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MONETARY CONTROL: THE NEW ARRANGEMENTS

I. Introduction

1. The purpose of this paper is to set out:

   (i) the form that the new arrangements, which are shortly to be put into effect, will take;

   (ii) how they will function;

   (iii) what they are seeking to achieve.

It is not, of course, possible to provide a complete textbook before the new arrangements have even been put fully into effect. It is inevitable that they will evolve with use and experience. With the exception of the timing of the suspension of MLR, the paper is agreed between the Treasury and the Bank.

2. One of the features of the new arrangements is that they can be operated with a variety of styles of monetary policy; for example, with a high or low degree of discretion in the setting of interest rates, with greater emphasis given to wide or narrow aggregates. The focus of this paper is essentially technical, concentrating on how the new mechanisms can be operated rather than the form of monetary policy which they are made to serve. The wider issues on the determination of interest rates and the role of different monetary aggregates in this are discussed in the companion papers - Setting Short Term Interest Rates and A Role for the Narrow Aggregates.

3. This paper will discuss:

   (I) The characteristics of the new arrangements

      (a) The interest rate band

      (b) Operations in bills

      (c) Discount window lending

      (d) Bankers' balances

      (e) Special deposits

      (f) Reserve asset ratio, prudential norms.

   (II) Transitional problems: minimum lending rate.

   (III) Presentation

   (IV) Procedures.

4. Following the debate on monetary control, culminating in the Prime Minister's seminar last November, the Chancellor announced a series of changes to be made to the system of monetary control. These were set out in the Bank's Background Note of 24 November. The process was carried forward in the Budget and in the Bank's paper of 12 March. These changes had a number of aims:

(i) to allow greater scope for market forces in determining the structure of short term interest rates. The Bank would formulate its objectives in terms of very short term rates (0-14 days), leaving the longer short term rates (up to three months) freer to vary;

(ii) to reduce the bias for delay which was thought to characterise administered interest rate changes;

(iii) to achieve a lower political profile for interest rate changes.

These changes could also lead to more flexible market related pricing of overdraft facilities which might reduce the scope for round-tripping and the distortions to monthly money supply figures which this can produce.

5. The Chancellor also said in November that no decision had been taken about the desirability of moving to a system of monetary base control. However, the changes to be made were seen as consistent with further evolution in that direction.

II Characteristics of the New Arrangements

6. Following the November statement, work was undertaken to design a system which would implement these objectives. Some changes have been made already - reduced emphasis on discount window lending, a movement by the Bank away from posting three months dealing rates. After the Budget, the Bank put proposals to the banks and other financial institutions. Discussion of these is more or less complete and a final draft of the detailed provisions was circulated in June. (A copy was sent to the Prime Minister on 19 June). Subject to any points raised by market participants, the final text will be issued in mid July, with the intention of putting them progressively into effect, beginning on 20 August (the start of banking September). The main features of the new arrangements are as follows.

(i) Interest rate band

7. The Bank will aim to keep very short-term interest rates within an unpublished band, the level of which will be determined by the authorities according to the requirements of its monetary policy. The band will relate to rates on Treasury bills of 0-14 days maturity from which rates for eligible bank bills of equivalent maturity will be derived. Although the

the paper.

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

6. There is, however, one unresolved issue - the timing of the suspension of MLR. Giving the market more of a role means giving the authorities less. Putting MLR into suspense is part of the new approach. But when this has been done the authorities will be unable to give such clear signals about their immediate interest rate intentions. In particular they will have considerably less direct influence over base rates and mortgage rates.

a. Retaining MLR for the time being would enable the authorities to give definite signals for a little longer - this might be desirable, for example, in the context of the current uncertainties in the foreign exchange market or to cap unwanted pressure on short term rates which might result if there is a sudden reflux of cash to the Government when the Civil Service strike ends.

On the other hand:

b. Suspending MLR with Immediate Effect on 20 August would gain the maximum presentational and operational advantage from the new arrangements. There would be a cleaner break from the past and the authorities role in influencing some of the more politically sensitive rates, would become less direct and obvious.

The issues are set out in paras 35-38 of Paper I.

