7. Monetary Base Control III

M2 Measure

Deflation & the Exchange Rate

Next steps in Monetary Control

28/11/1980 – 10/12/1980

Reference

Mrs Lomax 2/6/03

cc Mr Britton
Mr Middleton
Mr Riley
Mr Monck
Mr Culpin
Mr Grice
Mr Shields
Mr Davies
} Tsy

Mr Stibbard CSO

Mr Kentfield
Mr Reid
} BofE

M2 MEASURE

I attach a note on the meeting on ~~the~~ above held on Nov 24th.

Adam Bennett
FEU
x 3981
Nov 28th

CODE 18-78

12/12

Note of a meeting to discuss M2 held in room 41/G on 25 November. Present were:

Mrs Lomax	)	
Mr Riley	)	
Mr Culpin	)	Tsy
Mr Grice	)	
Mr Bennett	)	
Mr Stibbard		CSO
Mr Kentfield	)	B of E
Mr Reid	)	

M2: MEASURING RETAIL DEPOSITS

Following the Chancellor's statement on 24 November, the Bank of England were asked for assistance in discussions with the commercial banks, to whom they will be talking in the course of next week.

Purpose

It is important to bear in mind that the new monetary aggregate might be used for control purposes. It should also be a valuable source of new information about monetary conditions.

Criteria

It was agreed that the Bank would offer the commercial banks a list of possible criteria for defining retail deposits. The banks in turn were likely to set up a working party to discuss these proposals. The three most promising criteria were (i) size, (ii) initial maturity, (iii) type of deposit. Of these the last could include the option of adopting a US style criterion for transaction balances (US definitions broadly cover all sight deposits, checkable time deposits and deposits with negotiable withdrawal, irrespective of the financial institutions involved.) It was acknowledged that any definition of retail deposits would raise the issue of building society deposits. There was no question of their being included, at least for the time being. But if this changed the relevant data is already available. This was a problem which could therefore be left unresolved.

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Back series

It was agreed a back series would be extremely valuable, even if it was only an approximation.

Frequency of collection

Initially the data would be collected on a monthly basis, but the ultimate intention would be to collect on a weekly basis. The possibility of a change in the definition of the banking month was not held to necessitate special action in regard to M2, since all the aggregates would have to face this problem together. A change in the definition of the banking month would, however, be inconvenient should the new aggregate need to be targeted under MBC.

Timing

The Bank would raise the subject with the commercial banks next week (December 1-5). It is unlikely that figures can be collected in time for the Budget, but the Bank hope that negotiations would be at an advanced stage by then.

FINANCIAL SECRETARY

FEO/18/a3

c.c. Principal Private Secretary
PS/Chief Secretary
Sir D. Wass
Mr. Ryrie
Sir K. Couzens
Mr. Middleton
Mr. Monck
Mr. Britton
Mr. Lavelle
Mr. Unwin
Mr. P. V. Dixon
Mr. Riley
Mr. Bottrill
Mrs. Lomax
Mr. Grice
Mr. Ridley
Mr. Cardona

DEFLATION AND THE EXCHANGE RATE: PAPER BY MAURICE SCOTT

You asked me to comment on Maurice Scott's paper on monetary policy, the exchange rate and deflation.

2. The first part of the paper deals with the suggestion that Mo - defined to include notes and coin - should be the subject of the monetary target. I attach a note by Mr. Grice dealing with this part of the paper. It is difficult to distinguish the Scott proposal from non-mandatory base control although Scott shows no sign of recognising this. Mr. Grice's note outlines the argument for and against this approach. The only other issue is whether the non-mandatory base should include notes and coin or be limited to banker's balances.

3. We have been through the arguments for and against non-mandatory MBC recently and I am sure we are right to collect some further information. In the interim we need to consider the arguments for taking explicit account of other aggregates (broad and narrow) in making interest rate and fiscal decisions. I am discussing with Mr. Middleton and Mr. Britton how we might take this forward.

