MONETARY BASE CONTROL

PART 14

22 November 1983 – 25 November 1983

From: P E MIDDLETON
Date: 22 November 1983

CHANCELLOR

cc: Economic Secretary
Sir T Burns
Mr Cassell
Mr Lankester
Mr Monck
Mrs Lomax

MONETARY BASE

You have seen Mrs Lomax's minute of 18 November recording the results of my regular monthly meeting so far as the assessment of monetary conditions was concerned.

2. In fact we spent much of the meeting talking about the monetary base and what we might do between now and the Budget to "test out" the idea of setting a formal target for it next year. The Bank remain pretty hostile to the idea of a published range. But, with some reluctance, they agreed that it would be helpful to assess developments in Mo over the next few months as if we already had a target. They will also include a reference to Mo in the monthly press notice on the money supply.

3. As a practical matter, we settled on a range of 3-7 per cent for the current target period. With an underlying growth in Mo of about 6-7 per cent recently (6.8 per cent over the target period to mid-October), that leaves Mo now performing about as well, relative to target, as £M3. The Bank seemed disposed to argue for both considerably lower numbers - citing the rapid rise in velocity since 1979 - and a wider range. But they did not press the point because they adopted a scatter gun approach to the discussion, spraying anti-Mo slogans in all directions. Many of their arguments were debating points rather than serious suggestions

about what an appropriate range might be.

4. We have not yet resolved the question of how we would publicly justify an Mo target of the 3-7 per cent variety if we decide to have one. This is something we shall need to continue discussing. But it is not clear to me that we need an elaborate an explanation in terms of detailed explanations of velocity trends and so on. We have not done this for other aggregates, in the past; and the amount of science involved is strictly limited anyhow.

X 5. We are all agreed that it makes no sense to look at monthly movements in Mo which, as we have always known, is a particularly noisy series. Judging by some recent work we have done - summarised in the attached charts - we ought to be looking over three months at least, possibly six. We shall need to think further about how to get this message across to the markets and outside commentators - and what the implications are for the way we present monthly information on the other aggregates.

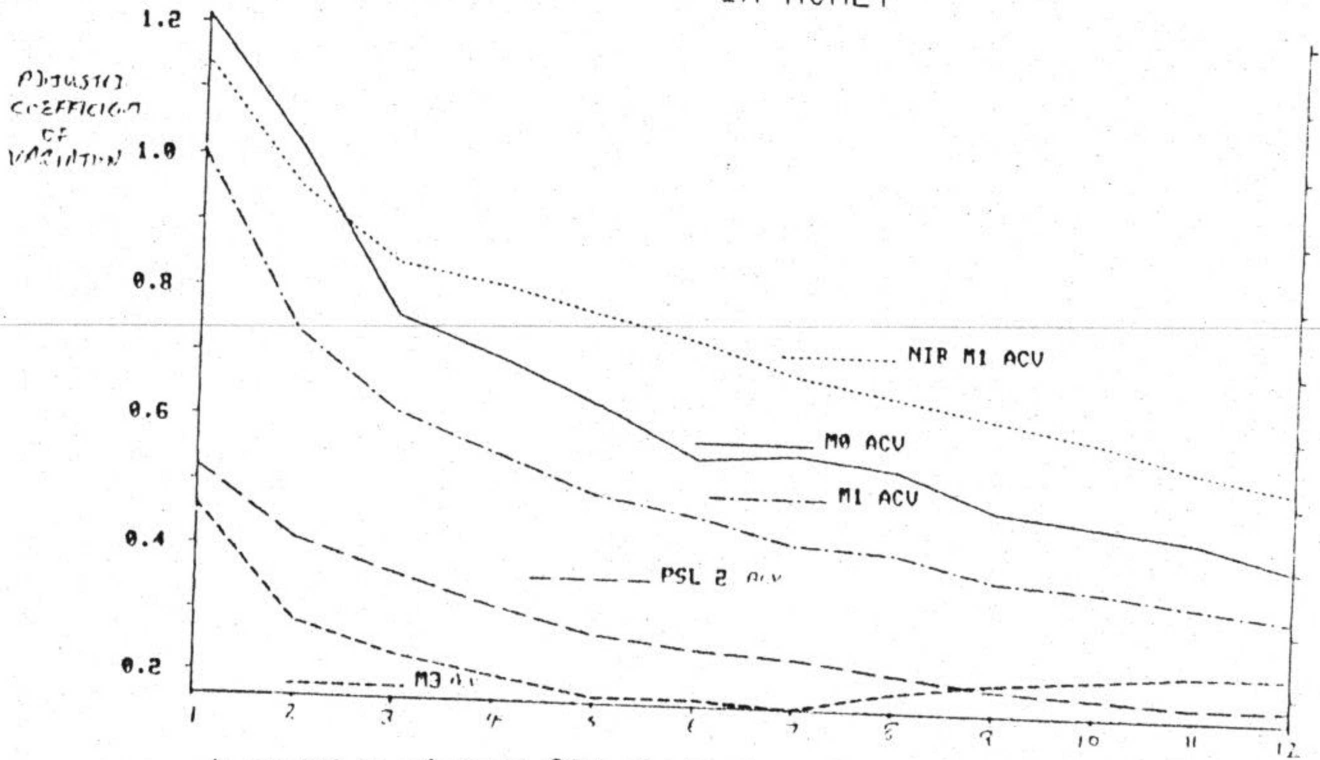
6. The opposition to targetting the base in some quarters in the Bank comes as no surprise. But the vehemence with which they have been putting their case is a little disturbing. The arguments are familiar enough: that Mo somehow lacks intuitive appeal; that it is unresponsive to interest rates; and distorted by structural changes in the means of payment. The Bank persist in regarding Mo as a very special case - to a degree that suggests that they have a real fear that a monetary base target will be a Trojan Horse for monetary base control, ie changes in the control system.

7. I think that all this will calm down as the Bank gets more used to the idea of Mo as a non interest bearing aggregate. Their present line of argument tends to drift into a general criticism of monetary targetting - which is a long way from what the Bank's actual position is. And over the next few weeks we shall try to persuade them that it is unreasonable to apply tougher criteria to Mo than they

would apply to other monetary indicators.