Setting Short Term Interest Rates

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

8. The Government is presently committed to £M3 as the basis for its medium term strategy.

Bank's open market operations will still extend to longer maturities it is only at the very short end that it will seek to control rates. It is proposed initially to set a width of 2 per cent which would be achieved on average over a week. The aim would be to keep actual dealing rates within an outer limit of 1 per cent on either side of the band. The width of the band would be reviewed from time to time, in the first place after six months. It should be noted that maintenance of bill rates within the band is consistent with wider fluctuations of comparable inter bank rates e.g if shortages or surpluses develop late in the day.

8. One of the objectives of the modifications to monetary control arrangements we are now introducing is to allow market factors more influence over short-term interest rates, both for their informational content and to facilitate prompter adjustment by de-politicising as far as possible the process of interest rate formation. There will still of course be substantial official influence over the general level of rates through the interest rate band at the very short end of the money market, but that influence will be less dominant and will be capable of being changed more flexibly if the level and width of the band are not revealed at the time. Otherwise, as with MLR in the past, official interest rate decisions would tend automatically to set the whole pattern of short-term rates - including bank base rates and mortgage rates - and so will continue as major political decisions which can lead to a "bias to delay". It is accepted that the proposed arrangements will mean more uncertainty about official interest rate intentions in the financial market but this is a necessary part of allowing the market's own expectations a greater role.

9. Given that we do not wish to reveal details of the band at the time, it follows that we will not wish to reveal, even after the event, details of the rates to which the band applies, how precisely it is operated, or how wide it is, since to do so would make it much easier for the market to discover the key parameters within which we operate and to use this information - rather than their own market judgement - to forecast future interest rates.

10. To a substantial extent fluctuations within the band will reflect random factors or "noise", arising from imperfect estimates by market participants, including the public sector, of the size of surpluses and deficits expected to emerge during the day. Movements in the longer short rates beyond the horizon of the band will be more informative than fluctuations of the rates confined within the band. But this is not necessarily to say that the latter can have no informational content. If overnight to 7 day rates move to the top of the band without any corresponding movement in three month rates we might assume that the market expected the fluctuation to be temporary. In this case we would interpret the movement as "noise" in the system. If, on the other hand, short rates moved to the top of the band for a period, and rates further out adjusted in sympathy, then the market would clearly be signalling its belief that rates need to rise generally - in other words that the band

should be moved. This could also be the case if longer short term rates rose but technical factors were continuing to hold down very short rates.

11. The precise figure of 2 per cent is very much a matter of judgement, as is the additional outer band of a further 2 per cent. Too narrow a band would in practice leave existing arrangements unaltered, and could not be expected to have any significant effect on the banks' behaviour in a direction that might be helpful to monetary control. Too wide a band could risk creating a damaging degree of volatility.

12. The very wide band set by the Federal Reserve in the US - often as much as 5 or 6 per cent - is not comparable to that to be introduced here. The Fed operates with a guideline for the quantity of market intervention (non-borrowed reserves) in a given period, and allows interest rates to fluctuate within a band whose purpose is essentially to trigger reconsideration of the reserves target between monthly FOMC meetings. Since we are not proposing to operate a system of quantity targeting, our band does not fulfil this role. Without such a guideline, a very wide band would serve only to increase uncertainty. While some element of uncertainty will be an essential factor in inducing changes in banks' behaviour such as the pricing of loans, there is little merit in increasing uncertainty per se, beyond the point necessary to give the Bank sufficient flexibility in its market dealings.

13. One of the implications of having an interest rate band rather than MLR is that banks' and building societies will not have an easily identifiable rate to which they can peg their base and mortgage rates. They will be left to make their own judgements. As a consequence it is likely that there will be less uniformity between individual banks and building societies, a further factor weakening the latter's cartel arrangements. In general the variability of banks and building societies rates is likely to depend more on the frequency of adjustment of the band than of fluctuations within it, though if rates were at the top of the band and were expected to say there or to presage an upward adjustment, some institutions might adjust their rates. As with prime rates in the US, it is possible that a bank will misjudge the market and have to reverse an interest rate change within a short period.

(ii) Operations in bills

14. The Bank is placing greater emphasis on open market operations and less on discount window lending. These operations are being conducted in bill markets rather than the inter bank market, largely through the Discount Houses. A number of consequential changes are necessary to ensure an adequate stock of commercial bills is help by the discount market;

(a) the list of banks whose acceptances are eligible for discount at the Bank and hence can be used in open market operations is being extended.