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4. The second part of the paper argues that if deflation is necessary the high exchange rate route is less unattractive than the alternative. Scott provides no new evidence for this either and there is little original in his exposition; it has been an explicit part of our argument that exchange rate behaviour is a crucial part of the transmission mechanism from monetary deceleration to lower inflation and that it should be allowed to function as such. Even so it is possible to be concerned at the moment that the exchange rate has moved so far out of line with relative costs and prices that inflation would have to be negative if we were to obtain the full anti-inflationary benefit of the high exchange rate. This requirement for falling pay and prices is likely to slow down the adjustment of prices and costs to the high exchange rate with consequent potential costs to trade and output. Therefore whilst a strong exchange rate is an important part of anti-inflationary policy, and it must bite if inflation is to be reduced, there are limits beyond which it is unwise to go otherwise we run into severe diminishing returns. I believe we are well past that point and a better balance of policy would be a lower exchange rate, lower interest rates, and a tighter but better balanced fiscal policy.

?

How?
Effects eg on unemployment

TB

(TERRY BURNS)

28th November, 1980.

MRS LOMAX

MAURICE SCOTT ON MONETARY BASE

You asked me to comment on Mr Scott's letter and paper to the Financial Secretary in which he proposes the £M3 monetary target be replaced by one for MO - the monetary base.

2. Scott's proposal is essentially that we should move to non-mandatory monetary base control. The arguments in favour of such a move are familiar to us: they were rehearsed at length, for example by Professors Brunner, Meltzer and Pierce at the Seminar hosted by the Bank of England in September. Scott has not produced any new arguments in his analysis.

3. We certainly see considerable intellectual merit in this position and it is an option we have considered carefully. On the other hand, there are formidable difficulties and we have not been fully convinced that these could be overcome.

4. There are three main arguments in favour of a monetary base target:

a) unlike £M3, or indeed any of the wider aggregates, the authorities would be able to control the base completely even over short time horizons;

b) as Scott points out, adherence to a base target would limit the government's ability to finance itself by printing money. This would provide assurance and prevent wage negotiators from agreeing excessive earnings growth;

c) limiting the growth of the base would ultimately limit the ability of the banking system to increase the wider monetary aggregates. Banks would not be able to support indefinite growth in their deposits if the base itself did not grow in line.

5. There are also three counter-arguments:

a) whatever else it is, the monetary base is not a definition of money. People clearly do regard their bank deposits as part of their money which they can use, just like notes and coin, to purchase goods and services and thus contribute to aggregate demand and inflation. On the other hand, part of the base - banker's balances at the Bank of England - cannot be used in this way at all. For similar reasons, a base target alone may not be a good device for influencing wage negotiators' behaviour. Contrary to Mr Scott's view, I would have thought most people would have formed a wide aggregate like £M3 an easier one to understand than a technical abstraction like the base;

b) we do not know what effect controlling the base would have on the wider monetary aggregates, which must be the proximate determinants of inflation. Even Profressor Brunner, one of the most committed base control advocates, believes that controlling the base would be tantamount to controlling the wider aggregates only over a period as long as five or ten years. Still less do we know the relationship between the base and inflation directly;

c) because of the present system of monetary control whereby the banking system has virtually no need for control bank balances at all, past movements in the base give little guide as to how the system would function if we were to move to monetary base control. It would therefore be very much a step in the dark.

6. Reflecting the balance of these arguments, ministers have decided upon an evolutionary process of change in monetary control which will involve paying closer attention to the base. But for the moment, it will also be necessary to retain wider aggregate targets, primarily expressed in terms of £M3.

7. There are two other technical points I noted which we might want to transmit to Scott at some level:

a) he notes the high correlation between movements in consumers' expenditure and the circulation of notes and coins. This accords with what we ourselves found but the correlation is even closer between notes and coin and non-durable consumption. People typically do not seem to use notes and coins to purchase durable goods. It also needs to be recognised that non-durable consumption accounts for only about 60% of gross domestic product and excludes all of the most volatile elements of that total. This observed correlation alone does not therefore guarantee that control of notes and coin would be helpful in controlling nominal incomes or prices;

b) Scott speculates on the interest sensitivity of banks' holdings of base and concludes that they are likely to be more sensitive than the non-banks' demand for notes and coin. At present, this is not true. Because of the institutional framework, bankers' balances are just 1½% of the Clearing Banks' contribution to eligible liabilities. They are not interest sensitive at all. They might be sensitive to interest rates under a proper system of monetary base control but we just do not know in advance. I think it is important to get this point across because it explains why the past behaviour of the base in the UK is no guide to the future.