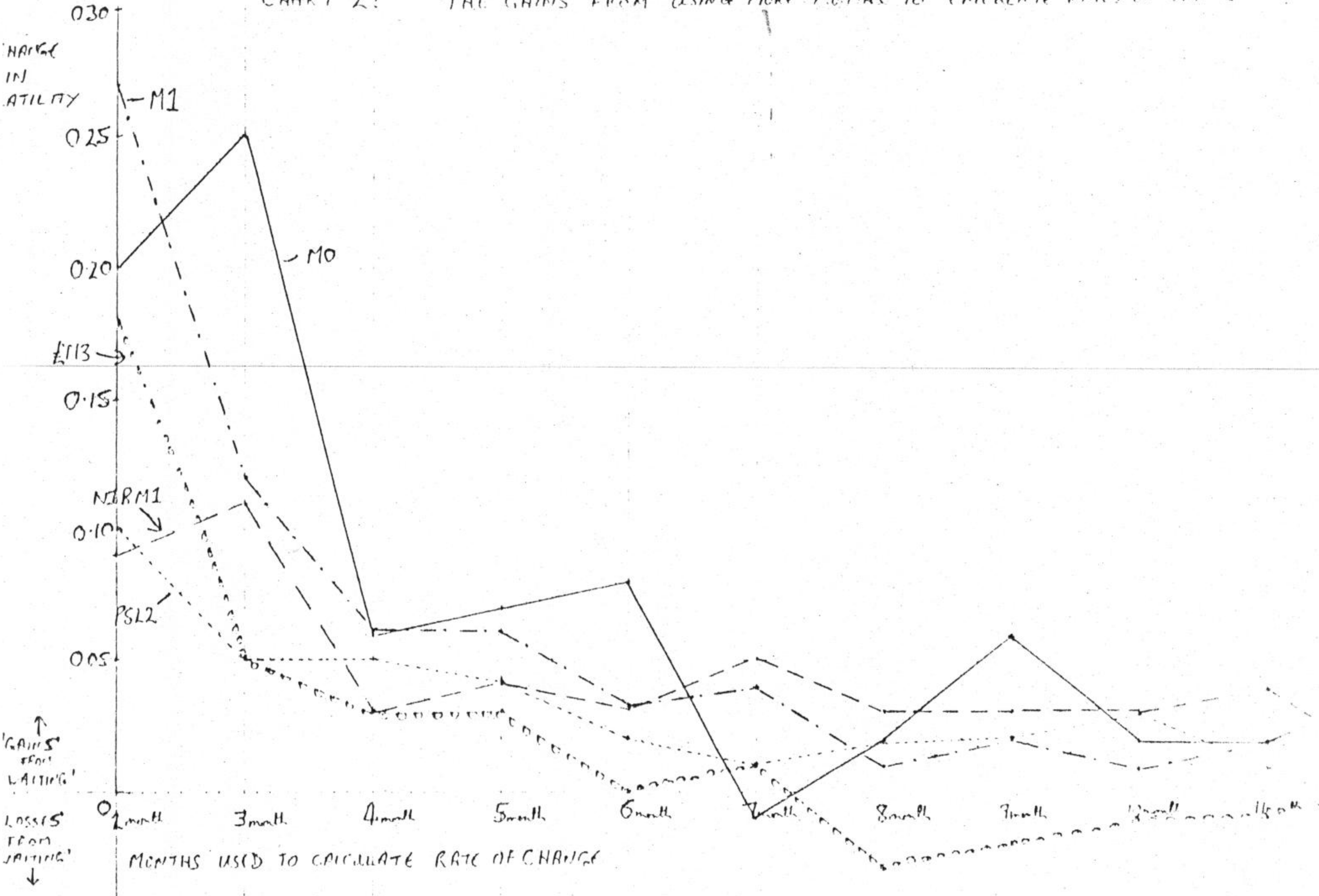
P E MIDDLETON

CHART I: VOLATILITY IN MONEY



Sample: Feb 81 Aug 83

CHART 2: THE GAINS FROM USING MORE MONTHS TO CALCULATE RATES OF CHANGE



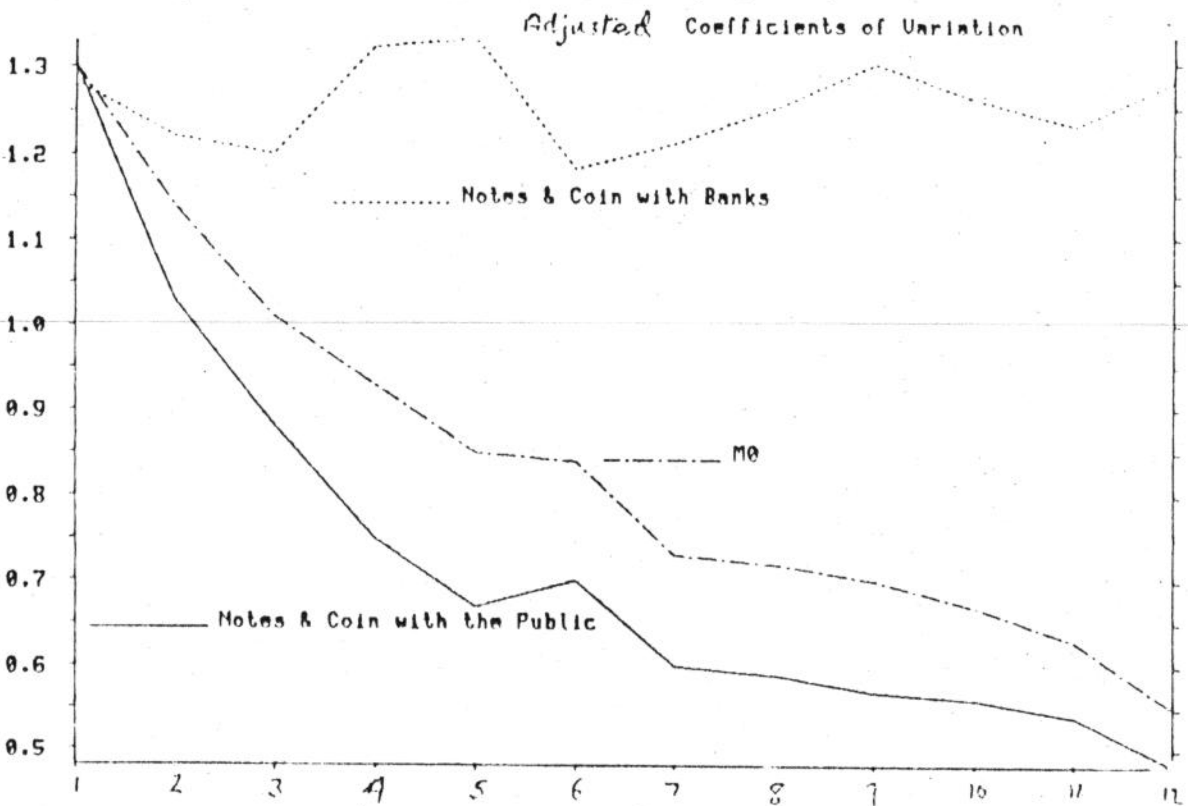


CHART 3. THE COMPONENTS OF M0
Adjusted Coefficients of Variation
1.3
1.2
1.1
1.0
0.9
0.8
0.7
0.6
0.5
Notes & Coin with Banks
M0
Notes & Coin with the Public
1
2
3
4
5
6
7
8
9
10
11
12
MONTHS USED TO CALCULATE RATE OF CHANGE
Sample: 1977-83

1. MR MIDDLETON
2. CHANCELLOR

From: A T O'Donnell
25 November 1983

cc: Economic Secretary
Sir T Burns
Mr Cassell
Mr Lankester
Mr Monck
Mrs Lomax

MONETARY BASE

You asked how much of the "noise" in the MO series is a result of fluctuations in bankers' balances at the Bank of England. The answer is about half. (Details of the calculations are given in Annex A.)