(b) In contrast with the sum of over £4 billion currently held by all banks on a daily basis with the discount houses under the reserve asset ratio, eligible banks will

undertake to maintain a minimum of secured money with the discount market - initially around £2 billion - and to aim at a daily average of some £3 billion. Included in the calculation of the latter will be secured call money with money brokers and gilt edged jobbers.

15. The Bank's normal operating procedure (already largely in place) will be to make a daily estimate of the banking system's net cash shortage or surplus and then, if there is no desire to influence short-term rates in any particular direction, to offset the shortage or surplus by matching bill transactions. At various times during the day the Bank communicates its estimate of the shortage or surplus to the market. It has recently begun to report twice daily to the market on the rate at which they have dealt.

16. In the case of a shortage, the Bank will invite the discount houses to offer bills for sale, either outright or for repurchase on a specified future date. The Bank may indicate the kinds of paper it wishes to buy - normally Treasury, local authority and eligible bank bills - and also the desired maturities. At present, the Bank distinguishes four maturity bands for bills -

(i) 1-14 days,

(ii) 15-33 days,

(iii) 34-64 days,

(iv) 64-91 days.

It may, however, on occasion be more precise still and specify paper maturing on particular dates.

17. The Bank's choice of maturity is influence primarily by the expected future pattern of surpluses and deficits so that, for example, the prospect of four weeks of continuing shortage will encourage the Bank to buy bills with a maturity of one month or more. Where there is the expectation of a significant cash surplus at some known future date, the Bank may set out to buy bills for repurchase by the discount houses on that date. With such a transaction, both the current shortage and the prospective surplus are simultaneously smoothed.

18. A second factor affecting the Bank's choice of maturity and the relative attraction of outright transactions compared with repurchase arrangements is the state of the market. The Bank may know, for example, that there are insufficient short-term bills in market hands to allow a large shortage to be dealt with.

19. For the reasons set out in paras 17-18, the Bank may therefore undertake operations in a range of maturities in pursuit of its objective for 1-14 day rates. When operating in the longer maturities the Bank will do so in a way which will not frustrate the objective of leaving longer short-term rates freer to vary - see paragraph 4(i) above.

20. If, in a cash shortage, a discount house wishes to respond to an invitation from the Bank, it may offer various amounts at a range of prices, just after midday. (This contrasts with the arrangements which operated until early this year, under which the Bank posted dealing rates based on the result of the previous week's Treasury bill tender). The Bank then accepts or rejects these offers in the light of the agreed objective; if the 1-14 day rates are required to rise, the Bank will not accept sufficient offers to reduce the cash shortage, rejecting the higher prices (lower interest rates). The market then has a second chance to offer bills in the early afternoon at lower prices and the same process will occur again. If the Bank still has not offset the cash shortage in full, the discount houses will be left to borrow from the Bank at a rate of the Bank's choosing (see paragraphs 23-26 below).

21. In the case of a prospective cash surplus for the day, the Bank will seek to "mop-up" spare cash by offering to sell Treasury bills[1], the maturity of which will be chosen to smooth out a prospective cash shortage on some specific future date. As in the case of a cash shortage (para 17-18), this may involve operations spanning more than 14 days though more typically only very short maturities are offered. Traditionally, the offer of mop-up bills has been confined largely to the discount market but in future it will be made also to banks active in the money market.

22. There are a number of other techniques which have been used for coping with money imbalances. For example:

(a) repurchase agreements for gilts and fixed rate export credit paper. These were used during 1980 but were finally run off in December. Such operations are regarded very much as a last resort, but in extreme circumstances it would be possible to reactivate them though the Bank would first consult the Treasury before doing so.

(b) foreign exchange swaps. On occasions swaps have been made mostly over the end of banking months, but within calendar months, on the presumption that they would not be "visible" in any published statistics. It is only possible to use this device if it is seen as consistent with exchange market and reserves management. Thus the scope for these operations may be limited. The Treasury are normally informed when such operations are contemplated by the Bank.

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[1] It is both cheaper (for the Government) and administratively easier for all concerned if the Bank sells Treasury bills rather than other forms of paper.

(ii) Discount window lending

23. Though discount window lending is being reduced in importance, (it has only been used on 7 days so far this year) it will still have a role to play. The Bank's background note of 24 November stated "The Bank would normally charge a rate of its discount window lending somewhat above comparable market rates but within the unpublished band...."

