated to the Bank. I indicated to Mr. Goodhart that I hoped to be able to submit the Committee's comments in the course of this present month.

I now enclose ~~4~~ 1 attd copies of a paper setting out the Committee's comments. I think that it represents the nearest that could be expected to a consensus on the part of the 16 Houses which could reasonably be expected on such a subject.

The paper is at present unsigned. Unfortunately my Chairman will not be back in his office until the end of August. He may wish to put some finishing gloss on to paper; but he did see it substantially in its present form and I do not expect it to be materially altered.

Yours sincerely,

L H L Cohen

L.H.L. COHEN
Director-General.

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7th August 1980

The Governor,
The Bank of England,
London, EC2R 8AH.

Monetary Control

You have asked for our comments on the Green Paper on monetary control with particular reference to the questions outlined in paragraph 6.4 of that paper. Before discussing these specific questions it may perhaps be best to outline our general approach to the subject.

The first point to be made is that we do not attribute the rapid rate of monetary growth experienced in this country in recent years primarily to defective techniques of monetary control. It follows that we do not believe that improvements in the techniques of monetary control can, in isolation, be expected to resolve these problems. Fiscal policy has been lax throughout the period of high monetary growth and few governments have ever run large and persistent fiscal deficits without experiencing high rates of monetary growth. (In this connection it is worth noting that we regard the argument that, adjusted for inflation, the public sector has been running a fiscal surplus as misleading and dangerous if used as a basis for policy: adjusted for inflation, government was in substantial surplus during the Weimar inflation).

The problem in the U.K. has been that the fiscal deficit has consistently been of a scale which required very substantial funding from outside the banking system. For much of the time this has been obtained, albeit at the cost of substantial distortion of the financial system, but the scale of the deficit has been such that any minor shortfall in funding has had substantial monetary consequences.

These problems have been exacerbated by the growing reliance of the public sector on the gilt-edged market as a source of funding. Up to the mid sixties a very substantial portion of the public sector's debt was held directly by the personal sector through channels such as National Savings, so that the public sector drew fairly evenly from the institutional and the personal savings market. During the decade from the mid sixties to the mid seventies this pattern changed radically with the public sector share of the personal savings market falling sharply while its share of the institutional market rose to a point at which other borrowers were effectively excluded.

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The Governor,
The Bank of England

7th August 1980

Thus a sharp rise in the public sector's borrowing requirement has been accompanied by a significant narrowing of its funding base. The monetary consequences of these two trends have been far reaching. First, the financial requirements of the public sector have become highly inflexible. Whereas in the fifties and sixties the authorities were largely concerned with debt management, by the latter half of the seventies they were committed to meet a demanding funding programme.. In the process the authorities have relied almost exclusively on the stock market in which they were the only effective borrowers. The result has been that the public sector has not been able to accelerate the pace of its funding without influencing both the capital account and the savings of the personal sector.

Second, the corporate sector has effectively been excluded from the capital market and thus driven to reply almost exclusively on the banking market for its external funding. It should be stressed that this was not a necessary consequence of inflation but rather of the scale and determination of government funding operations. Where government has relatively modest funding requirements, as in the U.S.A., inflation may cause a hiatus in the corporate bond market but it will not kill it. The closure of the capital market to corporate borrowers in recent years has added very substantially to bank loan demand, and where the funding of this loan demand has conflicted with targets for £M3, sterling deposits held by overseas residents have made up the shortfall.

It should be evident from the above that the background to our views on the technical issues of monetary control is a firm conviction that the overall fiscal stance and funding policy of the public sector are of far more decisive importance. That being said, we would not suggest that the techniques of monetary control are without significance for both the choice of target and the precise control mechanism used to achieve it can have a significant impact.

The use of £M3 as the target monetary variable is now a well established practice in this country with which the markets are thoroughly familiar. The monetary base proposals would involve a radical shift away from this policy and we take the proposals in Chapter 5 of the Green Paper as evidence of a strong official predilection for retaining £M3 as the target monetary variable.

