9. Monetary Base Control

9/4/81 – 13/4/81

DRAFT LETTER TO

J S Fforde Esq
Bank of England
Threadneedle Street
London EC2

You may recall that I wrote to you on 11 March about the two papers you proposed to issue the next day on Monetary Control and Bank Liquidity. I said that we were content with the drafts, but subject to ~~your meeting~~ one or two points to the discount houses in discussion of them. In particular, I asked you to make it clear that they could expect greater variability of interest rates, and that the new system could not be taken to guarantee their survival ~~sine die~~. I would be grateful if you could confirm that you did get this across to them.

2. There were ~~to~~ two further points in the latter on which it would be helpful to have your comments. The fourth paragraph asked for an assurance that the new arrangements did not ossify the existing institutional structure of the gilts market. ~~And~~ The penultimate paragraph ~~invited your views~~ asked for a draft on the nature of the further paper on prudential requirements which you referred to in the banking liquidity note. ~~Can you let us know soon, please, how things stand?~~

P E MIDDLETON

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1. MR MONCK amended in ms

2. MR MIDDLETON

Mr 10/4

cc Mr Britton
Mr Turnbull
Mr Pirie

Mr Middleton wrote to Mr Fforde on 11 March (attached) commenting on the two Bank papers 'Monetary Control: Next Steps' and 'the Liquidity of Banks' which they issued the next day. The letter asked the Bank to make a number of points about market operations in the future to the discount houses. On the understanding that these points were made, we agreed that the papers could issue as drafted. Mr Middleton also asked for a description of the further paper on prudential arrangements and a note on the timetable of discussions with the banks.

2. Mr Fforde has not yet replied to this letter. It would be useful to remind him. In the first place we would like an assurance that the discount houses were indeed told that they should expect greater variability of interest rates and that the new arrangements did not offer them any guarantee of survival. On the prudential front Mr Pirie tells me that they have held one meeting with the BBA, who indicated that they didn't see the need for further consultation on the first paper. The Bank can therefore press ahead with the second paper. It would be useful now to remind them of our interest.

I attach a draft letter.

H J DAVIES
9 April 1981

249/4

Chancellor of the Exchequer

cc Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr Ryrie
Mr Burns
Mr Unwin
Mr Monck
Mr Britton
Mr Turnbull
Mrs Lomax

MONETARY CONTROL

1. I had been hoping to avoid referring again to this subject until after Easter. But I am being pressed very strongly by Alan Walters who in turn says he is being pushed by the Prime Minister.

2. First, you might like to look at the attached minute from Walters to Mr Burns and myself. This followed a meeting with Walters after the Budget at which Mr Burns and I thought we had convinced Walters that the right course was to build on the changes which were already in hand, rather than start another exercise on the assumption that we should move rapidly towards monetary base control. This was after all what we had decided in the pre-Budget discussions. Walters' minute to the Prime Minister and his subsequent minute to us therefore came as something of a surprise - we clearly are not communicating very well. It is also a rather odd route through which to receive instructions. However, we do need to consider how to take issues of monetary control further.

3. Second, you might like to look at my note of 4 February on Monetary Control and the record of your meeting with Walters on 5 February when you rejected his proposals in favour of more rapid change.

4. The position, roughly speaking, is this:

a. The Government is committed to £M3 as the basis of the medium term strategy. The Prime Minister's manuscript comments on Walters' minute is useful confirmation of this. It would be a mistake to let it be thought that this question was to be re-opened.

b. MBC is therefore virtually ruled out as a means of medium term monetary control. In any case we would not now wish to

contemplate, as would some pure monetarists, fixing the growth in the monetary base at a particular figure as the sole means of bringing inflation down, and keeping it down, some time over the next century or so. Policies with this cosmic time dimension are of very limited value.

c. But there is an issue concerning the value of monetary base control as a way of improving short term control. Walters starts from the assumption that MBC is an obviously superior method of control. But we are a long way from establishing that. In this connection:

i. we have already agreed with Walters that controlling the base over periods of less than 6 months would be undesirable.