24. Two distinct sets of circumstances can be envisaged. In the first, discount window lending might be used as a deliberate operating technique when it is desired to increase market rates - either within an existing band or concurrently with a raising of the band - or to resist a decline in rates which the market is bringing about. Implicitly, the rates at which bills were being offered by the market would not be acceptable, or not in sufficient quantity for the whole shortage to be relieved, and a visit to the Bank would become necessary for the Houses to square their books. The size of the penalty to be applied when lending to them would reflect the size of the increase in market rates that was desired. It would be unnecessary to charge a rate higher than the top of the band, and the November paper said that the Bank would not do so. Nor would the Bank wish always to charge a rate exactly equal to the top of the band, if the objective remained to conceal precisely where the band lies. When lending is undertaken as a deliberate act of policy execution by the Bank, it would be done under the so called 2.30 arrangements, and the fact and details of the lending would be immediately make know.

25. There are other possible circumstances in which the Bank might wish to use discount window lending as a deliberate technique of market management, but without having any policy objective on interest rates to pursue. An example is provided by the events of 2 March 1981. On that day the market was massively short because of the payments of Petroleum Revenue Tax that were due; but the projections for the immediate future suggested that a considerable reflux would take place over the next week or so. Market management considerations therefore indicated that much of the cash provided should be repayable in about seven days, and this would not have been possible by outright purchase of bills. In principle, bills could have been bought on a repurchase basis, but the available supply of bills was too limited for that to be done. The only available technique was, accordingly, to lend at non-penal rates. In such circumstances, the lending would be explained to the market as an exception to the normal rule of "lending somewhat above comparable market rates".

26. Thus it may not be appropriate in all circumstances to impose a penalty but in general the lending rate should be somewhat above comparable bill rates in order to ensure that the discount houses offer sufficient paper at acceptable rates and thus that bills operations remain the main means for supplying cash. A modest fraction - e.g ¼ per cent would generally by sufficient. On occasions, however, a larger penalty might be required, the limit being the upper end of the band.

(iv) Bankers' balances

27. Under the old arrangements, the clearing banks maintained 1½ per cent of their eligible liabilities as bankers' balances with the Bank of England. This sum served as the fulcrum for money market management. Under the new arrangements all banks and licensed deposit takers with eligible liabilities in excess of £10 million will maintain a non-operational non-interest bearing deposit of ½ per cent of eligible liabilities - currently about £330 million. The non-operational balances will be an amount to be observed at all times. In addition the clearers will voluntarily maintain operational balances, again non-interest bearing, initially of around £150-200 million. Overdrafts will not be permitted. Under the old averaging system, holdings of cash above the required level were tolerated more readily as they in effect bought the right to go below at a later date. Under the new system, any "excess" holdings will have an opportunity cost and the clearers will therefore have strong incentive to keep such holdings on the minimum required to operate the clearing system. As experience is gained with the new system, the clearers may be able to cut down the size of the operational balances.

28. Observation of the banks' desired cash holdings might make it possible to learn something about the properties of monetary base system, particularly a non-mandatory one consisting of bankers' balances. However, while it is true that some element of voluntary or excess balances will appear for the first time, it cannot be assumed that the level of balances banks choose to hold under one set of arrangements will be translated to another. Desired balances will depend on the degree of uncertainty about the cost of funds, the assurance that there is an upper limit to the cost and the availability of assets only slightly inferior to cash such as money at call with the discount houses.

29. The present banking sector for statistical purposes, comprising some 350 banks (including the National Girobank, the Banking Department of the Bank and banks in the Channel Islands and the Isle of Man) will shortly be enlarged into a new monetary sector. The enlarged sector will include <u>all</u> recognised banks and LDTs, the National Girobank, the Banking Department of the Bank, the Trustee Savings banks and those banks in the Channel Islands and the Isle of Man which are subject to broadly parallel cash ratio arrangements. The effect of this enlargement will be to produce a once-off net addition to the stock of £M3 of around £8 billion (13 per cent). In monitoring progress against the monetary target, allowance will be made for this. It is not expected that the trend growth of £M3 will be significantly affected.

(v) Special Deposits

30. The Special Deposits Scheme will remain in place under the new arrangements, and will apply to all institutions with eligible liabilities of £10 million or more. As before, calls will be set as a percentage of eligible liabilities. Special Deposits carry Treasury bill rates. The authorities have to give notice, and, because of the number of banks involved, it may

take up to ten days for a call to become effective, though releasing deposits takes only a matter of a few days.