Our view is that reliance on a single monetary variable is inherently undesirable. There are both general and specific reasons for this. On general grounds the continuous structural evolution of the financial system makes it unlikely that any single monetary aggregate will remain an accurate measure of monetary growth over time. On more specific grounds experience has shown that attempts to control a particular aggregate will tend to distort its relationship to the system as a whole, a point well illustrated by the experience of the Supplementary Special Deposits Scheme. If targets were to be expressed in terms of a number of monetary aggregates such distortions would be less likely to occur and a better overall measure of monetary growth would be achieved.

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The Governor,
The Bank of England

7th August 1980

It may be objected that the maintenance of public confidence in the conduct of monetary policy requires the authorities to commit themselves to the control of a particular monetary variable. However, most active market participants are aware of the complexities of the financial system and for this reason watch the development of a number of monetary aggregates: market confidence in official policy is undermined when the authorities are committed to the control of a single monetary aggregate which is widely known to be distorted, not least by official controls. With regard to the wider public we consider that a broad commitment to the control of monetary aggregates will carry more conviction than a particular target for an aggregate whose composition is not understood. For these reasons we would argue that the confidence of both market participants and the public at large would be enhanced by a commitment to the control of a range of aggregates.

The choice of aggregates is obviously a matter for technical debate, but we would argue that measures of both liquidity and credit are required. Liquidity measures should range from measures of the banking system's liquidity through narrow and broad definitions of the money supply to a broad measure of liquidity in the economy. Measures of credit have become of much greater significance in the last year or so with the revival in sterling's international role and the relaxation of exchange control.

A preference for judging policy by reference to a number of aggregates must imply a general preference for the use of interest rates rather than reliance on specific quantitative controls. It does not however necessarily preclude control of specific quantities as a means of influencing the price of money.

The monetary base proposals are radical in two senses. First, they involve relying on the control of base money rather than on direct control over a broader monetary aggregate. Second, they involve acting directly on the volume of money rather than attempting to influence volume through acting on the price of money. The latter approach, in the absence of perfect information, involves a measure of judgement on the part of the authorities as to the level of interest rates needed to achieve a particular rate of monetary growth whereas monetary base proposals are inherently non-discretionary.

There are two distinact questions about the monetary base proposals which have to be answered. The first is whether they are practicable as a way of controlling the monetary system. The second is what the consequences of their adoption would be for the portfolio behaviour of banks and their customers and, by extension, for the economy as a whole.

A non-mandatory base system is, in principle, preferable to a mandatory base system in that it does not create artificial costs for the banking system and thus should not distort the system by inducing disintermediation. However two problems arise in connection with such a system. The first is that it assumes that banks will always find it prudent to carry a similar proportion of base assets in their balance sheets, which may not be true at all stages of the interest rate cycle. The second is that it implicitly assumes that base money is the only form of liquidity available to the banking system. If no discount facility is available it is true to say that base money

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The Governor,
The Bank of England

7th August 1980

is the only absolute liquidity available to the banking system as a whole, but in practice short government paper has a high degree of liquidity for both bank and non-bank investors: U.S. Treasury bills are prime liquidity even though the authorities in the United States do not customarily stand ready to discount them.

In a country such as Switzerland where the authorities have pursued extremely conservative fiscal policies over many years and there is consequently little federal government paper in the market, the supply of such prime assets is necessarily limited so that the banking system as a whole has no real alternative to base money as a source of liquidity. In such circumstances the control of monetary base is probably the most efficient way of controlling the money supply, but it is worth noting that against a background of fiscal conservatism such as has characterised the Swiss economy for many years the problems of controlling domestically-generated monetary growth are not excessive.

The level of the public sector's primary debt and the lack of fiscal conservatism in this country in our view precludes the introduction of non-mandatory base system. The introduction of a mandatory base system in this country would have a profound effect on the banking system. Reserve costs in this country have typically been low, in sharp contrast to countries such as the U.S. and West Germany, and this is reflected in the structure of our banking system.