... 2. The attached chart shows the total noise in MO and the lower amount of noise there would be in the MO series if bankers' balances were entir predictable. The greater noise in total MO demonstrates the cost in terms of larger prediction errors of concentrating on MO rather than notes and coin in circulatin with the public and the banks. This is another way of emphasising the size of the spanner that bankers' balances throw into the MO works.

3. Mr Johnston's more elaborate econometric work also suggests that predictions of MO are likely to be about half as accurate as predictions of notes and coin with the public.

Gus O'Donnell

A T O'DONNELL

Annex A

DECOMPOSING THE NOISE IN MO

MO is the sum of cash (ie notes and coins in circulation with the public and the banks) and bankers' balances. Changes in MO can therefore be decomposed into the result of changes in cash and changes in bankers' balances. One estimate of the change in MO is simply the weighted sum of the estimates of these two constituents. (The estimates are calculated from regressions with lagged values of the changes and a time trend as the explanatory variables.) The difference between actual and estimated changes in MO is a measure of the unsystematic movements (ie the "noise") in the MO series. This noise can be subdivided into errors in estimating changes in bankers' balances and errors in estimating changes in cash. However, variations in the errors in predicting MO need not simply be the sum of variations in the errors of predicting the two constituents, because the errors may be offsetting (if they are negatively correlated), or compounding (if positively correlated). In fact cash tends to be unexpectedly high when bankers' balances are unexpectedly high, so the errors are compounded.

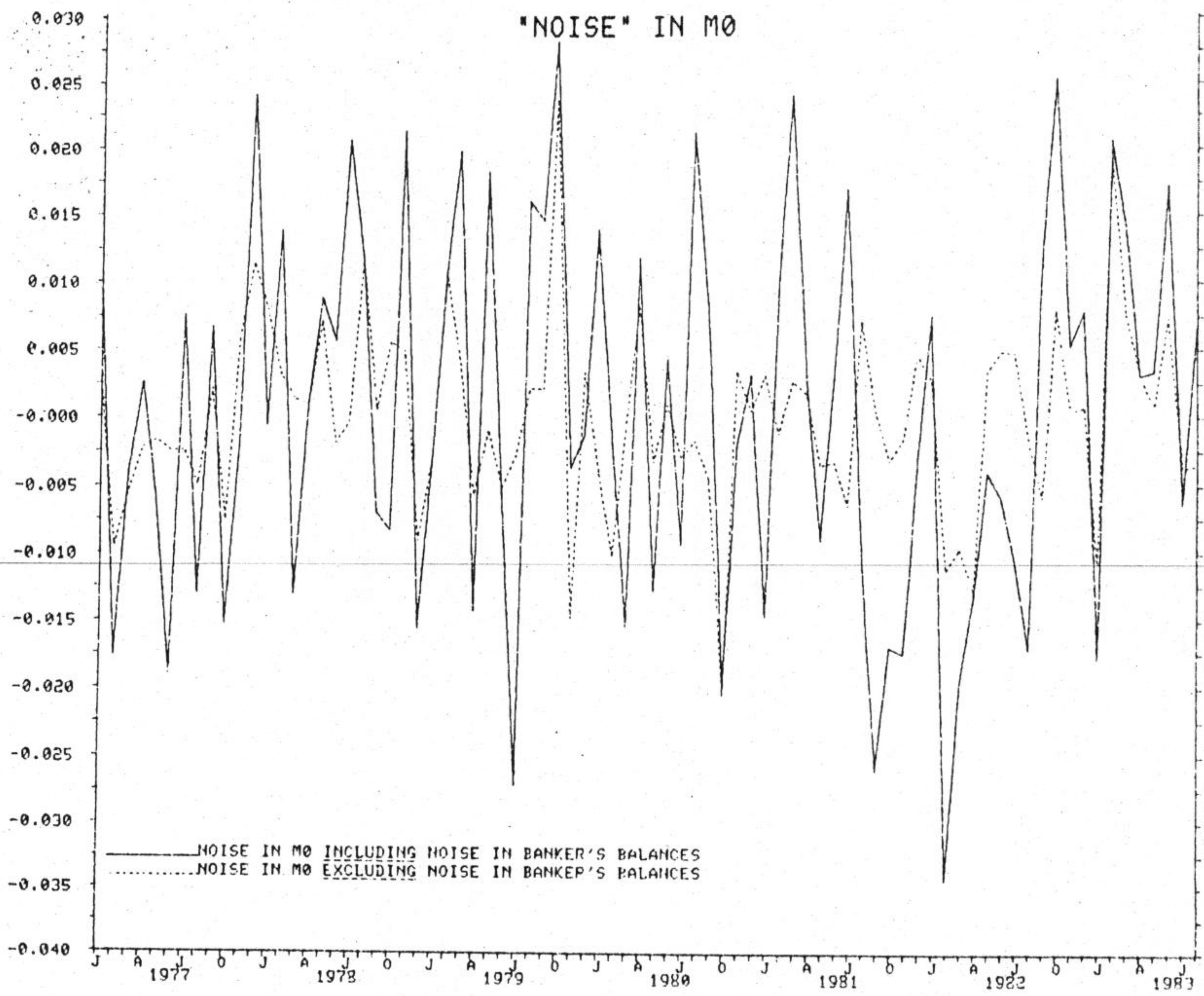
2. The table below shows the percentage of the noise in MO that is due to noise in cash, bankers' balances and this compounding effect. The figures are shown for the period before and after the change in the definition of MO in August 1981. The proportion of the noise due to bankers' balances in the two sub periods increased somewhat from about 50% to 60%. But the proportion due to the volatility of the cash series is substantially lower in the post August 1981 period. One implication of this change is that, while before August 1981 cash was about twice as easy to predict as MO, recently it has been about five times more predictable.

Table <u>The Constituents of Noise in MO</u>

	Noise in Cash	Noise in Bankers' Balances	Compounding Effect[2]	Noise in MO
<u>1975 - July 1981</u>				
Noise measure[1]	12.7	14.3	1.5	28.5
Percentage of total noise	45.0%	50.2%	5.3%	100%
<u>August 1981 - August 1983</u>				
Noise measure	5.1	13.7	4.3	23.1
Percentage of total noise	22.1%	59.3%	18.6%	100%
<u>1975 - August 1983</u>				
Noise measure	10.7	14.6	2.7	28.0
Percentage of total noise	38.2%	52.1%	9.7%	100%

1 Noise is defined as the variance in the errors from a regression with percentage changes in the variable on the same quarter in the previous year as the dependent variable. (The explanatory variables are a time trend and lagged values of the dependent variable.) The noise in MO is the sum of the noise in cash, bankers' balances and the compounding effect.

