

PREM19

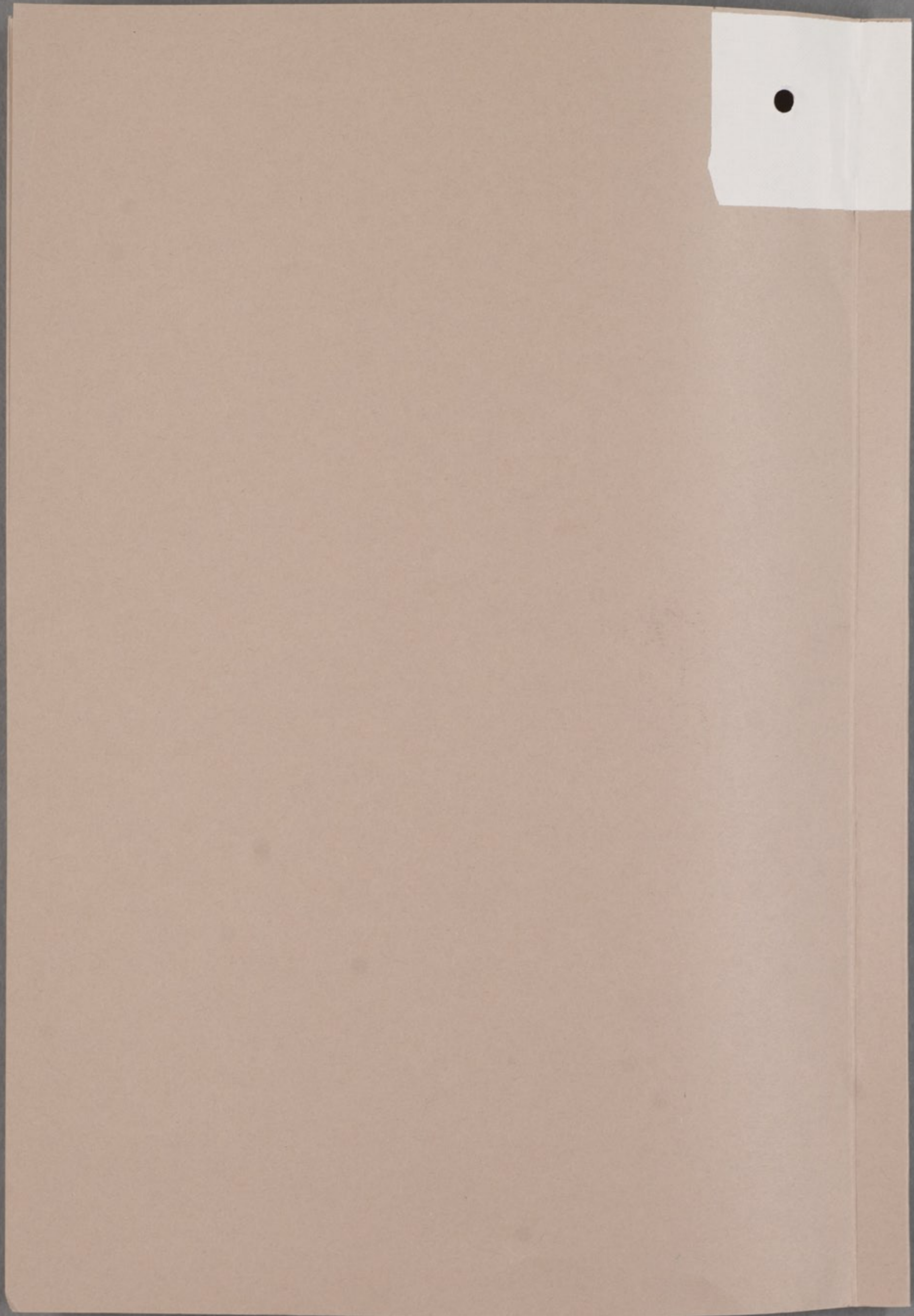
33

ECONOMIC POLICY

(Monetary policy -
domestic)

(Part 1)

PREM 19/33



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Pr1

Confidential Filing

Domestic Monetary Policy.

