MONETARY BASE CONTROL

PART 10

22 July 1981 – 24 July 1981

NOTE OF A MEETING HELD IN THE CHANCELLOR OF THE EXCHEQUER'S ROOM, H.M. TREASURY ON WEDNESDAY, 22 JULY, 1981 AT 2.30 P.M.

Present:

Chancellor of the Exchequer
Sir Douglas Wass
Mr. Burns
Sir Kenneth Couzens
Mr. Ryrie
Mr. Middleton
Mr. Britton
Mr. Monck
Mr. H.J. Davies

Governor
Deputy Governor
Mr. J.S. Fforde
Mr. A.D. Loehnis
Mr. A.L. Coleby
Mr. E.A.J. George
Mr. C.A.E. Goodhart

PRIME MINISTER'S SEMINAR ON MONETARY CONTROL

The Chancellor noted that three papers had been prepared for submission to the Prime Minister, which - subject to any further points emerging from the present discussion - were agreed between the Treasury and the Bank. Mr. Walters had participated in their preparation, but had not shown them to the Prime Minister. The Prime Minister might also be interested in recent moves on debt management and funding techniques, which were the subject of a report prepared by the Treasury and the Bank earlier in the year. He proposed to send her a brief report on these questions, but saw no need for any substantial discussion of them at her seminar on 31 July.

The principle of monetary base control (MBC)

2. It was noted in discussion that the Prime Minister might seek to use the occasion of the seminar to extract a commitment to an eventual move to MBC. However, there was general agreement between the Treasury and the Bank (with Mr. Walters not dissenting that - whatever the merits of MBC as an ultimate objective - it would not be operable now. Given present uncertainties about what MBC would involve, and how it would work, it was essential to avoid any decision in principle in its favour at this stage.

The Chancellor said he would speak to the Prime Minister about this in advance of the seminar.

The practical arrangements

3. The Treasury and the Bank were fully agreed on the nature of the new arrangements, and on how they would be operated. It was noted that, although the Reserve Asset Ratio (RAR) would disappear, a development which - by itself - would permit a reduction in the banks' total call money with the discount market from £5 billion to £3 billion, the banks had agreed not to make any significant changes in their liquidity until discussions with the Bank of England on prudential supervision had been completed; there was thus no question of the new arrangements precipitating rapid and radical changes in the financial markets. It was accepted that interest rates would continue - as in recent months - to be determined by reference to a variety of factors, including movements in the exchange rate and developments in the economy more generally as well as movements in the monetary aggregates.

4. The question was raised whether the 20 August starting date for the new arrangements should be confirmed, despite the absence of the Chancellor and the Governor from their offices at that time. It was agreed, however, that to change this date - which everyone was expecting - would now look very odd; and for the reasons already given, no sharp change in market behaviour was to be expected. Plans should therefore go forward to implement the new arrangements on the present schedule.

Interest rate signals

5. It was agreed that - as previously envisaged - MLR should be suspended when the new arrangements came into effect. It was noted, however, that some mechanism would still be needed whereby the authorities could, if they so wished, enforce an immediate change in the general level of interest rates. This was in no way inconsistent with the general principle of the new arrangements that the structure of short-term interest rates should be determined by the financial markets. There was no question of

the Bank maintaining a continuously posted dealing rate; but it was accepted that the Bank would need to be ready to state its intention to move the level of the rate at which it was willing to deal, even if there was no market shortage on a particular day which would enable the Bank to enforce its view immediately through market operations. This device should be available not only in times of "crisis" (e.g. a sharp change in sentiment in the foreign exchange markets), but also as a policy step to be taken in association with other policy measures, for example in the Budget. New rates, once announced in this way by the Bank, would only be maintained until they were varied in the course of the Bank's market operations.