2 The compounding effect allows for the dependence between the noise in cash and bankers' balances. (Formally the noise in MO equals the noise in cash plus the noise in bankers' balances plus twice the covariance between noise in cash and bankers' balances. This last term is what I have denoted the compounding effect.)



"NOISE" IN M0
Difference between actual and estimated changes in MO on the same month of the previous year
0.030
0.025
0.020
0.015
0.010
0.005
-0.000
-0.005
-0.010
-0.015
-0.020
-0.025
-0.030
-0.035
-0.040
NOISE IN M0 INCLUDING NOISE IN BANKER'S BALANCES
NOISE IN M0 EXCLUDING NOISE IN BANKER'S BALANCES
1977
1978
1979
1980
1981
1982
1983

B2

PS/Mr MIDDLETON

cc: Mr Cassell
Mr Monck
Mrs Lomax

STATEMENTS ON MONETARY BASE CONTROL

Rachel Lomax and I have tracked down the attached copies of key statements on monetary base control, as requested. They cover the period 1980-81 when the subject was live. Thereafter we have not been able to find any significant statements - the subject was not referred to in the 1981 Mansion House Speech or the 1982 Budget for example.

D L Willetts
D L WILLETTS

14/30

[illegible] REFERENCES TO MONETARY BASE CONTROL

/‾Green Paper	March 1980_7
27 October 1980	Chancellor's evidence to TCSC
24 November 1980	Statement in the House: Chancellor:Hansard c.205
November 1980	Methods of Monetary Control - Background Note by Bank of England (BEQB Dec.1980)
December 1980	Economic Progress Report
14 January 1981	Thatcherism in Practice: Speech by N Lawson (FST)
10 March 1981	Budget Speech: Monetary Control: Hansard col.765
/‾12 March 1981	Monetary Control Next Steps(BEQB March 1981)_7
May 1981	Chancellor's Mais Lecture
30 July 1981	Chancellor's PQ from Mr Newens : Hansard col. 498
5 August 1981	Press Notice - New Monetary Control Arrangements
/‾ 5 August 1981	Monetary Control - provisions BEQB Sept. '81_7

Note

Documents referred to in /‾_7 are not attached.

Chancellor's (Sir G. Howe) appearance before TCSC on 27 October 1980

808. Professor Friedman in his Paris speech recently criticised the management of the money supply and urged introduction of monetary base control with the analogy that it was like trying to regulate the output of the motor car industry by regulating the general demand on manufacturing industry and that by resorting to money base control it was controlling supply of steel to the motor car industry. Do you agree that that is a meaningful analogy?

(Sir Geoffrey Howe) He is repeating a point, as I recollect, that he made in his evidence to the Committee.

809. Is it not, in fact, the position where monetary base control—or Professor Friedman's version of it—is proposing to control the supply of British steel to the motor car industry while allowing a free market in import of steel from other suppliers? Would not money base control, in effect, entirely open up the shift of the banking of companies to the overseas branches of the banks in that they are already organised to shift the business there should you introduce money base control?

(Sir Geoffrey Howe) It is a little difficult to follow it in the Milton Friedman analogy, but basically, as you know, the foundation for monetary base control system, if one went over to that, is to concentrate on the control of the supply of the basic commodity rather than control of its price so that the availability of the supply would in due course influence its price. Under either system—under any system of monetary control—in any country in the complex interrelated world economy we now have you are bound to face the question, are you operating solely on the money supply which is domesticated within your own economy? How far is that a true measurement of the money that could influence your economy and, because of the openness of all the world economies at the moment, that raises the question of where you draw the line and how you define the frontier. I do not think that particular problem is solved by not having a monetary base control or solved by having a monetary base control. The problem of definition of the frontier and of that which you can call British money, if one puts it like that, will be with you anyway.

815. But is it not the case that if one were to adopt monetary base control of the kind Professor Friedman is advocating it would mean effectively the Government renouncing any question of controlling interest rates, whereas if I understand the position correctly in recent months the Governor, presumably under your instructions, has been pumping vast quantities of money in to prevent interest rates rising, and would that not seem to be an overwhelming argument against monetary base control, unless one wanted a policy where interest rates could go to whatever level was required and then diminish?

(Sir Geoffrey Howe) It is important to distinguish between mandatory monetary base control and one which is subject to a discretionary override. It is for that reason that the intervention you have referred to has been taking place. You have to consider carefully (a) whether you move to monetary base control, (b) what sort of monetary base system you move to and (c) at what pace and in what way you move towards it. One of the things which has prompted people looking at this subject to favour a move in that direction is that there is a case to be made for having interest rate movements more influenced by the market than they are with the totally administered rate, and monetary base control would move you in that direction. Whether one would want to remove the effect of government is doubtful, and it was one of the points you drew attention to in the closing paragraph of your report on the subject. I believe there is a fundamental question of principle involved in monetary base control, and certain things would follow if you decided to make that change. You have to be careful about deciding at what pace and by what means you get there, and it is unlikely that any government would refrain altogether from retaining some means of intervening on interest rates.

Hansard
24. Nov. 1980

Col. 205

The Treasury and the Bank of England have completed the consultations arising from the Green Paper on methods of monetary control published last March. As a result, between now and the Budget a number of improvements will be set in hand.

First, detailed consideration of new prudential arrangements for the banks will be brought to a conclusion so that the reserve asset ratio, which has complicated monetary control, can be phased out.

Secondly, the Bank of England will develop changes in its open market operations and last-resort lending in ways that will allow the market a greater role in the determination of the structure of short-term interest rates.

Thirdly, we are considering the future of the clearing banks' cash ratio and also collecting and publishing an additional series for banking retail deposits. These steps are desirable in their own right. They would be consistent with a gradual evolution towards a monetary base system and will help us to judge how far such a system would contribute towards our medium-term monetary objectives.

Economic Progress Report

Published by the Treasury

No. 128 December 1980

The Chancellor's statement of economic policy

On 24 November the Chancellor made a statement on economic policy to the House of Commons. He announced a number of items including the outcome of consultations on monetary control, certain changes in public expenditure programmes in 1981-82 following ministers' annual review of public spending, increases in the rate of employees' national insurance contributions in April 1981, and a new supplementary oil tax to be paid in addition to Petroleum Revenue Tax. The Chancellor also announced a reduction in Minimum Lending Rate from 16 per cent to 14 per cent.

The changes are designed to further the Government's medium-term financial strategy[1] of securing a sustained reduction in inflation through reduction of monetary growth with complementary fiscal policies. They will also help to lighten the relative burden on the private sector, especially on non-oil companies which have been subject to particular financial pressures. The Chancellor made it clear, however, that the main fiscal decisions for 1981-82 must await the next Budget. The changes are described in more detail in the following pages.

