11. Monetary Control Consultations

10 October 1980

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10 October 1980

HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

COMMENTS BY CHRISTOPHER JOHNSON

Note by the Secretaries

The attached letter and note by Christopher Johnson is circulated for information.

M D K W FOOT

M L WILLIAMS

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In replying please address
THE ECONOMIC ADVISER

Peter E. Middleton, Esq.
Deputy Secretary,
Treasury,
Parliament Street,
London,
SW1P 3AG.

Your reference:
Our reference:

7th October, 1980.

cc Mr Wiggins 9/10

Dear Peter,

Congratulations on organising a most interesting conference at Church House. I am sure that it helped all of us to clarify our views, and I am only sorry that you and your colleagues did not feel able to say more, since I am sure that your comments would have been much more interesting than those from the private sector! (However I am gaining some fascinating insights into your thinking by catching up on my Minutes of Evidence to the Treasury Committee from last July.)

I thought you might like to have the full version of my rather disjointed comments to the Church House meeting, which I committed to paper afterwards. You may have seen the shorter version which appeared in the Sunday Telegraph. (I see that Brian Griffiths has put the opposite case in today's Daily Telegraph, so the honours are about even in the propaganda battle.) We are now all waiting with baited breath to see what you come out with, but it is a tribute to your discretion that nobody has even attempted to speculate as to what it will be.

With best wishes.

Yours sincerely,

Christopher Johnson

Christopher Johnson
Economic Adviser

12/10

MONETARY CONTROLS - BACK TO BASE?

(An abridged version of this paper appeared in the Sunday Telegraph, 4th October 1980)

The Government's monetarist policy depends on the achievement of a series of descending targets for sterling M3, the broadly defined money supply. The target for 1980-81 was set at 7-11 per cent in the Budget, and backdated to February.

Up to August, the increase in sterling M3 since February was at an annual rate of 26 per cent. It was 8 per cent in the two months of July and August alone, partly as a result of the lifting of the 'corset' controls on the banks. Even if monetary policy has begun to get the rate of inflation down during the last three months, by means of an old-fashioned recession, judged against the targets it has failed.

The Government is therefore thinking of switching to a new, more effective form of monetary policy, known as monetary base control. This consists in regulating sterling M3 by controlling the banks' cash reserves at the Bank of England, and possibly also the issue of banknotes held by the banks and the public.

The Treasury and the Bank of England published a green paper about monetary base control in March, from which it appeared that neither institution was particularly enthusiastic. Until the terrible July and August monetary figures came out, it thus looked as if the system would survive the ending of the 'corset' without any very radical changes.

But Mrs. Thatcher herself has now become an enthusiast for monetary base control, partly as a result of a meeting in Switzerland with Professor Karl Brunner, the leading Swiss-American monetarist. Professor Brunner, who has advised the Swiss National Bank on their monetary base control system, was called to a meeting at the Bank of England last week with other foreign central bank advisers (September 30). The Treasury and the Bank of England are therefore having to re-examine the arguments for monetary base control, and a decision may be reached in a matter of weeks.

The case in favour is very simple. If the Bank of England can control the monetary base, and if there is a fixed relationship between monetary base and sterling M3, then the Bank of England can control sterling M3. This looks easier than the present roundabout method of controlling sterling M3 by changing interest rates. Some monetarists claim that monetary base control avoids the need to raise interest rates so high, but this is doubtful, and anyway not essential to their case.

The arguments against monetary base depend on exactly what system is proposed. The more rigorous the system, the stronger some of the objections become. The less objectionable the system is made, the less likely it is to be effective. The main objections to any such system are as follows:

1) Any monetary controls can be evaded, either by the use of close substitutes for money such as commercial bills, or by the use of money outside the definition of sterling M3, such as foreign currency inside the UK or 'euro' sterling outside the UK held by residents, or sterling held inside the UK by non-residents. The ending of exchange control last October, while desirable in its own right, has made monetary control far more difficult.

2) The Bank of England does not have complete control of monetary base at present. Monetary base consists of certain Bank of England liabilities. These change from day to day with intervention to steady the exchange rate, assistance to the London money markets to relieve cash shortages, and tax payments. Either the monetary base would in practice have to be allowed to fluctuate from day to day, or the Bank of England's policies with regard to financial markets would have to be fundamentally changed.

3) The relationship between monetary base and sterling M3 is unpredictable, and may vary considerably. The banks would probably try to keep some flexibility by holding excess reserves of monetary base, so that they could still expand deposits and credit without running short. There is little past experience to go on, since the present $1\frac{1}{2}$ per cent of their liabilities which the banks have to keep in Bank of England balances has not been used up to now as a method of control.

4) It is not clear what would happen if the banks ran short of monetary base. The Bank of England would have to impose penalties, either by making enough monetary base available at a high cost, or in some other way. The history of the 'corset' suggests that penalties for infringing monetary control may not be an effective deterrent. Banks incurred 'corset' penalties, sometimes unintentionally, and sometimes deliberately, in order to maintain their share of the market.

5) Monetary base control could mean the end of the overdraft system in its present form. The undrawn portion of overdraft facilities, particularly for large companies, can be seen either as a source of uncontrollable increase in the money supply, or as a flexible insurance policy against rapidly changing financial requirements. Either banks would have to charge commitment fees for undrawn facilities, or borrowers would have to draw down the whole of a loan and redeposit it - thus paradoxically increasing sterling M3 as a result of monetary base control.