The imposition of reserve or base costs on the U.K. domestic banking system would necessarily lead to a period of structural change in the banking system and its relationship to the broader financial system. For a time the figures for monetary growth would seriously understate the trend in the growth of liquidity and credit in the economy but this trend distortion would disappear as the adjustment was completed. It can be argued that such problems would be transitional and analogous to those associated with the introduction of Competition and Credit Control. This does not in our view justify ignoring the considerable risks involved in the transition to a mandatory base system.

If the transitional problems could be successfully overcome the workings of the system would depend on which of the two fundamental variants of mandatory monetary base described in the Green Paper was adopted. If all banking claims against the central bank were to be treated as base assets then day to day control of base assets would have to depend on the authorities maintaining an overfunded position and then using discretionary repurchase agreements to inject sufficient base assets into the system to achieve the desired level. Two issues arise from this. The first is that of access to repurchase agreements. These should in our view either be open to all competing banks or restricted to institutions such as the discount houses who do not compete directly with other banks. In this connection we note with approval the decision to open recent repurchase agreements to all listed banks.

The Governor,
The Bank of England

7th August 1980

The second issue concerns the assets against which the authorities are prepared to enter repurchase agreements: although this may appear a technical point it could be a cause of significant problems if the selection of assets were unduly narrowly defined.

We are confident that in principle base asset control could be managed on such a basis with the caveat that a very large public sector deficit would still produce significant strains. On the technical questions of whether the base asset requirement should be leading, coincident or lagging we are agnostic. There seems to be no fundamental reason to consider any of these systems unworkable and no doubt the banking system could adapt to deal with any of them. If we have a preference it would be for a coincident requirement. It should be noted that our confidence that such a system would be manageable depends on our judgement as to banks' likely portfolio behaviour under such a system which is set out below.

The other principal variant of mandatory base asset control set out in the Green Paper is the proposal to create Negotiable Entitlements (N.E.s). As the aggregate supply of these would be arbitrarily set by the authorities it cannot be doubted that such a system could be made to work in the technical sense. There are however two principal objections to such a scheme. First, the removal of pressure on the authorities to either control or fund its deficit could well lead to a dangerous build up of liquidity in the system. Second, the revenue potential of such a system from the official point of view could, if exploited, lead to a very high level of disintermediation.

The issue of disintermediation is crucial to the analysis of the various mandatory monetary base systems. The issue is not a simple one in that both corporate and public funding depend in the first instance on encouraging a process analogous to disintermediation (and both contribute to monetary control). If the public sector sells stock to a bank depositor and reduces its liabilities to the banking system the money supply falls but a similar process involving Treasury Bills although analogous in its initial monetary effect is in practice fundamentally different in that it is readily reversible. However, although these examples may be clear cut there are necessarily many which occupy a less clear cut middle ground such as transactions in floating rate stocks.

Under a mandatory base asset scheme banks would have to resolve the conflict between the desire of their commercial customers for flexible borrowing facilities and the authorities' determination to limit the growth of the base assets of the banking system. They would do so either by carrying excess base assets, which would be expensive, or by holding a growing proportion of their assets in a form which could be readily taken up outside the banking system. The important point to note is that profit maximisation would depend on developing an asset structure which could be cheaply and efficiently disintermediated in times of strong loan demand and reintermediated in times of

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The Governor,
The Bank of England

7th August 1980

weak loan demand. Thus the type of disintermediation and reintermediation encouraged by a mandatory monetary base system would be of little real significance in terms of either liquidity or credit even though it would keep monetary growth in the narrow sense under complete control.

For these reasons we would be opposed to a mandatory monetary base system.