Industry Act forecasts

The Chancellor opened his statement by announcing the publication of the economic forecasts required by the Industry Act 1975[2]. These projections were issued in a press notice on the same day, and are also available in a supplement accompanying this edition of *Economic Progress Report*. They should be read bearing in mind the large margins of error involved and include, for gross domestic product, falls of 3 per cent in 1980 and 1½ per cent in 1981; a balance-of-payments surplus of £2 billion in both years; and a rate of increase in the Retail Prices Index of 15½ per cent between the fourth quarters of 1979 and 1980, falling to 11 per cent between the fourth quarters of 1980 and 1981.

Monetary policy

The Chancellor said in his Budget speech of 26 March that he would be considering in the autumn the roll-over of the monetary target of 7 to 11 per cent growth (in sterling M3) at an annual rate set for the period from February 1980 to April 1981. He has decided to continue the target at its present rate till the end of that period. A new target will be announced in the next Budget, which will be designed to ensure that the thrust of the medium-term strategy is maintained.

This decision has been made in the light of developments in monetary matters and in the economy generally. Monetary growth is expected to exceed the target this year, even allowing for recent statistical distortions.[3] However, it should slow down in the near future, with the rate of inflation now falling and the increase in bank lending showing signs of slackening.

The Treasury and the Bank of England have been reviewing monetary control techniques in the light of the consultations that have taken place since the Green Paper on Monetary Control was published last March [see *Economic Progress Report*, May 1980]. The Green Paper raised the possibility of moving towards a system of control in which judgements about the appropriate level of interest rates are replaced by control of the monetary base (banks' cash balances at the Bank of England). No final decision can yet be taken about monetary base control. But it is clear that while it has attractions, evolution in control techniques must be gradual, and that there are a number of useful changes which should be made now whether or not there is an eventual move to monetary base control. The Chancellor announced a number of changes which will be made between now and the next Budget. The reserve assets ratio will be abolished, as soon as consultations about alternative prudential arrangements have taken place. The Bank will be discussing changes in the way it conducts its money market operations, designed to allow more flexibility in short-term interest rates and a greater role for the market in determining the level of rates. Access to last resort lending will be made relatively more expensive and less routine. The cash ratio requirement for London clearing banks to hold 1½ per cent of eligible liabilities in non-interest-bearing deposits with the Bank of England will be reviewed. The Bank of England will discuss with the banks the collection of statistics for a new monetary aggregate, intermediate between M1[4] and M3[4]. Apart from providing immediate benefits, these changes should help to produce information relevant to assessing the longer term potential of monetary base control.

The Chancellor is to take further steps to mobilise directly a larger share of personal savings. In particular, he will extend the

[1] See *Economic Progress Report*, April 1980.

[2] Required twice a year, and usually taking place at the time of the spring Budget and in November.

[3] Due to the effects of the Supplementary Special Deposits Scheme, and its abolition in June this year.

[4] M1, the narrow definition of money supply, includes notes and coin in circulation and bank current accounts. M3, the wider definition of money supply, also includes bank deposit accounts.

Methods of monetary control

This background note was issued by the Bank on 24 November.

1 Since publication of the Green Paper on Monetary Control[1] the Treasury and the Bank have carried out extensive consultations and discussions on proposals for a change to a system of monetary base control and also on possible improvements to operational techniques within the existing framework.

2 From the consultations on monetary base control, two main types of proposal emerged, with an important distinction drawn between:

(i) non-mandatory systems in which banks are free to choose the amount of cash balances which they hold at the Bank of England; and

(ii) mandatory systems in which banks are required to hold a specified proportion of their liabilities as cash balances at the Bank of England.

3 Present arrangements do not allow firm judgments to be made about the desirability of moving to either kind of base control. In the case of a non-mandatory arrangement, it is not known whether the cash which the banks would choose to hold would be stably related to the money supply or to nominal income over an appropriate period. A mandatory system, on the other hand, particularly if related to a broad monetary aggregate, could prove vulnerable to the diversion of monetary flows outside the controlled area. In addition, and before fully moving to either system, time would be needed for adequate information and experience to be gained about the banks' demand for cash.

4 In this context, the Chancellor has announced in the House of Commons this afternoon that a number of improvements to the present system will be set in hand. These are desirable in their own right but they would also enable more to be learnt about the properties of a monetary base system and would be consistent with further evolution in either of the directions set out in paragraph 2 above.

5 The improvements to be set in hand within the existing framework are as follows:

(i) Once consultations with the banking system regarding adequate holdings of liquid assets have been completed, and appropriate norms agreed, the reserve asset ratio will be abolished. This was foreshadowed in the Green Paper.

(ii) Further consideration will be given to the future of the $1\frac{1}{2}\%$ cash ratio currently applying only to the London clearing banks, with a view to establishing arrangements that would be equitable within the banking system, and that could enable the authorities to monitor the development of the functional demand for cash balances at the Bank of England which could ultimately be associated with a non-mandatory system of monetary base control.

(iii) Discussions will take place with the banks regarding the collection of additional statistics on retail deposits, which would provide further information on monetary conditions and could, if that subsequently seemed appropriate, become the denominator of a cash ratio associated with a mandatory monetary base system.

(iv) Changes will be developed in the Bank of England's methods of intervention in the money market:

(a) It is envisaged that the Bank's intervention will place a greater emphasis on open market operations and less on discount window (lender of last resort) lending. It has been decided that these operations should continue to be conducted in the bill markets rather than through the inter-bank market, and in large part through the existing intermediaries, members of the London Discount Market Association, to whom discount window facilities would remain confined.

(b) Initially, the Bank's operational aim would be to keep very short-term interest rates within an unpublished band which would be determined by the authorities with a view to the achievement of their monetary objectives. The Bank would normally charge a rate on its discount window lending somewhat above comparable market rates but within the unpublished band. At an appropriate stage the Bank might cease to announce a minimum lending rate. These arrangements would allow market factors a greater role in determining the structure of short-term interest rates. It is accepted that this could lead to more flexible, market related, pricing of overdraft facilities.

(c) The Bank's operations would be broadly intended to offset daily cash flows between the Bank and the money markets. The present technique of creating initial shortages in the money markets which the Bank then acts to relieve would be abandoned. There would accordingly no longer be a deliberate over-issue of Treasury bills at the weekly tender.

(1) *Monetary Control* (HM Stationery Office, Cmnd 7858)

we have had our difficulties, our setbacks and our problems—and I shall seek to identify and evaluate these at some length before I sit down. But fashionable comment today all too often concentrates exclusively on those difficulties, setbacks and problems; and that would be an error which I am sure you would neither wish me nor indeed expect me to commit.