ECONOMIC

POLICY

Pr1 May 1979

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
10.5.79							
7.6.79							
4.6.79							
15.6.79							
19.6.79							
29.6.79							
4.7.79							
12.7.79							
18.7.79							
2.7.79							

PREM 19/33

PART 1 ends:-

Ch Ex to S/S Emps 25.7.79

PART 2 begins:-

TL to PM 7.9.79



*PM has seen
Econ
Bl. 2*

Treasury Chambers, Parliament Street, SW1P 3AG

01-233 3000

25 July, 1979

cc Mr Hoffman

Prin Minis

*A good letter, explaining
for Mr Prior's benefit that
direct controls are
no substitute for
high interest rates.*

Dear Secretary of State,

MONETARY POLICY

You raised the question at 'E' Committee recently why high interest rates were being used to control bank lending, rather than direct restrictions - in terms of either total liabilities or prescribed priorities amongst borrowers.

*12
26/7*

The short answer is that there already is a form of direct control over the growth of banks' liabilities - the Supplementary Special Deposit scheme - and there is qualitative guidance about categories of lending. To go further with more specific controls over particular types of lending would both run directly counter to our general approach to economic management, and risk damage to the structure of the financial system, without significantly affecting the availability of liquidity and credit. None of these changes would avoid the need for high interest rates until money supply had been brought under control.

Under the Supplementary Special Deposit scheme or "corset", a guideline is set for the growth of each bank's interest bearing eligible liabilities. If such liabilities exceed the guideline, the bank has to place supplementary special deposits on a progressive scale with the Bank: the effect is to increase sharply the effective cost to the bank concerned of securing additional funds for lending, once it has exceeded the guideline. An increasing number of banks are in or approaching this position: two of the clearers are already in the penalty zone.

A bank which needs to cut back on its lending because of the corset has little alternative but to raise interest rates. It can clearly do something by restricting new facilities and renewals of existing facilities, especially for the personal sector, but the effect of this is small because most of the increased lending will be in the form
/of the

The Rt. Hon. James Prior, M.P.



of the increased use of existing facilities. However once a number of banks start to raise their rates to borrowers, this spreads rapidly to other parts of the financial system as the would be customers of those banks seek alternative finance.

Indeed, one of the reasons for raising MLR in the Budget was that it was clear that if bank lending continued at its high level, the rates charged on bank lending and other market interest rates would very soon start to move upward as banks found themselves increasingly constrained by the SSD scheme. Thus it was preferable to pre-empt such an upward drift in rates, which might have looked like a vote of no confidence in our economic strategy: raising MLR last month rather than letting things drift should mean that bank lending will turn down earlier and our gilt sales would be better, both helping to bring forward the time when interest rates can be reduced.

The SSD scheme is supported by qualitative guidance from the Bank to banks, indicating both priority categories - finance for working capital and investment by manufacturing industry, exports and import saving - and ones to be restrained in the interests of priority categories - persons, property companies and purely financial transactions.

There were more specific ceilings over bank lending under the Labour governments in the late 1960s: they were running into increasing difficulties before the 1970 election, and were ended after it. The main difficulty with them was that their effect was as much to encourage finance to by-pass the controlled part of the financial system - whether through secondary banks or direct from company to company - as to control the total amount of credit in the economy. This by-passing of the banks not only led to prudential difficulties, which were one of the causes of the 1973 secondary banking crisis, but involved a degree of discrimination between the banks and their competitors which was hard to justify, and brought the system into disrepute.

But the essential point about the level of interest rates is that, as we all agree, constraint in the growth of the money supply (and so bank lending) is essential to the control of inflation: employers in the public and private sectors must realise that finance will not be available irrespective of the level of wage settlements. This involves restricting the availability of finance and, in as sophisticated and complex a financial system as ours, such restraint in the private sector can only be achieved by price - i.e. interest rates. The level of interest rates necessary to achieve the monetary target will also depend on the constraints imposed on the public sector - the size and composition of the PSBR, and particularly

/the level



the level of public expenditure. The prospect for reductions in interest rates depends very much on what we decide on the last.