The indicator proposals outlined in Chapter 5 of the Green Paper reject the substance of the monetary base proposals but would involve a major shift from a discretionary to an automatic system of interest rate adjustment, which it has been argued could reduce a bias towards delay in interest rate adjustment. As mentioned above we have considerable reservations about any system based on £M3 and as is outlined in the Green Paper. However, setting this question apart, there are a number of general points to be made about automatic systems even when, as proposed in the Green Paper, there is a residual power to over-ride the indicated rate.

The first concerns the potential instability of interest rates. The experience with market determined changes in MLR was not an entirely happy one and problems were experienced during periods of both rising and falling interest rates. In practice the authorities chose to over-ride the market frequently in the past and we see no reason to expect matters to be different in the future.

Whether the present system of discretionary changes in interest rates is necessarily biased towards monetary ease is in our own view debateable. There will always be pressures influencing the conduct of monetary policy and whether they are to over-ride an automatic change or to initiate a discretionary change the authorities must bear them. The real danger with an automatic system is that the authorities may be inhibited by the system from a proper exercise of their judgement and in consequence lose their direct responsibility for the outcome.

A more general point emerging from these questions concerns the significance of short term fluctuations in monetary growth. The official view as embodied in both the Green Paper and the recent Budget Report would seem to be that short term fluctuations in monetary growth do not matter in any objective sense in that the relationship between money supply and money G.N.P. is essentially a medium term relationship. Importance is nevertheless attached to such movements on the grounds that they affect market confidence, and indeed the indicator system would involve an automatic response of interest rates to such short term fluctuations. Our experience is that market participants share the official view that short term fluctuations in monetary growth are of little fundamental importance but watch them with great attention because they have learnt that they provide a good indicator of the authorities' immediate intentions with respect to interest rates and funding operations. In countries such as Switzerland and Germany the market accepts large fluctuations in the rate of monetary growth quite calmly because they have learnt by experience that the authorities' own policy actions will not be influenced by them.

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The Governor,
The Bank of England

7th August 1980

In sending you our comments we have treated the Green Paper in isolation. However these matters are closely related to both the issues raised by the paper on the Measurement of Liquidity and the promised paper on the Cash Requirement. For this reason we have been somewhat less specific on certain points than we might have wished, but we would hope to revert to them in the light of the continuing discussion with the Bank on the Liquidity paper and of the paper on the Cash Requirement.

Yours sincerely,

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MCC(80)40 COPY NO.

22 September 1980

HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

COMMENTS BY BRITISH OVERSEAS AND COMMONWEALTH BANKS

Note by the Secretaries

The attached comments on the Green Paper from the British Overseas and Commonwealth Banks Association are circulated for information.

M D K W FOOT

M L WILLIAMS

H M Treasury

THE BRITISH OVERSEAS AND COMMONWEALTH BANKS ASSOCIATION

HON. SECRETARY & TREASURER
Ian P. Cameron Black
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10 CLEMENTS LANE,
LOMBARD STREET,
LONDON EC4N 7AB.

11th September, 1980.

recd 15 SEP 1980 2.15pm

The Rt. Hon. Gordon Richardson, M.B.E.,
Bank of England,
Threadneedle Street,
London, E.C.2.

Copied to: The Deputy Governor
Mr [illegible]
Mr [illegible]
Mr Page
Mr [illegible]
Mr [illegible]
Mr Coleby
Mr [illegible]
Mr [illegible]
Mr [illegible]
[illegible]
[illegible]
[illegible]

Dear Governor,

Monetary Control

In my previous letter to you on the subject of the [illegible] green paper, Monetary Control, I advised you that our working party would look again at the paper to see whether they could make any useful comments.

I attach two commentaries that have been submitted. Both writers emphasise that what they have written reflects their personal views.

I hope that they are of assitance to you.

Yours sincerely,

Ian Cameron Black

Hon. Secretary.

Enclosures.