Arguably the most important change that has occurred, however, is not one that can be quantified in any way, but one that is no less real for that. I refer to the change in the crucial psychological climate of the economy; the new mood of realism that now prevails on both sides of industry. In the labour market, after a year of unreality in which wage settlements were made far beyond the capacity of firms to pay and far in excess of what was sensibly compatible with the Government's monetary framework, and in which average earnings rose by over 20 per cent, we are now, in the present wage round, seeing single figure settlements become commonplace—without, to repeat, any formal pay policy, with all its rigidities, distortions, and high political costs.

At the same time there has been a marked improvement in industrial relations, with many fewer man-hours lost in strikes.

The change on the management side of industry has been equally profound. Managers who in the past were seeking little more than a passive point of equilibrium between Government guidance on the one hand and trade union pressures on the other, are now actively managing again. As a result, British companies throughout the length and breadth of the country are becoming more efficient, leaner, tauter, fitter and more productive.

While this may not itself constitute economic success, it is undoubtedly a necessary precondition of success, and has long been recognised as such.

Monetary Growth

Let me now turn to the difficulties, setbacks and problems—both expected and unexpected—we have encountered on the way. These may usefully be divided into two main categories: those connected with the execution of our policies, and those connected with the outcome of those policies—or indeed of the other forces, outside government control, which bear upon the economy.

In the context of the first of these two categories, I mentioned earlier in this talk that the heart of our economic policy is the Government's published and indeed quantified medium term financial strategy, the core of which is a steady slowing down in the rate of monetary growth over a four-year period, buttressed by a gradual reduction in the size of the underlying budget deficit, which in turn is to be achieved by a steady reduction in the real level of total government spending.

On the crucial monetary front, it must be conceded that the picture is somewhat obscure and rather patchy.

What is clear is that we inherited a situation of excessive monetary growth, which had to be tackled as a matter of urgency. Over the eighteen months immediately prior to our taking office, narrow money—M1, or notes and coins plus private sector sterling sight deposits—had been rising at an annual rate of 14½ per cent, and the usual measure of broad money—sterling M3, defined as M1 plus public sector [illegible] deposits and all sterling time deposits—at 13½ per cent.

In fact, this latter figure was an understatement of the true underlying growth [illegible] broad money. In mid-1978 the previous Labour government had reimposed the [illegible] called 'corset', a device invented by the Bank of England during the latter period [illegible] the previous Conservative government, and designed to curb bank advances [illegible] thus deposits) by the imposition on the banks of financial penalties for the ex[illegible] growth of such advances and deposits. In practice this artificial constraint [illegible] to various forms of disintermediation: that is, resort to financial transactions [illegible] by-pass the banks. This occurred most notably (though by no means exclusively) through the financing of the private sector via acceptance credits. Since [illegible] acceptances are not included on the definition of sterling M3, the only lasting [illegible] of the corset was to distort this particular statistic without in any way curbing [illegible] true growth of broad money. The present Government duly abolished the corset [illegible] June: with the wisdom of hindsight a strong case can be made for the proposition that we should have followed our original instinct and announced its abolition immediately on taking office, a year previously: a thermometer which gives a [illegible] reading, however flattering, is no use to anyone.

Be that as it may, the aftermath of the abolition of the corset was inevitably [illegible] unwinding of all the disintermediation and other distortions that had accumulated during the two years in which it was in force, thus artificially inflating the published sterling M3 figures by as much as they had previously been artificially deflated.

However, a rather better guide to the true growth path of broad money can be [illegible] from the published series for what we call PSL 1 (PSL standing for private sector liquidity). Some 90 per cent of PSL 1 is accounted for by sterling M3; but it does [illegible] include other money market instruments and thus catches the acceptance credits used to evade the corset. I therefore propose to use this series when referring to broad money, even though it has to be said that not even PSL 1 has been wholly unaffected by the distortions and counter-distortions of the corset saga.

Over the eighteen months prior to our taking office, then, narrow money had been growing at an annual rate of 14½ per cent and broad money at an annual rate of some 15½ per cent. Over the eighteen months since we took office, the annual rate of growth of narrow money has fallen sharply to 5 per cent (and there has been a similar sharp fall in the rate of growth of the monetary base, or M0), but the annual rate of growth of broad money has remained almost unchanged at 16 per cent. This compares with a published target for the period concerned of 9 per cent, plus or minus 2 per cent.

How Tight a Policy?

Does this mean that monetary policy, in the sense that matters for the conquest of inflation, has been tight, as the Government manifestly intended—and indeed [illegible] intends—or has it been alarmingly lax? We have all along made it clear, most [illegible] in the Green Paper on Monetary Control that we published last March, that [illegible]

underlying monetary conditions properly it is necessary to take account of the evidence of *all* the various monetary indicators. And certainly the evidence of the main financial indicators, which generally speaking reflect monetary conditions—the strong exchange rate, high interest rates, the tight corporate liquidity position, and decelerating inflation—would appear to confirm the message of the narrow money figures: namely, that monetary policy has indeed been tight.

Unfortunately it is not quite as simple as that. For the purpose of setting the annual target for monetary growth—and indeed for the four year path set out in the medium-term financial strategy—we have (like our predecessors, but unlike most other countries, incidentally) chosen broad money as the single most useful guide. I believe we were and remain right to do so. Narrow money has the advantage of being easier to control, but it suffers from being almost too easy to control. In particular, a rise in interest rates (and short term interest rates have been at unprecedented levels during the year to last November) will inevitably lead to a marked switch from non-interest bearing sight deposits to interest bearing time deposits, thus sharply depressing the growth of narrow money far beyond any true change in underlying monetary conditions. Nor can we forget that under the Heath administration, when monetary growth exploded, with the inevitable inflationary consequences, the authorities were lulled into a false sense of security by the fact that the rate of growth of narrow money was declining steadily, throughout that Government's lifetime, from some 13½ per cent in 1970-71 to 3½ per cent in 1973-74.

Thus despite the tight conditions that have undoubtedly prevailed hitherto, we cannot, I believe, view with equanimity, so far as the medium term course of inflation is concerned, the fact that the growth of broad money has been running well ahead of the target rate. So far, however, the excess growth that has occurred need not have adverse inflationary consequences. In reinforcement of the message conveyed by the various financial indicators to which I have already referred, it has to be borne in mind that a high level of short term interest rates, in addition to artificially depressing the rate of growth of narrow money, has probably also artificially inflated the rate of growth of broad money.

This occurs in two ways. First, there is an 'investment' demand for interest-bearing money which is held for non-monetary purposes and which will be switched back into non-money assets as soon as short rates fall. Second, since the whole structure of interest rates tends to rise and fall together, albeit by different amounts at different ends of the spectrum, a high level of short rates paradoxically encourages companies to resort to short-term bank finance, rather than long-term bond issues, to which they will revert once the general structure of interest rates has fallen to what appears to be normal or even favourable levels.

This emphatically does not mean that monetary growth is, other than for short periods at particular times, inflated by high interest rates and reduced by low ones. What I am referring to is an essentially temporary phenomenon: at a particular stage in the process of bringing down inflation, through which the British economy has just been passing, high interest rates have a much less dampening effect on the demand for money (and hence on its supply) than might have been expected [illegible] excess demand can be expected to disappear again as the cycle enters its [illegible] phase.