Announcement of the new arrangements

6. It was noted that, if the new arrangements were to come into force on 20 August, an announcement would be required by 5 August. The terms of this announcement would require careful consideration, particularly about what was said on the factors to be taken into account in determining interest rates. In view of previous Parliamentary statements (on 24 November 1980, and in the 1981 Budget) this might conveniently be made by means of a Written Answer on 3 or 4 August, if Parliament were still sitting. Mr. Middleton undertook to arrange for the production of a draft of the announcement, which would take into account the need to "de-politicise" decisions on interest rates to the maximum degree possible.

Conclusion

6. The Chancellor asked Mr. Middleton to review the covering paper for the Seminar, so as to take into account the points made in discussion, and to provide a short report for the Prime Minister on debt management and funding techniques. The papers for the Seminar should be sent to the Prime Minister on 24 July.

JW

A.J. WIGGINS

23 July 1981

Distribution

Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr. Burns
Sir Kenneth Couzens
Mr. Ryrie
Mr. Middleton
Mr. Britton
Mr. Monck
Mrs. Lomax
Mr. Turnbull
Mr. H.J. Davies
Mr. Ridley

PS/Governor of the Bank
of England

24.7.81

Chancellor of the Exchequer

cc Financial Secretary
Chief Secretary
Minister of State (L)
Minister of State (C)
Sir Douglas Wass
Mr Ryrie
Mr Burns
Sir Kenneth Couzens
Mr Hancock
Mr Britton
Mr Monck
Mr Kemp
Mrs Lomax
Mr Turnbull
Mr H Davies
Mr Lavelle
Mr Peretz
Mr Riley
Mr Grice
Mr Shields
Mr Bennett
Mr Ridley

THE PRIME MINISTER'S SEMINAR ON MONETARY CONTROL

I attach a revised covering brief, in the form in which it was sent over to No 10. The other papers are as circulated on 10 July. You will however need to substitute the attached pages in Papers I and II.

P E MIDDLETON
24 July 1981

Encs

SEMINAR WITH THE PRIME MINISTER: NOTE BY OFFICIALS

1. In his Budget Statement the Chancellor said:

"Discussions are now to take place with the financial institutions about these and other changes, including the future of the cash ratio. When they are complete, the Bank will aim to keep very short-term interest rates within an unpublished band, and in due course suspend altogether the practice of having an announced MLR, which would by then have lost its operational significance."

2. The purpose of the seminar is:

a. to take note of the new arrangements. Some elements are in place already; a further set of changes will come into effect on 20 August.

b. to consider how the unpublished bands should be determined.

3. There are 3 papers which:

I. Describe the new arrangements and explain how they work.

II. Discuss the role which the narrow aggregates could play in monetary policy decisions.

III. Explain how the considerations set out in the Budget Speech might be brought together in taking interest rate decisions.

The papers have been prepared by a Working Group of officials from the Treasury and the Bank. Mr Walters (No 10) was a member of the Group.

The Arrangements (Paper I)

4. The arrangements follow from decisions taken at the Prime Minister's seminar last November. They were first described in the Chancellor's November 1980 statement and were carried forward in the 1981 Budget. They reflect extensive discussions with the financial institutions culminating in the Draft Provisions issued by the Bank in June (and shown to the Prime Minister by the Chancellor on 19 June). The Draft Provisions are attached for the sake of completeness, but all the relevant points are covered in

the paper.

-. There is no dispute about the form of the arrangements which are due to go into operation on 20 August. The intention behind the changes is to give the market a greater role in determining the term structure of interest rates and to enable the authorities to exercise influence over short term rates in a more flexible and less prominent fashion.

6. The Prime Minister particularly asked about the timing of the suspension of Minimum Lending Rate. Giving the market more of a role means giving the authorities less. Putting MLR into suspense is part of the new approach. We therefore recommend that MLR should be suspended on 20 August. This would gain the maximum presentational and operational advantage from the new arrangements. The Authorities' role in influencing some of the more politically sensitive rates, would become less direct and obvious.

7. But when this has been done the Authorities will be unable to give such clear signals about their immediate interest rate intentions. In particular they will have considerably less direct influence over base rates and mortgage rates.