MONETARY CONTROL

The Government has resolved to reduce the growth in money supply in order to achieve a permanent reduction in inflation in the United Kingdom. In order to do so, it has considered ways in which it could acquire control over the money supply in the medium term, whilst at the same time minimising short term fluctuations in money growth within the overall trend. The money aggregate £M3 has been chosen as the appropriate measurement of growth.

The Green Paper, which is a joint consultation paper by H. M. Treasury and the Bank of England, considers the following alternatives:-

a) Monetary Base Control

b) Indicator Systems

A. MONETARY BASE CONTROL

A known proportion of a banks' deposits to be kept in base money whether voluntarily or mandatory. In this case, the Authorities have the option to control the base and thereby bank balance sheets, as growth is restricted to a multiplier of the base, or use movements in the base to trigger changes in interest rates. Whether there is a mandatory requirement for base assets or not, this scheme would require a fundamental change in the fabric of the London financial markets. To be effective, the Bank of England would have to cease open market operations as they are known today to become truly a lender of last resort in times of crisis rather than a lender of first resort, as it has sometimes been described. The Authorities seem to have stepped back from making such changes and the status quo has been preserved. With such a constraint, the efficient application of Monetary Base Control would be limited. Certainly its adoption would require bankers with vast experience and expertise within the existing market framework to acquire new skills and there would undoubtedly be a difficult transitional period during implementation.

The Paper clearly rejects Monetary Base Controls for the following reasons:-

a) "Significant institutional effects resulting in a less flexible

/...

money market."

b) Lead time measuring success and therefore uncertainty of benefit.

c) "Known costs and uncertain benefits."

d) Interest rate changes generated might not produce a smooth short term monetary growth.

The "pros and cons" of Monetary Base Control do not seem to have been fully discussed in the Paper and perhaps a closer look at attempts in other countries might be appropriate, e.g. Switzerland and the USA. However, without a willingness to change the present market structure, such discussion is somewhat academic.

B. <u>THE INDICATOR SYSTEMS</u>

This scheme seems more attractive to the Authorities and avoids the need to control the base. The Authorities would simply react to movements in the base against the desired level of growth, which would trigger changes in short term interest rates. It is suggested that changes in interest rates could alternatively be linked to changes in £M3 as indicated from weekly returns to the Bank of England by banks.

The trigger mechanism would be automatic, except that the Authorities would maintain the discretion to override the trigger points.

Weekly figures would undoubtedly place a greater burden on banks than the existing monthly returns. A pilot study has already been collected from a sample of banks, but unfortunately this was not particularly satisfactory, as it did not show the same trend as the monthly figures for the market as a whole. Possibly this was due to reintermediation between the "Corset" make up days.

The advantage of this scheme as seen by the Bank of England is that the market structure need not be altered in any way and so radical change is unnecessary. Although the Paper suggests that the Authorities would have to justify discretionary changes in interest rates, the fact they they are able to means that they will remain under political pressure when appropriate action seems politically unpalatable.

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When looking at Monetary Base Control or the Indicator System, there appears to be a concentration on short term interest rates as a treatment to the symptoms of an excessive supply of money. Arguments that the Authorities should concentrate more on the actual supply of money rather than attempt to treat the effect are not answered in the Paper and greater discussion on this point seems necessary.

In addition to the above schemes for monetary control, the paper announces the intention of imposing a cash requirement on all Recognised Banks and Licensed Deposit Takers, in addition to the London Clearing Banks. This is not covered in great depth by the Paper, because it is meant to be covered by a follow up paper, which is now well overdue, possibly being held back whilst market conditions are so illiquid. Whilst it may seem more equitable to spread the responsibility for providing cash to the Bank of England, to support its open market operations, it is likely to be more costly to non-Clearers and therefore more onerous. One cannot comment more fully on this aspect until the details of the cash requirement have been published for discussion.

MONETARY CONTROL

The opportunity to comment on the joint Treasury-Bank of England Green Paper on monetary control is welcome, both because of its importance for economic policy and because, combined with the Bank of England's proposed liquidity requirements, it is likely to be a major determinant of the shape of the financial system over the next decade.