31. Since the early 1970's Special Deposits have not been used deliberately to squeeze bank liquidity, since banks tended to respond to reserve asset pressure in ways which increased rather than reduced the money supply. Special Deposits were however used to mop up excess bank liquidity, to pre-empt a rise in bank lending by indirectly raising the cost of wholesale funds. Under the old RAR, a call for Special Deposits was no different from varying the level of the reserve asset ratio. The same technical effect could (and can) be achieved by official sales of bills providing the banks are willing to buy and hold bills offered for sale. Special Deposits may sometimes be a surer way of offsetting fairly short lived fluctuations in liquidity. They also have an announcement effect, which can be useful if the authorities want to give a clear signal to the market.

32. Under the new arrangements, Special Deposits should still provide one way of mopping up excess bank liquidity. The new prudential arrangements will be much more flexible than the RAR, and it is not intended that they should operate as a monetary control. But it is probable that the banks will have a reasonably stable demand for liquid assets - and will continue to regard Special Deposits as, to some extent, a substitute for bills and LA deposits. The chief difference may be that there will be much more elastic in the system; how much depends on how far the banks hold excess reserves, in response to changed money market tactics. The risk of distorting the monetary aggregates if Special Deposits are used to squeeze bank liquidity may therefore be rather less than under the old RAR. Since the option of varying the reserve asset ratio will no longer exist, Special Deposits - though possibly a rather weaker instrument - may still prove a useful addition to the authorities' armoury of instruments.

(iv) Reserve asset ratio and prudential supervision

33. The reserve asset ratio will be abolished on the starting date for the new arrangements. While discussions on developments in supervision are continuing, the banks have given assurances that they will discuss in advance any changes in their policies for the management of their liquidity. Meanwhile supervision will continue to be exercised by the Bank in the normal way. The Bank will shortly be resuming discussions with the banks on a new prudential regime on the basis of a new paper on liquidity measurement. The evolving prudential system will not be characterised by a universal requirement for all banks like the RAR but will seek to establish with individual banks what are the liquidity characteristics which are appropriate given the type of business they conduct.

34. These liquidity policies will not be operated as requirements to be observed either constantly or on make up days. It is intended that there should be a substantial degree of variability around the liquidity pattern agreed so as to accommodate pressures on bank

liquidity, for example during periods of high tax payments. This will permit liquidity to be used when it is most needed, something which the RAR tended to obstruct. These new arrangements should therefore help in avoiding local crises of shortage of liquid assets and should therefore conflict less with the operation of monetary policy. It would be an exaggeration, however, to claim that the requirements set for individual banks will not have any monetary effect. The new arrangements cannot help solve a potential secular shortage of bank liquidity caused by a tendency for bank lending to grow faster than deposits. If liquidity has been seriously eroded, there is likely to be pressure on the money supply as banks seek deposits in order to increase their holdings of liquid assets. While the liquidity norms can accommodate seasonal variations, it will not be appropriate to relax general prudential standards to accommodate a chronic problem of monetary policy.

II. Transitional Problems: Minimum Lending Rate

35. It was announced in the Budget that the Government's intention was "in due course to suspend altogether the practice of having an announced MLR, which would by then have lost its operational significance". Retention of an MLR would not fit well within the new arrangements as it would present a clear signal of the authorities' views about interest rates beyond the very short rates which the authorities will keep within the band. This would limit the expression of a market view. It would also retain the high political profile of administered changes.

36. It is important, however, to recognise the full implications by suspending the practice of an announced MLR which would be operational as well as presentational. The authorities leverage over longer short term rates (1-3 months) would be less and this may sometimes be unwelcome. Relying on open market operations, the authorities will not be able to provide a signal about its interest rate objectives as precisely, quickly or credibly as they could with MLR. The banks and building societies have in the past, related their base and mortgage rates to MLR. In its absence, their behaviour is likely to be less predictable. If market pressures were generating a sharp rise in 3 months rates for example which the authorities considered to be unjustified, this might only be prevented by intervening to cap the longer short-term rates, a step which even if it did not formally amount to reviving MLR would be tantamount to doing so. In short, giving the market more influence - in order to secure prompt changes in interest rates and reduce Ministerial responsibility further - can only mean giving the authorities less. In general, the Bank feel more confident about their ability to achieve an upward movement through money market operations, than they do about leading the market downwards.