6) Interest rates would vary much more with monetary base control, as they have in the US since it adopted this kind of system last October. The long-run average level of interest rates might not be higher. But the uncertainty about future interest rates might affect long-term financial markets, and the difficulty of selling gilt-edged or company debentures would then be increased. The effect would be that the government and industry would have to borrow more from the banks, and less from the capital markets, thus once again raising the money supply.

7) Even if a monetary base system might eventually be made to work in the UK, the transition period could be difficult and prolonged, and monetary control might for a time become even less effective than it is at present. A good example of the perils of running in a new system is the monetary expansion which followed the introduction of the Competition and Credit Control policy in 1971. The onus of proof should thus be on the proponents of radical reform.

The defenders of monetary base would reply that the existing system of control has been so ineffective that the onus of proof is on those who wish to retain it. A number of amendments would make the present system more effective, and easier to defend.

1) Since the main objective of the government's monetary policy is to reduce inflation, its main targets should be a series of ranges for the retail price index. Instead of saying as now, that it wants sterling M3 to be rising by 4-8 per cent by 1983-84, it should make this its target for prices by then. It should try to achieve this objective not by putting all the strain on monetary policy, but by also using taxation, public expenditure, nationalised industry and, if necessary, incomes policies.

2) The sterling M3 targets appropriate to the inflation target should be fixed every year, as a rate of increase on the previous year. Sterling M3 would thus be measured in the same way as the inflation rate, and month-to-month fluctuations such as inevitably occur would be seen in the context of a whole year. The next target is due to be announced in October, and the present figure of 7 - 11 per cent is about right, starting from the higher base level that has now been reached.

3) Sterling deposits of overseas residents, and foreign currency deposits of British residents held in the UK should be included in M3, as the latter were until 1976, when the term 'sterling M3' was coined. Targets should also be set for the Bank of England's new wider measure of private sector liquidity, PSL2, so as to include building society deposits and other substitutes for money within the system of controls. Savings deposits of two years and longer, which banks are now encouraging, should be excluded from M3, as they already are from PSL2, because they do not provide liquid [illegible] and are thus not 'money'.

4) The authorities can make the present system as tight or as loose as monetary base control or any other system. It depends on how aggressively they are prepared to buy or sell bills and gilt-edged in open market operations, and call for special deposits from the banks. Although the present $12\frac{1}{2}$ per cent ratio of reserve assets to banks' liabilities is to be ended, the reserve assets will all continue to be held in roughly the same quantities as at present under the new name 'primary liquid assets', and it is on these that the Bank of England will be able to operate. If the government wants money to be controlled, however, it must give the Bank of England more freedom than it has done so far to vary interest rates up and down - though not as much as would be required under monetary base control.

5) Monetary policy must be flexible enough to allow some limit to the variation of the exchange rate. The Bank of England has intervened in recent months to prevent the exchange rate moving even higher than it has already done, and would doubtless also want to prevent any fall getting out of hand. Britain might be well advised to join the relatively fixed exchange rate mechanism of the European Monetary System next year, at a lower exchange rate than now. The monetary targets would then have to become even more flexible. As long as the main aim of reducing inflation is achieved, this need not matter.

Christopher Johnson
Economic Adviser, Lloyds Bank Limited

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HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

LETTER FROM G C POWELL

Note by the Secretaries

The attached letter from Mr Powell is circulated for information.

M D K W FOOT
M L WILLIAMS

H M Treasury

States of Jersey

ECONOMIC ADVISER'S OFFICE

Economic Adviser : G.C. Powell, M.A.(Cantab.)
P.O. Box 267, 15 Broad Street, St. Helier, Jersey.

Telephone : Central 27451 STD. 0534

Our Ref: 1/10/GCP/KLeM

Your Ref:

Mr. P. E. Middleton,
H.M. Treasury,
Parliament Street,
LONDON,
SW1 P3HE

7th October, 1980.

Cc to Mr Williams 9/10

Dear Mr. Middleton,

I should like to express my appreciation for your inviting me to join in the most interesting seminar on monetary control held at Church House last week.

From the standpoint of Jersey, there were two aspects of the seminar which I found of particular interest. Firstly, I was struck by the considerable uncertainty attaching to the expected outcome of any change in the system of monetary control. The differences of opinion expressed on such subjects as the interest rate level and volatility likely to flow from the adoption of monetary base control appeared to my mind to add considerable weight to the arguments put forward by those questioning the need for revolutionary, as opposed to evolutionary, change.

The other thought related very much to the comments in the article by Tim Congdon, published in the London Times on the day of the seminar, in which he raised the issue of the likely encouragement of off-shore banking that would follow from the adoption of a system of monetary control that placed undue burden on the U.K. banking community.

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Mr. P. E. Middleton,
H.M. Treasury.

6th October, 1980.

Our experience with the response of banks to the actions of other monetary authorities would certainly lend weight to this point of view.

I shall look forward with interest to seeing the way that the United Kingdom Government's Monetary policy unfolds, with obvious particular concern for the implications of that policy for the Channel Islands.

Yours sincerely,

G. C. Powell.

MCC(80)46

10 October 1980

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