ii. There is also agreement that the techniques to be used to control the base would be those we are presently developing.

iii. So the base is really being looked at as an alternative monetary aggregate.

iv. But work so far suggests that it has some serious drawbacks. It is in many ways inferior to other narrow aggregates such as M1. Only the currency component of the base appears to show any systematic relationship to money incomes or prices, but since this is entirely demand determined, it provides no firm evidence of a causal link.

v. The relationship of the base to interest rates is not well determined and looks to be pretty unstable; if this is right there would be far reaching implications for building societies and mortgage rates.

vi. And it is certainly not possible to use MBC on its own as a means of controlling £M3 or any other wide aggregate.

d. This does not rule out taking the base into account among the other factors which determine interest rates. We now have a series and shall wish to monitor the base and its components. But this is not the same as basing policy exclusively on targeting the base.

e. The line we took in the Budget was in this sense a step away from MBC. It was a move away from excessive reliance on one aggregate and an attempt to bring other factors - including a range of monetary aggregates - to bear on the determination of interest rates.

f. Moreover, we are still in the process of completing a series of interim changes in our techniques for bringing about discretionary changes in the level and structure of interest rates. Most of these changes are of relatively minor importance from a monetary control point of view:

i. The Bank will be letting me have a note next week on their discussions with the banks. Subject to that, we hope that by the summer:

ii. the Reserve Asset Ratio will actually be abolished - it has to all intents and purposes gone as an impediment to monetary control.

iii. Access to the discount window will be further reduced and - with luck - MLR will be suspended or abolished.

iv. Bank operations will be conducted in bills, with the discount market protected - this is already happening.

v. Interest rates on 7 day money will be kept within bands which can then be gradually widened - we are close to implementing this arrangement. In effect interest rates are fluctuating in a band around MLR.

vi. The problem of the Bank's income will have been settled and the banks will observe a minimum ratio of ½%.

g. The area in which we have made an important contribution to monetary control is in funding techniques. Here we want to move further in developing

- the use of indexed gilts
- the more aggressive approach to National Savings
- and possibly a more flexible approach to conventional debt

h. There will still be a good deal of work involved in completing these changes in f and g.

5. To take any decisive step towards MBC would mean moving before

the new M2 series was available. It would rule out one of the two main MBC methods. I do not regard this as serious but many such as Brian Griffiths would certainly do so. Moreover a further step would require a further extensive round of consultations. In simple practical terms we cannot undertake this until we have finished the present round - and probably not for a period after that.

6. My own view is that we should concentrate on improving the present system of control, including the role which the monetary base can play in it, rather than look for major new departures. The Budget has been something of a watershed. The Government nailed its colours to maintaining the present strategy and to gradual change in methods of monetary control. It would create unnecessary uncertainty to switch course now. There might be a case for a completely new system if there was a real crisis of confidence in the markets about the Government's ability and determination to pursue its strategy - as for example there was in October and November last year. But whatever else the Budget has done it has certainly restored that confidence. I would be against disturbing it not only for the reasons suggested above but also because:

a. Moving to MBC would rightly or wrongly be interpreted to be taking up an extreme position. Policy would appear to be narrowly based on controlling notes and coin. Yet at this juncture it is important to gather support for the policy.

b. It would also be seen as a move in the direction of rigidity rather than the more flexible approach which was set out in the Budget and which has been generally welcomed.

c. It would be very difficult to get the Bank to cooperate given the Governor's increasingly strong stand. Inevitably it would intensify the public spectacle of the authorities falling out.