37. Though it is agreed that MLR should eventually be suspended, there may be a case for not doing so simultaneously with the start of the rest of the new arrangements. There are two arguments for delay. First there may be some advantage in a phased transition. Market

participants might find it easier to adapt to the new arrangements with less uncertainty if MLR were retained for a time. Secondly, particular circumstances could arise in the immediate future when it might be helpful to have the greater ability MLR provides for giving definite signals. For example, the unwinding of the Civil Service dispute could bring to the surface the underlying pressures on bank liquidity and create upward pressures on very short term interest rates which for monetary policy reasons the Government may consider inappropriate to see reflected further up the yield curve; or a change in MLR might be helpful in the current uncertainties in the foreign exchange markets. Although operations within the interest rate band could give a signal about the authorities' views, having MLR available would anable this to be done more clearly.

38. These considerations point to delaying the final demise of MLR until the autumn. The case against delay, which could prove to be prolonged unless the strike and its effects come to an end earlier than at present seems likely, is that it slows progress in depoliticising interest rates. There will be a tendency for much public discussion to remain focussed on MLR (even if some expert commentators were beginning to appreciate its reduced status). Retention of MLR could therefore delay the presentation and operational benefits which the new system is intended to bring and could cast doubt on the authorities' commitment to the new arrangements. The timing of the suspension of MLR is an issue which needs to be decided at the seminar.

III Presentation

39. The new arrangements are attempting to:

(i) reduce the high political profile and scale down the degree of direct Ministerial responsibilitiy. If this can be done if should help to:

(ii) reduce the so-called bias for delay. Interest rates will be adjusted more promptly and there will no longer be the presumption that the direction of a change will not be reversible within a matter of weeks.

40. In principle control of a quantity - money - should imply freedom for the price - interest rates - to vary. In practice, however, it will be difficult to achieve public acceptance of this proposition. Although the monetary target is a quantity rule, the links between money and interest rates are not very direct or precise nor have we committed ourselves to being guided only by one monetary aggregate. What we do not have is a quantity rule at the point at which monetary policy is operated i.e in the money markets. This contrasts with the position on the exchange rate where the objective of achieving no net intervention rule is directly operational or with monetary policy in the US where the Fed sets a path for the supply of non-borrowed reserves. Only if we were operating a policy of controlling the supply of monetary base month by month (targetting the wide base over

6 months would be little different from targetting other aggregates) would there be a sufficiently precise quantity rule.

41. Although the task will not be easy, there are ways in which the arguments can be presented and which emphasise interest rates as the product of policy rather than their objective.

(i) It should be stressed that control of a quantity, money, implies that there cannot be a separate interest rate target. Though the Government has some discretion this is very much circumscribed. The authorities can influence the timing of interest rate changes and can choose the speed with which deviations from the monetary target are corrected.

(ii) There will eventually be no MLR which is pivotal to the whole structure of interest rates, and thus a single rate to which banks can link a base rate. It is to be expected that base rates will both be less important in pricing loans and be moved more often.

42. A change will be needed in the way briefing is prepared and in the way Ministers refer to interest rates. It will be necessary to talk less in public about the Government "setting", "cutting" or "raising" interest rates. Instead the emphasis must be on creating conditions which produce or permit lower rates, or if rates have to go higher, on the need for higher rates. Ministers' statements will have to be symmetrical, refraining from taking credit when they have "cut" rates. Ministers will also have to refrain from commenting day to day operations in the money markets and on interest rate changes by banks and building societies and still more from attempting to exert moral suasion on them.

43. There area a number of practical steps by which public understanding of the Government's position on interest rates could be got across:

(i) Guidance could be prepared for the Press Office and Economic Briefing setting out the way in which interest rates will be determined and how this should be presented.

(ii) A guidance note could be prepared for Ministers on the same lines.

(iii) On a suitable speech occasion a Treasury Minister could include a passage about interest rates under the new arrangements.

Finally, it will be necessary to consider the terms in which the Bank's operations in the money markets are described e.g in the Quarterly Bulletin. Paragraph 9 above indicated that we will not want to reveal the width or location of the band. The description,

therefore, will have to be carefully constructed so as to give the public an adequate account of developments without undermining the authorities' freedom of action.