Thus, we already have a form of direct control over banks' balance sheets - the Supplementary Special Deposit scheme - but this is not an alternative to increases in interest rates. Indeed it can cause them. To shift to more direct controls would risk similar unfortunate consequences to those of the Labour Government's controls in the late 1960s.

It would involve intervention of a kind which we all regard as counter-productive and it would not achieve the necessary objective of controlling the underlying monetary conditions.

I am sending copies of this letter to the Prime Minister, the other members of 'E' Committee and Sir John Hunt.

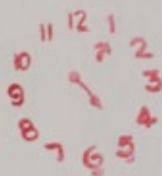
Yours sincerely,

Mark Hall

p.p.(GEOFFREY HOWE)

[Approved by the Chancellor of the Exchequer and signed in his absence]

25 JUL 1979



NOTE FOR THE RECORD

*Subjects filed on Econ PA
Econ PA: May 79: Cor. with
J. Sparrow
c.c. Mr. Wolfson*

Mr. John Sparrow called on the Prime Minister at 1430 hours on Monday, 23 July. The following are the main points which came up in discussion:

(i) President Carter's Cabinet changes.

Mr. Sparrow said that he thought William Miller would be a better Treasury Secretary than Mr. Blumenthal had been. He had consistently said the right things about monetary policy and energy pricing: it remained to be seen whether his words would be turned into action. It was disappointing that the Administration had failed to announce that energy prices would be increased to reflect real economic costs immediately.

(ii) Sterling

The Prime Minister said that it seemed that there was little that the Government could do to moderate the rise in sterling - though, with the very bad trade figures, it must come down before too long. The latest relaxation of exchange controls had, if anything, improved confidence; further relaxation was probably called for, but it would be unwise to move too fast. Mr. Sparrow commented that it was generally assumed in the City that exchange controls would wither away. The trade figures would probably continue very bad for the next few months in his view. Companies such as Courtaulds were rather exaggerating the adverse effect which the exchange rate was having on their operations; but there certainly were some companies which were suffering. In his view, a sterling/dollar rate of between 2.20 and 2.40 was about right.

/ (iii)

(iii) Interest Rates

Mr. Sparrow said that industry was being adversely affected by the high cost of borrowing, which combined with the effect of the high exchange rate on liquidity. He thought that there was a case for a phased reduction of M.L.R.. The July bank lending figures would probably be bad, but there should be an improvement in the August figures. By then the corporate sector should be spending less on inventories partly because of cheaper imports. Loan demand was not sensitive to interest rates; but companies which were borrowing were having to pay dearly. The City were generally convinced that interest rates must come down before long. So if M.L.R. were reduced, there was little doubt that interest rates would follow. In other words, a signal from the authorities in the form of an M.L.R. decrease would not be ignored. The Prime Minister pointed out that interest rates were still below the current rate of inflation. Mr. Sparrow denied this on the grounds that the V.A.T. increase in the Budget was not part of the underlying rate of inflation. The underlying rate of inflation was running at about 12 per cent, which was the same as the yield on gilts. This meant that the bulk of investors in gilts - namely the pension and insurance funds which did not pay tax - were keeping up with inflation. Mr. Sparrow went on to say that the institutions would probably hold back their subscriptions to the new long tap until September when they hoped that interest rates would be on the turn. It was true that, if they firmly believed that interest rates should fall, they would be subscribing now; however, they tended to act like "sheep" and wait until their expectations were confirmed before moving. Falling interest rates would not have much effect on the exchange rate, but they would help to moderate the present high level.

(iv) Equities

Mr. Sparrow said that the general tone in the equity market was one of gloom and doom. This was due to the strong pound, the poor prospects for profits and the fears of a bad winter.

(v) Aid

Mr. Sparrow said that he hoped the Government would consider the possibility of diverting part of the existing aid programme to E.C.G.D. financed projects. This would help to ensure that U.K. industry benefited from the programme. The Prime Minister explained that the bulk of the aid programme was already tied.

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25 July 1979



Econ
JBL

10 DOWNING STREET

From the Private Secretary

20 July 1979

Dear Tom.

I attach my note on Wednesday's monetary seminar.

I am sending a copy of this letter and enclosure to John Beverly (Bank of England) and Martin Vile (Cabinet Office).

Low ev.