8. There may however be occasions when the Authorities will wish to signal changes in interest rates before a change in the Bank's market operations can become fully effective. The most obvious circumstances would be in response to sharp fluctuations in the foreign exchange markets. These occasions will be exceptional. But, in presenting the new arrangements, it will need to be made clear the Authorities will retain the capacity, on occasion, to signal in advance the rate at which they will provide cash to the market.

This issue is considered in paras 35-38 of Paper I.

Setting Short Term Interest Rates

9. The other two papers discuss the crucial issue of how we first set, and then change, the band within which very short rates (ie up to 14 days) are allowed to fluctuate.

10. The Government is presently committed to £M3 as the basis for its <u>medium term strategy</u>.

11. The Government also restated its <u>annual targets</u> in terms of £M3 in the Budget, while recognising that other factors needed to be taken into account in determining short-term interest rates.

12. The Prime Minister in her minute of 4 June to the Chancellor of the Exchequer said that she believed that we must switch to a system of quantitative control sooner rather than later. So the group has concentrated on those changes which seem to be practical possibilities for immediate implementation.

13. The new arrangements are consistent with a widening of the interest rate bands and moving to monetary base control. But none of us is advocating an immediate move to a monetary base regime which would exclusively determine short-term interest rates. The changes we have considered are those which to quote the Budget Speech are:

> "Desirable in their own right and consistent with a gradual evolution to monetary base control."

14. The immediate issue, as we see it, concerns the determination of the band for short-term interest rates. Broadly speaking there are two options:

a. Make this decision depend primarily on one or other of narrow aggregates - essentially the choice is <u>between M1 and the wide monetary base</u>. This would mean abandoning the annual £M3 target. We do not regard the option of dual targets - eg for M1 and £M3 - as viable.

b. Retain an annual target for £M3 and set the interest rate band <u>on the basis set out in the Budget Speech</u>. This said:

> "Decisions about short-term interest rates will continue to take account of the whole range of monetary indicators referred to earlier and other factors that affect the significance of the numbers, especially the progress of inflation."

The other factors included: the narrow aggregates, the exchange rate and the real cost of borrowing.

We all agree that whichever option is adopted it would be necessary to retain some discretion to depart from the set criteria, in special circumstances.

The Narrow Aggregates (Paper II)

15. The paper sets out the implications of moving to the narrower aggregates:

a. the narrow aggregates are not demonstrably inferior to £M3 in predicting long run trends in inflation. Like all aggregates, however, they show large and erratic short-run variations which are not closely associated with movements in nominal incomes.

b. M1 would be easier to influence by changes in the level of short term interest rates than £M3. But it does not have the same obvious links with expenditure and tax policy. And the response of M1 to interest rates is still subject to a margin of error.

c. M_0, the monetary base, would be more difficult to control by changing the level of interest rates than M1 (and possibly than £M3).

d. It would be possible (subject to the qualification in b above) to relate interest rate decisions to a quantitative objective for the growth of M1 over 6-9 month periods.

e. An immediate move to M1 would mean either adopting figures which seem high both in relation to the £M3 targets and to nominal incomes, or accepting high real interest rates.

f. Such an objective for M1 would make it difficult and sometimes impossible to meet, at the same time, an annual target for £M3. There might also be some conflict with the medium term £M3 targets; these would cease to have much day to day operational significance though they would remain very important at Budget time.

g. In the event of a narrow aggregate deviating from target, the presumption would be - much more clearly than with £M3 -

that the initial response should be to change the level of short-term interest rates. This instrument would not, therefore, be available to meet other objectives, without adverse implications for achieving the target for the narrow aggregate.