J. W. Grice

J W GRICE
20 November 1980

Mr Middleton

cc Mr Britton
Mr Pirie
Mrs Lomax
Mr Riley
Mr Culpin
Mr Boote
Mr Grice
Mr Pickford

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N J Monck
Under Secretary

28 November 1980

E A George Esq
Bank of England
Threadneedle Street
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NEXT STEPS ON MONETARY CONTROL

I gather that John Fforde has spoken to Peter Middleton, and that they have agreed that we should set up a joint Bank/Treasury Working Group, under my chairmanship, to follow up the changes announced by the Chancellor and the Bank last Monday. The Group would report to John Ffo and Peter Middleton. I see its role as working out in more detail what practical steps are now going to be taken (but relating these steps clearly to longer term aims or options) and to identify any issues that need to be resolved.

2. I am writing to give you our preliminary views on the issues the Grc might tackle.

3. There are some unresolved questions which this Group probably need not discuss. One is the 1½% cash ratio and the related issue of the Bank's income. Another is funding techniques, in which I include RIGs, the case for selling more short-term central Government debt and for experimenting with auctioning it, as well as new methods of selling conventional gilts. We are preparing a further paper on the principle (the RIG, and on the eligibility problem, which we will be discussing separately with you and the Department of Trade. We expect both of the: subjects (other than RIGs) to be handled by Douglas Wass who will probal be writing about them soon.

4. There is also no immediate need for the Group to do anything more about the new M2 series. I gather the Bank statisticians have already talked to the economists here, and that the next step is for them to sound out the banks. When we have a report on that, the Group may need consider the outcome.

5. That leaves a complex of issues which are inter-related in varying degree: the ending of the reserve asset ratio, the nature and timing o new prudential arrangements, the implications of the discount window proposals, the timing of the moves towards more flexible short-term interest rates, and last but by no means least, the problem of defining a set of ground rules for setting interest rates under these new arrangements. These can be grouped under two headings.

. The Reserve Asset Ratio and Prudential Arrangements

6. This must be the immediate priority. We shall need to make rapid progress if we are to be rid of the RAR by the time of the Budget. It may be helpful to start with what we understand to be the agreed general aims:

i. to avoid or minimise special assistance in the first quarter of 1981;

ii. to abolish the RAR by the Budget and to substitute new prudential arrangements that are, and are seen to be, adequate;

iii. to ensure that these new arrangements are compatible with a move to either form of MBC and with getting useful information for taking a decision on this within the next few years.

7. We would find it very helpful to have a paper on the Bank's present thinking on the timetable and method of phasing out the RAR, covering in particular:

i. the prudential implications of changes in money market operations and reduced or more costly discount window lending (both affecting the terms on which banks can get cash);

ii. the nature of the prudential arrangements which we should be aiming to achieve when consultations are complete;

iii. when these arrangements might be operational;

iv. what would be necessary in the interim to allow us to abolish the RAR by the Budget;

v. what immediate steps we could take (ie before the Budget) to relax the RAR, thus avoiding the need for substantial money market assistance in January and the rest of the first quarter of 1981.

b. Money Market Operations and Discount Window Lending

8. This is the area in which we shall need to do most work. We for our part, are less than clear about the precise implications of the changes announced last Monday, and about the timetable for introducing them. We need to focus on the content of the guidelines for setting interest rates. We should first like to discuss how the Bank will influence the movement of interest rates on a day to day basis: what will determine the object of open market operations, and (ie whether to maintain, raise or lower interest rates of a particular term) the availability and cost of discount window lending. We shall then need to consider a broad range of questions: the interest rates to which the band (or bands) apply, the width of the band, the criteria to be used in setting and changing it, the triggers for considering changes and procedures for agreeing them.