Two General Points

Two general points can be made. The Green Paper concentrates on problems of short-term monetary control. Short-term fluctuations in money supply growth do not in themselves pose a threat to anti-inflationary policy, and there is a danger that efforts to control monetary growth - and particularly the growth of the wider monetary aggregates which react more slowly to policy changes - on too short a time-scale would be counter-productive. In particular, the proposal to alter interest rates in line with weekly movements in sterling M3 appears inappropriate.

Secondly, it is clear from the Green Paper that the authorities wish to retain a large measure of control over interest rates, either by discretion or according to a predetermined rule. Effective short term control of the money supply probably requires a greater willingness to allow the level of interest rates to be decided by the markets.

Proposals for monetary base control

The practical objections raised to a system of monetary base with a mandatory relationship between base and deposits (Sections 4.10-4.16 and Appendix B) are convincing. The use of a more informal system of monetary base control, combined with targets for sterling M3, should not, however, be ruled out.

The advantages of monetary base control are that the monetary base is under the direct and immediate control of the authorities and that it is less open to distortions than are wider monetary aggregates. Control of the monetary base (provided that there is not a mandatory ratio between base and deposits) would permit short term fluctuations in the wider monetary aggregates while providing some assurance that they are only temporary.

Monetary base control would require a willingness by the authorities to accept short term fluctuations in interest rates, and the Bank of England's lender of the last resort facility would have to be available only in the last resort. It is reasonable to expect that interest rate fluctuations would be reduced as the market becomes used to the new system and operators learn to iron out fluctuations which they perceive to be temporary. Any change to a system of monetary base control would involve a difficult transitional period requiring continued support from the authorities.

Indicator systems

The intention of an indicator system, whether related to the base or to Sterling M3, is presumably to depoliticise interest rates changes. We suspect that the frequent opportunities for the use of the official override that could be expected with a system based on weekly figures would make interest-rates charges more, rather than less, sensitive politically. As the Green Paper notes, the scale of response to deviations from the monetary target would be arbitrary; there is thus little reason to believe that the system would be an effective means of short-term monetary control.

Ce - 1. Mr Cirio Mrs Hammex

MR BURNS)
MR MIDDLETON) Copy to each Mr Culpin cc Mr Monck 9.9.80
Mr Riley (o/r)
Mr Unwin

Mon. Cont. Box.

FEU 2/6/08 Part C

MONETARY POLICY: SOME OPTIONS

1. Over the next few weeks it will be necessary to take some very difficult decisions about the future conduct of monetary policy if the Government is to be able to present a coherent policy framework in a statement to be made in mid-October. It will be necessary to consider together the problems created by the over-run on the existing money supply target and the more fundamental question of the monetary control method we employ. It is clear that there will be no easy solution to these problems, so I hope you will bear with me if I put forward some ideas suggesting rather radical changes.

2. Taking the Green Paper on Monetary Control as the starting point, we should now be considering how to bring £M3 back on track by some combination of higher interest rates and tighter fiscal policy. That is not what we are in fact currently doing and it may be worth starting by asking why it is that we are so reluctant to adopt the Green Paper solution. Clearly, the extent of the measures we would need is itself quite a deterrent. We may know rather better when the forecast is completed how sizeable the required correction is, but as a working assumption for the purpose of this minute, I suggest 5 per cent of the money supply. I have not attempted to work out what scale of fiscal package that would require, but clearly it would be a very substantial one indeed. We are not contemplating such a package, partly because the economy is so well deflated already, but also because fiscal policy measures which can be taken at short notice tend to raise prices and hence make control of £M3 more difficult in the short run.