£M3 Plus Other Factors (Paper III)

16. The paper explains the implications of retaining the annual £M3 target and the associated considerations set out in the Budget Speech:

a. It follows directly from the Budget Speech, and is more obviously consistent with the MTFS. It would not need a new announcement, though we might wish to give more explanation of how the various factors were to be taken into account.

b. It provides a less clear guide to changes in the interest rate bands. £M3 responds to the structure of interest rates as well as the general level of interest rates. It can be unpredictable in the short term, and can take a long time to respond.

c. The additional factors to be taken into account are difficult to quantify.

d. Decisions would be taken with a longer forward timescale in mind, and in practice are likely to be taken less frequently.

e. It appears to be more flexible because it gives the authorities greater discretion, whereas an M1 approach might look more rigid. This flexibility will however be seen as a disadvantage by those who want to give maximum weight to preventing shocks coming through on to the money supply.

17. In one way or another a range of factors will be taken into account in arriving at decisions on interest rates; this has been stated repeatedly by Ministers since the Green Paper on Monetary Control. The choice between the two approaches is one of emphasis in determining the bands - primacy to M1 or primacy to £M3.

Presentation

3. If interest rates are to fluctuate more, changes in the interest rate bands should be seen as a natural response to the criteria by which interest rates are set. We need to do everything we can to ensure that changes, whether up or down, are not seen as overt political acts. So far as possible Ministers need to stick to the line taken by the Prime Minister in Ottawa and avoid commenting on particular actions by the Authorities in the money markets or on changes in particular interest rates.

PEM
24 July 1981

AMENDMENTS TO MONETARY CONTROL: THE NEW ARRANGEMENTS

Paragraph 3: after (II) delete "Transitional problems:"and insert "Suspending" to read:

"(II) Suspending. Minimum Lending Rate."

Paragraph 33: in the fourth sentence delete "will shortly be" and replace with "is" to read:

"The Bank is resuming discussions with the banks ..."

Before paragraph 35 after (II) delete "Transitional Problems:" and insert "Suspending".

Paragraph 35 should end after the first sentence. The rest of that paragraph becomes new paragraph 36.

Old paragraph 36 becomes new paragraph 37.

Delete existing paragraphs 37 and 38 and substitute the following paragraph 38:

"38. There may be occasions when a substantial change in short-term interest rates is either required immediately or needs to be timed to coincide with policy action in other fields. The Bank of England's open market operations could not be relied on to ensure that such changes would occur to the right extent and at the right time. In such exceptional circumstances, when the Authorities consider that an immediate signal about such a move is necessary, it will still be possible to give one by announcing in advance the rate at which the Bank will provide cash on the next available occasion. Thereafter the normal arrangements, under which no advance announcements about rates would be made, would be resumed."

was non-monetary in origin: the increase in world export prices in 1973-5 was preceded by a sharp rise in world monetary growth in 1971/72, echoes of which can be seen in the UK for both the broad and narrow aggregates.

9. This explanation does not resolve all the problems about the monetary origins of the 1975 inflation, but it casts doubt on the popular view that the behaviour of £M3 and M1 in the early '70's proves conclusively that, for the UK, broad aggregates are more economically significant than the narrow ones. The period 1972-75 aside, M1 has been slightly better than £M3 in predicting the rate of inflation and since 1978, M1 has been distinctly better, with £M3 showing a marked tendency to under-forecast the rise in prices that occurred.

10. The more important point, however, is that simple relationships between money (and money alone) and prices are not very good at tracking movements in inflation over periods as short as 2-5 years, though they may be adequate for explaining long run trends. Inflationary shocks of various sorts - stemming from movements in world oil prices changes in tax policies, income policies and their aftermath etc. - may significantly affect the speed with which prices respond to movements in the money supply. Even though these fluctuations may be ironed out in the long term, they can be very important in determining prices in the short to medium term. But over the long term, as noted above, the various monetary aggregates tend to move fairly closely together.

11. This suggests that it is not possible to discriminate adequately between the different monetary aggregates on the basis of their relationship with prices. Restraining the rate of inflation by controlling the money supply is a fairly long run policy and, over this time horizon, one aggregate will broadly do as well as another.