9. At Peter Middleton's meeting last week I thought John Fforde was volunteering a Bank paper on guidelines. This seems to us an excellent way of getting the discussion going; would you be prepared to produce such a paper, covering the questions in paragraph 8 or as many of then as you can reasonably deal with quickly?

General Issues

10. Although I have grouped the questions under two separate headings to make them manageable, there is a common issue underlying them. Our objective is to begin collecting useful information, from next year, about the banks' demand for cash - defined for these purposes as balances with the Bank of England. For this to be possible, a clearer distinction will need to develop than there is now between cash and other assets, such as bills for the discount houses and money at call for the banks. In the light of our various objectives, therefore, we need to consider how rapidly it will be possible to reduce the present degree of assured and "non-penal" substitutability between cash and these other assets and the implications of that for the present role of the discount houses. This was the issue of substance underlying the discussion of the reference to "primary" liquidity in the Bank's background note about Monday's announcement

Treasury Representation

11. The Treasury will be represented by HF both on the monetary control side (HF3) and, for a. the prudential side (FH1), and by FEU. Robert Culp will act as Secretary at our end and it would be helpful if you nominate someone who could do the same at your end.

Meeting

12. There is clearly a great deal to be done in a short time. We ought to have the first meeting as soon as possible and well before Christmas. But it would be highly desirable to have at least one of the papers menti in paragraphs 7 and 9 for that meeting. I will be in touch to discuss timing.

Yours
Nick

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NOTE FOR THE RECORD

cc Mr Middleton
Mr Britton
Mrs Lomax
Mr Pirie
Mr Riley
Mr Culpin
Mr H Davies
Mr Turnbull

NEXT STEPS ON MONETARY CONTROL

I talked to Mr George on Monday about the timing and content of the work of the Group (see my letter to him of 28 November).

2. On timing I stressed the need for rapid progress and he accepted this generally but particularly in relation to the need to avoid a renewal of special assistance to the market in January. However he said that the Bank representatives(himself, Tony Coleby and Charles Goodhart, perhaps plus a secretary) would need to clear their lines within the Bank before a meeting. He thought the earliest sensible day for a meeting would be Monday, 15 December and I shall try to fix that. I pointed out the very small number of working days between 15 December and the beginning of January, saying that we did not want to be faced with a disagreement on some basic point if we were up against a deadline for an operational announcement affecting banking January. In the end Mr George agreed to let us have first drafts of two papers early in the week beginning Monday, 8 December. One draft would deal with the reserve asset ratio and prudential arrangements (by Tony Coleby) and the other would deal with money market operations and discount window lending by Eddie George himself. But he stuck to the view that the Bank would not discuss these papers at a meeting before 15 December, for which revised versions would be available by the weekend, ie Friday, 12 December. I said that we woul have to decide what to do about that when we have seen the first draft of the papers.

3. Mr George argued that basic issues of the kind mentioned in paragraph 10 of my letter would not be raised by the probable interim proposals designed to avoid special assistance in January. He confirr to me that the Bank would not be consulting the City about their

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proposal before talking to us.

4. The proposal to deal with the January problem, which would need to be announced on 5 January, was very likely to be a reduction in the reserve asset ratio from 12½% to 10% and an addition of 1% to the existing 2% of commercial bills that would count as reserve assets. These changes should be big enough to avoid the need for special assistance. But the Bank were not yet ready to put them forward. Before doing so they wanted to make sure that such reductions would be compatible wit two requirements they believe to be necessary for making the new market operations etc work. These requirements were:

a. that the "bill market should be broad enough" for the Bank to operate it; and

b. that there would in aggregate be a sufficient quantum of primary liquidity for the banking system as a whole to be prudentially sound.

b. was consistent with the view that there was no prudential need for individual banks to have any particular norm for primary as distinct from total liquidity.