The conclusion I draw from all this—and I make no apology, before so [illegible] audience as this, for going into the matter in considerable detail: it is [illegible] surprising that in the sophisticated modern world, and in particular for a country [illegible] financially advanced as the UK, monetary control is a highly complex matter [illegible] that is no reason for getting it wrong, still less for abandoning the task altogether [illegible] to repeat, the conclusion I draw from all this is that monetary conditions in the [illegible] have not been inflationary so far, but that it is essential from now on to [illegible] lower rate of growth of broad money, and indeed, over the three remaining [illegible] the medium term financial strategy, it might well be prudent to claw back [illegible] some of the excess growth that has already occurred.

To some extent, as I have already indicated, this will be greatly facilitated [illegible] natural development of the economic cycle: in particular, as the de-stocking [illegible] which has been particularly dramatic over the past year, enters its final phase [illegible] private sector's demand for bank finance will greatly moderate; and there are [illegible] signs that this has begun.

Where Improvement is Needed

But the crucial determinant of the Government's success in controlling the [illegible] broad money must clearly lie, first, in a better control of public sector [illegible] (and hence of government spending), along the lines mapped out in the medium [illegible] financial strategy and, second, in a better ability to finance in a non-monetary [illegible] the public sector borrowing requirement that does emerge—in other words, [illegible] ments in funding techniques.

Both elements are vital. So far as funding is concerned, the position is to some [illegible] complicated by the fact that in the United Kingdom, almost uniquely in the [illegible] is the Central Bank rather than the Treasury which is responsible for financing [illegible] Government's Budget deficit. But this oddity should not be allowed to be [illegible] impediment to what needs to be done. Since the publication of the Government's [illegible] discussion paper last March—the Green Paper on Monetary Control to which I [illegible] already referred—it has become increasingly clear that there is a need to strengthen [illegible] the instruments of monetary control. We have had a period of intensive discussion [illegible] all this, and the Chancellor announced his preliminary conclusions to the House [illegible] Commons in November.

Increasingly, as those discussions developed, it became clear that funding [illegible] heart of the matter—not least because it is the method of, as well as the [illegible] funding which largely determines the system by which interest rates are [illegible] both the short end and the long end of the market. It is in this context that [illegible] deal of interest has been evinced in the various systems of monetary base [illegible] variant of which is of course the essence, as I understand it, of the Swiss [illegible] monetary control. Thus it was that the Chancellor announced to Parliament [illegible] November last a number of minor changes designed, *inter alia*, to 'allow [illegible]

a greater role in the determination of short-term interest rates' and to 'be consistent with a gradual evolution towards a monetary base system'.

But the differences between Britain and Switzerland are very considerable, and need to be borne in mind. One of them is the relative importance of the public sector and the relative size of the Budget deficit. In Switzerland these are small by comparison with most other industrial countries. By contrast, in the UK we have a relatively large public sector and the public sector deficit to be financed is very large indeed in relation to the total capital flows in the economy. Indeed, in recent years issues of gilt-edged stock have represented not far short of 90 per cent of total capital issues. It is this difference, incidentally, which to some extent explains the greater importance the UK attaches to the behaviour of broad money.

A second major difference between Britain and Switzerland is that we in the UK have very little idea of the size of cash balances the banks would wish to hold if we were to move to a system of monetary base control under which the Central Bank no longer supplied the banks, at a known non-penal rate, with whatever reserve assets their balance sheets required.

It follows from this that any move towards monetary base control in the UK is bound to be evolutionary; and, in the meantime, that we are bound to pay attention to other aspects of improving our funding techniques.

The Public Sector Borrowing Requirement

At the same time, we are keenly aware of the need to achieve a better control of public sector borrowing. At the time of the Budget, last March, the total Public Sector Borrowing Requirement for 1980-81 was forecast at £8½ billion, or some 3¾ per cent of forecast GDP. In his statement to the House last November, the Chancellor admitted that it looked like turning out some £3 billion higher than this—more than half the excess due to the recession being deeper than expected, thus causing increased expenditure on unemployment benefit, lower tax revenues, and higher borrowing by the nationalised industries, whose need for external finance is an important component of the total public sector borrowing requirement.

It may well prove that the final outturn is even greater than this: in addition to the direct effects of the recession on tax revenues, there is the tendency, when money is tight, for both companies and individuals to delay payment of the tax due from them so far as they are able to do so.

The difficulties of accurately forecasting the public sector borrowing requirement are inevitably very considerable. In the first place, it is the difference between two vast magnitudes—public expenditure and public revenues—each of which is running at well over £100 billion. Thus an error of 1 per cent on *either* side means a difference of £1 billion to the PSBR. Again, not much more than half the total represents borrowing by and on behalf of central government: the other half is divided more or less equally between the borrowing needs of the nationalised industries and other public corporations, which are particularly susceptible to the vagaries of trading conditions, and borrowing by local government.

This last element adds a further dimension of uncertainty, since under our existing system the central government has no control whatever over the proportion [illegible] capital expenditure the various local authorities decide to finance by [illegible] (rather than by local taxation), despite the fact that local authorities are a[illegible] borrow at privileged rates which bear more relation to the cost of Government [illegible] than to the credit rating of the individual authority. Nor is this the only way in which the constitutional principle of local government autonomy impinges on [illegible] finance. At the end of the day, central government has no direct control [illegible] over the one quarter or so of total general government expenditure that is a[illegible] for by local government current spending.

Needless to say, none of these difficulties—still less the traditional tendency [illegible] means confined to Britain, for every Minister round the Cabinet table to be [illegible] Government expenditure in theory but in favour of it in practice so far as [illegible] most exceptional Department is concerned—none of these difficulties absolve [illegible] Government from the contining need to do whatever is necessary to keep [illegible] spending and borrowing under control, in conformity with the medium [illegible] financial strategy.

Controlling Public Expenditure

Indeed, we have already taken a number of highly unpopular decisions, some of them involving highly controversial legislation in the welfare and other fields, to [illegible] this end. Total expenditure, in real terms, will be slightly higher this year (1980-[illegible]) than it was last year—though still very much less than our predecessors had planned—but from then on the medium term financial strategy sets out a steadily de[illegible] trend, until by 1983-84 it should be some 4 per cent lower than in 1979-80—the [illegible] in which we took office—and by 1982-83 11½ per cent lower than the planned [illegible] we inherited from our predecessors. We are determined to keep to that down[illegible] path.