7. This is certainly not to say that the system is perfect and is not capable of improvement. Indeed it must be improved, but by building on what we have and carrying the Bank with us. The interim arrangements currently under discussion are not likely to provide an enduring foundation for monetary control. Moreover, we are at

present relying heavily on the fiscal changes in the Budget and the better starting point this year to achieve the new target. Our monetary instruments are still unreliable and are in need of further development. The most obvious priorities are:

a. to follow up the work started in Sir Douglas Wass' grou on funding

b. to assess our experience with the indexed gilt and consider further steps and developments so that we can maintain a direct influence at the long end of the market

c. to develop working rules for taking into account the factors we saw in the Budget would be relevant to the determination of short term interest rates

d. to explore further the way that changes which are taking place in the securities markets, affect monetary policy. This important area has barely been touched on over the past year.

e. to build up our contacts - where we can without conflict with the Bank - with market operators and especially with the banks and investing institutions so that we improve our own knowledge of how to work the system we have got.

8. All this amounts to saying that Walters' minute left rather a lot out. I think we must deflect him for anything so vigorous that it is counter-productive. He clearly wants to come to see you. I suggest you should invite him over for a small discussion - with perhaps the Financial Secretary, Mr Burns and myself. I have already offered to produce a Treasury paper outlining the way ahead for the coming year and the role which the monetary base might play, alongside other factors, in the determination of interest rates. I should like to discuss the paper first with Mr Burns and Mr Ryrie and then with the Bank and Walters. You could repeat this offer to Walters. But at the same time we could make it clear that we are still in the gradual evolution business - not as gradual as the Governor suggested to the Select Committee - but not nearly as precipitate as Walters clearly has in mind. That way we stand a chance of making some necessary improvements relevant to the strategy to which the Government is committed. And I think that we could usefully use Alan Walters talents in contributing to this exercise.

PEM

P E MIDDLETON
10 April 1981

Mr Imbert
14/4 fradmept

Mr Fine
Mrs Lomax
Mr Davis

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

10 April 1981

P E Middleton Esq
HM Treasury
Parliament Street SW1P 3AG

Dear Peter

I am sorry that your letter of 11 March, about our paper on Monetary Control and other matters, has gone unanswered for so long. It raised three points on our paper on Monetary Control, one on our Liquidity paper and a final one on the interpretation of the MLR notice; and you will need a reply, for the record.

The three points on "Monetary Control: Next Steps" did not present us with any difficulty. But we did not seek to change our paper to reflect them, because it dealt only with those aspects of the November Note on which direct negotiations with parts of the banking system were about to be undertaken. We did however keep your points well in mind in our discussions with the institutions concerned and in talking to the press.

On the specific question of arrangements for the gilt-edged jobbers and the money brokers, what we were and are suggesting is essentially a continuation of present arrangements which permit these institutions to respond rapidly to changes in the climate of the gilt market and make a larger and more efficient market than would otherwise be possible. Our suggestion is wholly neutral with respect to any major institutional change of the kinds discussed in the recent Working Party on Funding chaired by Sir Douglas Wass.

You also asked for a description of the further paper mentioned in Paragraph 9 of our Liquidity paper. It will be a technical paper reviewing the comments made on the technical specification of the "integrated test" described in our earlier paper "The Measurement of Liquidity" and making new proposals for discussion with the banks.

As you know, the timing of the abolition of the Reserve Asset Ratio is not dependent on the time taken to discuss this further technical paper on liquidity - existing measurement techniques are adequate to monitor banks' liquidity in the period following abolition. Nor is it dependent on the timing of the process of agreeing normal levels of holdings of what are presently reserve assets, referred to in paragraph 10 of our paper. We expect the assurances from the banks required in that paragraph as an interim measure to have been received soon enough for it to be possible to abandon the Reserve Asset Ratio when the various other matters in "Monetary Control: Next Steps" have been settled.

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Finally, you raised as a matter of record a question arising from the difference in wording between the relevant passage in the Budget speech and our Note to Editors regarding the reduction in MLR to 12%. I have consulted the Governor on this matter and would ask you to recall that the text of our Note to Editors was accepted by the Prime Minister at her meeting with the Chancellor and the Governor on the Friday evening before the Budget and to say that it indeed represented the reasons why the Bank proposed the change in MLR.