5. I pointed out that I was not at all clear about the meaning of the concepts in a. or b. or of the quantities involved. But I hoped that the first drafts of the papers which we would get next week would enlighten us and enable us to judge whether the argument in paragraph 3 above was right (as I think it may well be).

6. We noted that both the Prime Minister and the Chancellor were anxious that adequate prudential arrangements should be made before the reserve asset ratio was dismantled.

7. Mr George said a little about his current ideas about the how the new arrangements for money market operations etc would work. The Bank would aim to influence interest rates at the short end (overnight, 7 days, a month). He envisaged that the initial interest rate band

might be about 2½ or 3 percentage points wide. The Bank were at present more confident of their ability to relieve shortages than to mop up surpluses which might take interest rates outside the initial band. In the case of a shortage, the discount houses would be told that if they did not offer to sell enough bills to the Bank on terms within the band, they would have to pay a higher rate to borrow at the discount window (perhaps ½ or 1% higher). The extent of the penalty would vary, for example depending on the cause of the shortage and the relationship between current interest rates and the band. If rates were persistently at one end of the band, the presumption would be that the band should be shifted. We did not, however, discuss the general criteria for setting the bands.

NM

N MONCK
3 December 1980

3238/12 Sir Douglas Wass

MONCK

cc: Mr Middleton
Mr Burgess
Mr Culpin

cc: Mr Britton
Mrs Lomax
Mr Hirla
Mr Hailey
Mr Price
Mr Pickford
Mr Shields

FED 8/X/O/R

MONETARY CONTROL: NEXT STEPS

I attach drafts of two letters which Sir Douglas Wass might send the Bank to restart discussion of the cash ratio and funding techniques. The other issues outstanding from the recent statements on monetary control are already under review.

2. The draft letter on funding techniques assumes that, before it goes, Sir Douglas Wass's office will arrange a time for a meeting with Mr McMahon and his team, probably early in January.

An internal meeting before that would of course be desirable

Robert Culpin

ROBERT CULPIN
10 December 1980

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DRAFT LETTER TO :

The Rt Hon Gordon Richardson MBE
Bank of England
Threadneedle Street
LONDON EC2R 8AH

THE FUTURE OF THE CASH RATIO

This is just a procedural note to ask how you would like to carry forward the brief discussions we have had so far on the future of the cash ratio and alternative sources of income for the Bank. I take it that you will now have raised the matter with the Court, and it would be helpful if we could next take stock between ourselves. I should be happy to arrange a talk between the two of us if that seems sensible; or if you prefer, we could ask our people to sort out some options first. Perhaps I could leave it to you to say how you would rather proceed.

DOUGLAS WASS

DRAFT LETTER TO:

C W McMahon Esq
Bank of England
Threadneedle Street
LONDON EC2R 8AH

FUNDING TECHNIQUES

I am writing to confirm that the next meeting of the Bank/Treasury Group on Funding Techniques will be on .
As we agreed when we met on 28 November, the principal papers will be the Bank's Bulletin article of June 1979 and Eddie George's recent note for the Prime Minister's seminar. The object of the meeting will be to go through the issues outstanding, and to establish a work programme.

For myself, I suggest that we might give priority to three questions:-

i) What specific proposals look most promising for broadening the market in short-term central government debt? When might innovations start to be introduced, and on what scale? How soon could we "experiment with [illegible] the boundary between the money and capital markets"?

ii) Is there any scope for pursuing the option of borrowing by [illegible] nationalised industries in their own name? In particular could [illegible] the cost of their borrowing by giving guarantees while maintaining the experimental methods of selling had no implications for the gilts?

iii) If increased variability in gilt prices were, over time, to make it impossible for the jobbers to survive in their present form, what other institutions might take over the role of secondary market makers? Is there anything the authorities could reasonably do to encourage their emergence?

Needless to say, this is not intended to be an exhaustive list, but simply a suggested starting point. If you are able to offer supplementary papers on any of these three questions before the meeting, that would be splendid; but if you would rather have a general discussion first, I shall of course understand.

DOUGLAS WASS