T. W.

A.M.W. Battishill Esq
HM Treasury

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10 DOWNING STREET

Mini

I told Paula Diggie
that PM had
registered no objection.

I have not written
round.

MAP
20/11

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MS.

Prime Minister, am 12
The Chancellor has not seen this yet. Subject to his views, we go on contact?

Treasury Chambers, Parliament Street, SW1P 3AG

R Carter
Duty Clerk.

PRIME MINISTER

TAP STOCKS

You accepted yesterday that a new long tap stock should be announced tomorrow, Friday 20 July. I thought that you would now like to know what is proposed, after discussion between the Bank and the Treasury.

As was mentioned in discussion yesterday, we have already secured sufficient receipts from gilt sales for banking August, given the very low Central Government Borrowing Requirement. Indeed, additional receipts during that month could be something of an embarrassment, since they would tend to tighten money market conditions, and so increase pressure on short term interest rates. But there is a need for very high receipts in banking September, when the Central Government Borrowing Requirement may be not far short of £2 billion, partly because of the effects of the first round of the income tax reliefs, which are affecting pay packets in July. We probably need more than £1,500 million of receipts from gilt sales in banking September if we are to keep the growth of money supply in that month down to an acceptable figure. Gross sales will need to be greater than this, because we ought to be starting to buy in some of the £1,200 million of Treasury 10½% 1979, which matures on 1 November: we have also to allow for some sales going overseas or to the banking system.

It is envisaged that this financing should be achieved with the issue of both a long stock and a medium stock. We feel that we ought to announce one of the stocks now, in order to take advantage of present market conditions, rather than risk missing

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an opportunity to get ahead with our funding - the more we can get ahead of our funding, the sooner we may be able to reduce interest rates without jeopardising control of the money supply. Any stock announced tomorrow would clearly have to be on a part paid basis, with 15% payable on application and the balance payable in banking September. Such a part paid stock ^{does} run the risk of attracting overseas buyers, which both puts ^{upward} pressure on the exchange rate and is a relatively expensive form of external financing. The risk would be greater if the stock announced tomorrow were the medium stock rather than the long dated one. The Bank therefore propose, and I agree, that we should announce the long dated stock tomorrow and then announce the medium stock when it can be sold on a fully paid basis in banking September.

The long stock would be for an amount of £1,500 million maturing in 2007. The coupon would be $11\frac{3}{4}\%$, or $11\frac{1}{2}\%$ if the market moves upward tomorrow, to give a redemption yield of under $12\frac{1}{4}\%$.

I am sending copies of this minute to the Chancellor and the Governor.

Pcl

NIGEL LAWSON

19 July 1979

(Approved by the Financial Secretary and signed in his absence).

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CC Master

NOTE ON THE SEMINAR HELD AT 1500 HOURS ON WEDNESDAY 18 JULY
IN THE PRIME MINISTER'S ROOM AT THE HOUSE OF COMMONS

Present: Prime Minister
Chancellor of the Exchequer
Chief Secretary
Financial Secretary
Governor of the Bank of England
Chief Cashier
Mr. Adam Ridley
Mr. David Wolfson
Sir John Hunt
Sir Douglas Wass
Sir Kenneth Berrill
Mr. Michael Bridgeman
Mr. Peter Middleton
Mr. Clive Whitmore
Mr. Tim Lankester

The seminar had before it three papers from the Treasury - one on "Monetary Objectives and Prospects", the second on "Funding the PSBR and the Gilts Market", and a third on the "Monetary Base".

Monetary Objectives and Prospects

1. Introducing the Treasury paper, the Chancellor said that the achievement of the monetary target was a crucial element in the Government's strategy. It would inevitably involve a monetary squeeze, and this in turn would mean high interest rates until bank lending to the private sector fell significantly from its present high level.
2. In discussion, it was pointed out that what evidence there was suggested that bank lending in July was continuing at a high level; so there could be no question of an early cut in MLR. By the autumn there would no doubt be growing criticism from industry if interest rates remained high. The Government would have to ride this out. Confidence would quickly disappear if the Government appeared to resile from the monetary target, and this would undermine the prospects of recovery in the medium term. Even though bank lending was relatively insensitive to changes in interest rates, this did not imply that the present level of interest rates was unnecessarily high. In present circumstances, the markets would not accept a fall in MLR, and bank lending would in due

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course respond in the desired direction. Bank lending might fall off somewhat as a result of the likely slowing down of economic activity, and this would help to bring interest rates down. But with GDP in nominal terms growing twice as fast as the monetary target, interest rates were almost bound to stay relatively high. Other important influences would be the level of wage increases over the coming round, and the Government's success - or otherwise - in sticking to cash limits.