The measures of money, the rise in real interest rates and the slackening of inflation were significantly alluded to in the notice before the words "developments in the economy more generally". Such developments would clearly include the trends in output and employment.

Yours sincerely

John Fforde.

cc: Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr. Ryrie
Mr. Burns
Mr. Unwin
Mr. Monck
Mr. Britton
Mr. Turnbull
Mrs. Lomax

MR. MIDDLETON

MONETARY CONTROL

The Chancellor was grateful for your note of 10 April. He has commented that the response you suggest to Mr. Walters accords very closely with his own instinctive reaction to where we are now. He agrees it would be sensible for us to arrange a small informal discussion with Mr. Walters; provided the Financial Secretary and Mr. Burns are content, I will try to set this up in the week beginning 27 April.

2. The Chancellor strongly agrees that we should seek to use Mr. Walters' talents in pursuing the objective of an evolutionary improvement in monetary control. It would be easier to do this if Mr. Walters could be deflected from the habit of putting his views almost as telegraphically as the "Gang of 364".

A.J. WIGGINS
13 April 1981

AL

PRINCIPAL PRIVATE SECRETARY

CC PS/Chief Secretary
Sir D Wass
Mr Ryrie
Mr Burns
Mr Middleton
Mr Unwin
Mr Monck
Mr Britton
Mr Turnbull
Mrs Lomax

MONETARY CONTROL

The Financial Secretary has seen Mr Middleton's minute of 10 April, attaching a note by Professor Walters. He agrees with Mr Middleton passim.

He imagines the Chancellor will want to speak to the Prime Minister about the communication difficulty referred to in Mr Middleton's second paragraph.

SAJL

S A J LOCKE
13 April 1981

MR MIDDLETON

cc Mr Britton
Mrs Lomax
Mr Turnbull
Mr Grice
Mr Shields
Mr Davies

MONETARY CONTROL

At your meeting on Tuesday you will be in the rather odd situation of having three good papers by Mr Britton, Mrs Lomax and Mr Turnbull but they rather bare or reveal an uncomfortable situation, so far as monetary control is concerned.

2. We all seem to be agreed that the existing and emerging systems of control are weak and unreliable. By this I mean that pulling the monetary levers available could not be relied on to correct a sizeable divergence from the annual target for £M3.

3. But apart from Walters and his supporters, we are not at all clear how to correct this. Further work on funding - both in the sense of the follow-up on the IG and considering the Bank's forthcoming paper on the short instrument and a proper discussion first with Treasury Ministers and then with the Bank - seems unlikely to transform the situation, although it is worth doing.

4. The same goes for the obvious development of the emerging system - widening the band, which I also think needs some further work. Or for looking at ways of correcting what I think the Bank regard as one of the weaknesses of the emerging system, the greater difficulty of using bills to mop up excess liquidity rather than injecting cash.

5. At the same time, as Mrs Lomax has pointed out, the emphasis on discretionary or indeterminate methods of setting short-term interest rates is really a move away from purely quantitative controls like MBC whose great merit is supposed to be that they are pretty automatic, though the period over which control is attempted does qualify this.

6. In this uncomfortable and unpromising situation it does seem important to keep open the possibility of using interest rate movements

in both directions, particularly upward, despite the doubts about the size (and sometimes the direction) of the effect, and about whether they act first on nominal GDP or on money.

7. I also think it is important to install the new band system as soon as possible. At present we have in effect an unacknowledged band. We should formalise it, though I am not sure whether we can do this before MLR is suspended. I have written to the Bank asking them whether they are still opposed to suspension. If they are, I asked them to produce a paper on the reasons which we can discuss then and which might ultimately be the subject of a discussion between the Governor and the Chancellor. But unfortunately all of this is probably not very relevant to any decisive improvement in monetary control.

S. Wilkes
P.P. N MONCK
13 April 1981