Moreover, up to now we have been severely impeded on the public expenditure [illegible] by the massive explosion in public service pay, which accounts for some 30 per [illegible] of total general government expenditure. This arose partly as a result of the [illegible] standing 'fair comparison' system for determining civil service pay, but more par[illegible]cularly from the recommendations of the egregious comparability commission ne[illegible] set up, as I mentioned much earlier in this talk, to deal with pay in the rest of the public service. Again with the wisdom of hindsight, it is possible to argue that th[illegible] Conservative Party should never, when in opposition, have pledged itself to hon[illegible] whatever cheques the Clegg Commission, as it is (or was) commonly known, [illegible] present. But it would be foolish not to recognise that some kind of public [illegible] explosion was bound to occur in the aftermath of a period of formal income[illegible]

During this phase, not only was the cost of the public services greatly inflated, [illegible] quite disproportionate and wholly unfair share of the burden of the recession and the Government's harsh but necessary anti-inflation policies fell on the p[illegible] sector.

That phase, however, is now over: the Clegg Commission has been abolished.

I am prop[illegible] short-term monetary [illegible] by smoothing the uneven flow of tax revenue. The most important area is that of North Sea oil taxation, to which I shall come later. Other proposals will be described by my hon. and learned Friend the Minister of State later in this debate, if he is fortunate enough to catch your eye, Mr. Speaker.

MONETARY CONTROL

These initiatives will be accompanied by other improvements in monetary control. Following extensive consultations based on last year's Green Paper I outlined last November some changes that were desirable in their own right and would be consistent with a gradual evolution to monetary base control. These will come into effect during the coming financial year.

The reserve asset ratio has complicated monetary control. The first step in phasing it out was made in January. In the next month or two, at the conclusion of talks now to be undertaken with the banks, the ratio will cease to be a minimum requirement. Thereafter it will be adapted to have a transitional role as a prudential norm round which there will be variation, until the detail of the new arrangements has been settled.

The Bank of England has already made some useful changes in its money market operations. In its dealings with the discount houses it now relies mainly on buying and selling bills. Direct lending to the market has been greatly reduced. The interest rate on this lending is also now generally somewhat above comparable market rates, while the rates at which the Bank conducts its open market operations have become more flexible. In conducting its operations in bills the Bank no longer quotes rates for more than one month ahead. Instead, it responds to bids and offers. This has the great advantage of allowing the market a greater role in determining the structure of short-term interest rates.

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.

Decisions about short-term interests 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. Modest reductions in interest rates were made in the second half of last year. Progress in reducing inflation, strongly positive real interest rates, a noticeable slackening in the growth of sterling M3 in recent months, and a marked fall-off in bank lending point towards a further reduction in rates. The increases in taxation that I am proposing in the Budget will make it possible to have an immediate reduction. Accordingly, the Bank of England is today, with my approval, reducing its minimum lending rate by two percentage points.

[PUBLIC EXPENDITURE]

Further progress towards lower inf[illegible] interest rates does not depend primarily on impr[illegible] in funding techniques or in managing the money [illegible] important though these are. The overriding ne[illegible] more effective restraint of public spending. In the[illegible] public expenditure has put a severe strain on th[illegible] Much of the increased spending has been caus[illegible] effects of the recession being worse than expect[illegible] has been an increase of £¾ billion in sper[illegible] unemployment benefit and on special em[illegible] measures, notably the temporary short-time [illegible] scheme. On many central Government prograr[illegible] expected shortfall in expenditure has not happene[illegible] the total has been higher than expected.

The recession has also—inevitably—had an effect on the financial situation of most nati[illegible] industries. It has meant an increase in the total [illegible] industries' external financing limits for 1980-81 [illegible] £900 million, over half of which has been for [illegible] industry. Some of the nationalised industries [illegible] taking steps to reduce the overmanning and ine[illegible] which have built up over the years. But that too [illegible] more money initially.

These, however, have not been the only so[illegible] upward pressure. On defence there has been su[illegible] overspending—to the tune of £260 million—[illegible] above a cash limit that had already been increased [illegible] million. Local authorities' total cash spending ap[illegible] have been a good deal higher than allowed in [illegible] Budget—and the position would have been muc[illegible] without the firm action taken by my right hon. Fr[illegible] Secretary of State for the Environment.

Because of all these developments we have [illegible] able, in the course of 1980-81, to secure the full 5 [illegible] cut at which we were aiming in our predecessors' [illegible] volume of expenditure. We have nevertheless ac[illegible] reduction of about 3½ per cent.—or £3½ billion. M[illegible] since the Government came into office numbers e[illegible] in the Civil Service have fallen by 35,000, an[illegible] equivalent of about 40,000 full-time staff [illegible] government.

THE COMING YEAR

In the coming year, some of the upward pres[illegible] public sector spending are bound to remain with u[illegible] in mind, for example, last November's decision [illegible] more on industrial support and on special emp[illegible] measures to ease the effects of recession. Next [illegible] cost of special employment measures will be no [illegible] £1 billion. This will make it possible to off[illegible] unemployed school leaver a place on th[illegible] opportunites programme by Christmas. And we [illegible] offer other 16 and 17-year-olds, unemployed [illegible] months, places within a further three months [illegible] 440,000 opportunities will be offered—twice as [illegible] in 1979-80. In addition, the temporary short-time [illegible] compensation scheme is currently supportin[illegible] 700,000 people.

However, this need to spend more o[illegible] programmes cannot justify accepting the wro[illegible] balance. That is why we took the decision [illegible] announced last November to reduce most [illegible] Government's other programmes by £1,400 milli[illegible] These substantial cuts will go a good deal of th[illegible]

MAIS LECTURE

[illegible]
extensive and interesting public debate which followed the Green Paper on Monetary Control confirmed that there were improvements to be made to the monetary system, and that control of the monetary base had some attractions. But to make such a step would be a major change with widespread implications for many parts of the financial system. Rather than move precipitately our approach has been to proceed step by step, making changes which are desirable in themselves and which will enable us to learn more about the way in which alternative methods of monetary control might operate.

Supporting policies

I have never believed that the setting of monetary targets can be enough by itself. There are other requirements. First of all, fiscal policy must be compatible with our monetary policy. Experience shows that it is virtually impossible to finance an excessive public sector deficit without adding to the money supply. Even were it possible it could jeopardise success against inflation by adding to nominal incomes or precipitating a fall in the exchange rate. Excessive public borrowing could also in some circumstances increase the transitional costs of reducing inflation. The high interest rates which might be necessary to finance an excessive PSBR would bear most heavily on companies,

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Interest Rates

19. **Mr. Newens** asked the Chancellor of the Exchequer if he will make a statement on the present level of interest rates.

Sir Geoffrey Howe: Both short and long-term interest rates have risen in the last month. But there have been some signs of easing this week and United Kingdom rates remain lower than those prevailing in the economies of many of our principal competitors. The House will recall that my Budget speech foreshadowed a number of changes in our system of monetary control, the principal objective being to allow the market a greater role in determining the structure of short-term interest rates. Recent developments have begun to show the way in which these arrangements will operate in practice. I expect the full system to come into operation on 20 August, the first day of banking September.