3. It was further argued that the post-Budget forecast for the PSBR must not be exceeded. This required, amongst other things, that the assets disposals programme was successfully implemented. Assets disposals would not affect the PSFD, and there was likely to be some substitution of asset purchases for purchases of gilts. On the other hand, there was little doubt that, if the programme was not achieved, gilts sales would have to be larger; and this would push up interest rates.

4. The composition of the assets to be disposed of still had to be settled. If it were decided to make a major sale of BNOG assets in preference to BP shares, it might be difficult to achieve the full £1 billion by the end of the financial year. But provided the sale was tied up in principle by then, and provided there was a substantial advance payment, the markets might accept a few months slippage without confidence being undermined.

5. It was also suggested that large sales of New Town land and property ought to be possible. The £70 million offered by the Secretary of State for the Environment for 1979-80 was disappointingly small. It might not be possible to do more than this in 1979-80; but a bigger effort should be made for 1980-81. DOE should mount an exercise to locate properties which could be sold.

6. Summing up this part of the discussion, the Prime Minister said that the seminar generally endorsed the Treasury's paper. She would consider further how the work on disposal of New Town assets might be intensified.

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Funding the PSBR and the Gilts Market

7. The Prime Minister said that she had one principal concern about the Treasury paper - namely, the arguments advanced in favour of continuing to offer long dated stocks at current high nominal yields. If the Government were serious in its aim of bringing inflation and interest rates down, borrowing long was surely expensive. On the other hand, if inflation were to continue at a high rate, the Government was in effect defrauding the investor.

8. In discussion, the following points were made -

- i. the basic approach of the authorities was to fund the PSBR as cost-effectively as possible. This involved offering a wide range of gilt-edged stock. The pension funds and the life offices, which now accounted for a major proportion of gilt sales, liked to keep a sizeable portion of their portfolios in longer stocks. Since the authorities had to obtain finance on such a large scale, they had to cater to the institutions' requirements.
- ii. even on relatively optimistic assumptions about the rate of inflation, the real cost of borrowing long on present yields was still cheap by historical standards, and it was only slightly greater than the cost of medium-term borrowing.
- iii. if the authorities refused to offer longer stock to the institutions, they would be more reluctant to buy gilts and this would tend to push up yields on short and medium term stocks.
- iv. with more shorts, the volume of stock maturing each year would increase and this would add to the authorities' refinancing burden.
- v. if inflation did continue at a high rate, investors in long gilts would indeed suffer; but in that case the Government was not paying out too much on its borrowing.

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vi. the authorities should continue to look carefully at the relative cost of borrowing on different time-scales. Given the present slight real cost advantage of borrowing over 10 years and shorter compared with borrowing over 20 years, there might be a case for greater emphasis on the medium and shorter end.

9. Summing up this part of the discussion, the Prime Minister said that she was still not entirely convinced by the arguments put forward. However, she was prepared to leave it to the Bank's and Treasury's judgement as to how much reliance should continue to be placed on long-term borrowing. She accepted the proposal that a new long tap should be announced on Friday. She was strongly opposed to the issue of index linked stock.

/Monetary Base

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Monetary Base

10. The Governor said that the Bank had recently published a paper on monetary base control (MBC), which was intended to provoke comments and contribute to the on-going debate on this subject. The Bank were also working on a paper which would propose the abolition of the system of reserve asset control. The reserve asset requirement had not been successful as a control on the monetary supply. Its abolition was one change which the proponents of MBC wanted. The Bank proposed to get rid of the reserve asset requirement before consulting more widely on the monetary base proposals. The Bank intended to hold discussions with officials in Germany, Switzerland and The Netherlands later in the autumn on possible MBC systems; the BIS were planning a meeting on MBC in November; and after this, the Bank might hold a seminar on MBC with academics, bankers and market operators.