IV Procedure

44. The procedure for reviewing monetary developments and prospects and for deciding on the interest rate band will represent a development of current practice. Shortly after the publication of the provisional money figures for one month, an exercise is undertaken to assess the prospects for the current plus the following two months. This, together with a report by the Bank on recent money market operations,[2] and a note relating the monetary prospects to developments in the economy more generally, is then discussed at a Treasury/Bank meeting chaired by Mr Ryrie - the Bank team is led by the Deputy Governor. The meeting will attempt to form a view about interest rates and in particular whether changes in the interest rate band are required. It will also consider the prospects for funding and what our objectives should be over the coming months.

45. Initially the Bank will aim to keep rates within the band without being committed to aiming at the centre. Indeed the amount of "noise" might make this difficult to achieve. However, as experience grows, a band of 2 per cent might prove more than enough to accommodate noise. One response would be a decision to operate with a narrower band. Alternatively deciding to aim at a particular area of the band might become a possibility e.g in circumstances in which the case for an upward shift of the band was accumulating but one of the regular occasions for decisions was not imminent. The authorities in these circumstances might want to push rates within the band towards the upper limit or not seek to resist a tendency for rates to stay near the upper limit. It is too soon, however, to gauge whether such tactics would be desirable.

46. The outcome of the meeting will, as now, be a submission to the Chancellor (the Bank representatives will send their own submission to the Governor) which will set out the monetary prospects and, if necessary, make recommendations on the interest band. The Chancellor will then discuss the proposals with the Governor and seek the agreement of the Prime Minister.

47. Although this procedure is built around the banking month and the publication of the money figures, there will certainly be occasions when interest changes need to be considered outside this timetable. Once MLR has gone, however, there will no longer need to be a presumption that changes are made on a Thursday; indeed it will be desirable to prevent an easily predictable pattern of behaviour by the authorities from becoming recognisable.

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[2] Information on money market influences and the Bank's operations, eg what maturities were traded at what rates, is sent over to the Treasury each week.

THE ROLE OF THE NARROW AGGREGATES

SUMMARY AND CONCLUSIONS

1. There are two broad ways in which the narrow aggregates (M1 and Mo) could be given a greater role in monetary policy decisions: we could set explicit targets for them, or they could be used more informally as indicators, alongside £M3 and other variables, to inform interest rate decisions.

Targets

2. The **alternatives are:-**

(a) a single target for one of the narrow aggregates in place of the existing annual and medium term targets for £M3;

(b) a short term (6-12 month) operational target for M1 or Mo, with £M3 remaining as the medium term target for MTFS purposes;

(c) a short term target for either M1 or Mo as an adjunct to both the annual and medium term targets for £M3.

3. The case for replacing £M3 depends on whether either M1 or Mo is judged preferable to £M3 on control grounds, and in terms of its relationship with prices. A case can be made out for M1, but Mo does not look a strong candidate because, unlike M1, it would be difficult to control by varying the level of short term interest rates. But it would be difficult to abandon £M3 entirely without damaging the credibility of the strategy. A target aggregate like M1, which can in principle be controlled by varying interest rates alone, might also fail to act as an effective constraint on fiscal policy. (See paras 7-20).

4. There are strong objections to multiple targets (options b and c) which have special force where targets for both broad and narrow aggregates are annual. Different aggregates have not tended to move together over periods as short as a year. Measures taken to control one aggregate

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could throw the other further off course. We could well end up missing both targets, (see paras 21-27.)

Indicators

5. A more low key approach would be to take systematic account of the information contained in the narrow aggregates, alongside £M3, in taking interest rate decisions. This could be done without setting formal targets for the narrow aggregates if the forecasts were used as a benchmark to identify unexpected developments in M1 and Mo. The narrow aggregates have not on average been reliable forward indicators of movements in broad money but on occasion they have signalled when interest rate movements have become excessive (eg. 1977) and provided an alternative measure of monetary conditions in periods when the broad aggregates are known to be distorted by special factors (eg. the early '70's and 1980). But this does not point to any very simple rule. (See paras 28-34.)

Outlook for 1981/82 and 1982/83

6. The narrow aggregates are likely to grow fast relative to both £M3 and nominal incomes as inflation decelerates, unless interest rates rise in real and possibly nominal terms. This is because the velocity of M1 tends to vary with nominal interest rates and thus with the rate of inflation. A target for M1 which accommodated some fall in velocity over the next few years would probably have to be over 10%. It might not be possible to meet a single figure target without high real interest rates, given the fiscal framework set out in the MTFS. (See paras 35-39)