3. We are also reluctant to raise short-term interest rates for broadly similar reasons. We are ~~in~~ some doubt now whether higher interest rates would have a significant impact on £M3 at all, and certainly we believe they would make little impact in the course of the next few months. One must add also, I think, that our reluctance to raise interest rates has something to do with the view that financial conditions are in fact already tight. Even if we didn't believe this ourselves, we would have to take account of the perception of financial conditions which has a bearing on the political reception we could expect for a further tightening. Added to all this, of course, there is the problem of the exchange rate, which could only be made worse by a sharp increase in MLR.

4. If we are not able or willing to follow the deflationary courses of action suggested by present methods of monetary control, should we take the relatively easy way out and re-base our monetary targets on a substantially higher level? For the sake of argument, let us again take 5 per cent as a rough order of magnitude. This may in the end be what we have to do, but it does seem to me very difficult to accompany an announcement of substantial base drift with another announcement that we consider existing methods of monetary control to be adequate. The situation can only look more confused if we also announce that we are continuing to give substantial relief to the market on a continuing basis. What we would be saying, in effect is that the money supply targets set out in the Budget speech were <u>much</u> too ambitious and we would be offering little hope that control of the money supply would be significantly better in future.

5. Some, at least, of the difficulties with monetary base control that are identified in the Green Paper do seem to be associated with the choice of £M3 as the target aggregate. It is also, of course, the case that M1 is currently growing a great deal slower than £M3 or the wider aggregates. One option I would like to consider would amount to the adoption of a system of monetary control similar to that used in the United States. In other words, we would adopt a method of control on the lines of monetary base control but apply it to a relatively narrow aggregate. This would enable us to maintain the money supply as the centrepiece of the Government's attack on inflation without taking any more severe deflationary measures than have been taken already. It would also provide us with a target aggregate that we had some prospect of controlling by means of financial as opposed to fiscal policy measures. The immediate steps one might be taking in the remaining months of this year would include some announcement about the beginning of serious consultations with financial institutions about the form of monetary control methods, together with a redefinition of the target path set out for the money supply in the Budget speech as applying to M1 or some similar concept. In those circumstances, it would be possible to think of interest rates moving down - perhaps not at once, but within the reasonably near future.

6. The objections to mandatory monetary base control set out in the Green Paper are of two kinds: first, that we cannot control the base, and second, that operations on the base to the extent that they

control money supply at all do so in ways which are cosmetic or involve disintermediation. It would be necessary to think very carefully about the methods we would adopt to control the base if that were to play an important part in the control of the money supply. As you know, I have felt for some time that an additional short-term asset under the direct control of the monetary authorities would be a great assistance to tactics at the short end of the market. The objection has been made that offering such an asset to the non-bank private sector provides at best a cosmetic solution to a problem of excess money supply. If the money supply were redefined as a transactions total, then this argument would be a great deal less telling. If the base requirement applied only to some classes of deposits (perhaps non-interest bearing deposits or retail deposits or sight deposits) then the banks might respond to a shortage of base by changing the maturity or other characteristics of their liabilities. If the control total is all-embracing, as it almost is under £M3 system, then this option is not open to them. It would be worth looking at the experience of other countries which work to a narrow money supply target, to see to what extent control is based on adjustments of this kind. The problems associated with disintermediation would be less severe if the banks were able to alter the form in which intermediation took place, whilst at the same time, making a substantive change in the maturity or other liquidity characteristics of the deposits they accept.

7. Another option we might consider, I suppose, would involve moving to an M1 target whilst maintaining very much the present system of monetary control. We do know, after all, that changes in MLR, our only tactical weapon at present, do produce a reasonably swift response from M1. Even so, there are significant gains to be made by adopting something rather more like monetary base control. In particular, it would make it possible for us to think in terms of quantities rather than prices when judging the tactical steps necessary in order to achieve a particular path for M1. We may be reasonably confident that M1 responds to interest rates in the right direction, but we are, of course, very much in the dark as to the precise magnitude of response we could expect. It also remains true that the authorities would be able at times to pursue a more appropriate monetary policy if they were able to distance themselves a little from the interest rates that were implied. To many, indeed, that is the principal attraction of a monetary base system.