11. The Governor went on to say that he had an open mind about the merits of MBC. The present methods of controlling the money supply were imperfect. However, he was by no means certain that there would be any net gain from moving over to an MBC system. If it did turn out to be an attractive proposition, it would not make it any easier to avoid high interest rates. Nonetheless, the Bank were ready to examine various MBC options in detail.

12. In a short discussion, it was argued that, while MBC would not be painless in that there would be no way of avoiding high interest rates if monetary growth had to be brought down, it might still offer the prospect of better control. On the other hand, its introduction would involve a major structural change for the banking system. Before there could be any serious thought of its being introduced, all the possible weaknesses and implications of the system would have to be thoroughly considered. There was a strong case for getting on with this work, rather than wait until the late

/autumn.

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autumn. The Treasury and the Bank could jointly consider possible MBC schemes, and this work could proceed alongside the Bank's work on abolishing reserve asset requirements. In due course, a detailed paper might be published as a basis for consultation and discussion; but before doing so, it would be necessary to consider the possible market objections - since publication of such a paper might itself have an upsetting effect.

Summing up, the Prime Minister said that there appeared to be sufficient merit in MBC to justify a more detailed study than the Bank and Treasury had so far undertaken. They should now prepare a joint study, which would consider a variety of possible concrete schemes. After the study was completed, it would be for consideration whether it should be published and what form consultation on it should take.

R

19 July 1979

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Subject filed as Econ. Pol.
~~Domestic Monetary Policy~~: May 79
Meetings with Gordon Pepper

NOTE FOR THE RECORD

Mr. Gordon Pepper called on the Prime Minister at 1030 hours on Wednesday, 18 July. Most of the discussion turned on the argument about issuing long gilts as opposed to short and medium gilts. This is recorded separately in my note of 18 July. Other points which came up were:

- (i) Mr. Pepper said that the banks were likely to make very high profits this year, and this was likely to result in high pay settlements in the banking sector. This could have an impact on Civil Service pay next year because of the P.R.U. comparability arrangements.
- (ii) The Prime Minister said that local authority three-month bonds appeared to be taking money away from the building societies. These bonds were secured, as she understood it, on the local authority rates. Would it not be a good idea to take away this security? Mr. Pepper said that the problem of diverting funds from the building societies was basically about high interest rates generally. If local authority bonds were no longer available, the building society money would be going somewhere else. And interest rates would stay high as long as inflation stayed high.
- (iii) Mr. Pepper said that he hoped the Government would seriously consider proposals for Monetary Base Control (MBC). A serious study was now needed of different detailed options. But before coming to any final decisions, it would be important for the Government and the Bank to consult widely with bankers and market operators. The Prime Minister told Mr. Pepper that she was chairing a seminar later that day which would be looking at MBC.

12

25 July 1979

PRIME MINISTER *Sam*

You may want to be reminded of Gordon Pepper's arguments against the Bank issuing too many long stocks. These were:

- i) It is expensive if we genuinely expect inflation to come down. Since our whole policies are aimed at this, it is an admission of defeat to borrow from long stock.
- ii) Borrowing long at high normal rates into the 1990s makes it more difficult to bring inflation down. High interest payments add to the burden of public expenditure and add to the PSBR.
- iii) Borrowing long at high rates makes it difficult/^{if not impossible}for industry to borrow long; yet it is industry which really needs to come in for long term borrowing.

You argue that we should not take on long term debt if this means being back in "debased currency". But this of course assumes that inflation continues at a high rate. And moreover, one can argue that if the institutions want to lend long, then it is up to them to take the risk.

Despite his preference for shorter term borrowing, Gordon Pepper does not think we should rule out long term borrowing altogether. He emphasised this after your meeting. Thus, it is more a matter of emphasis than of ruling out long stocks altogether. The Treasury paper in fact says that there may be a case for shifting from the very long to the medium stocks (ie ten years rather than 20 years).

18 July 1979

R



Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

Dear Tim

17th July, 1979.

MONETARY SEMINAR

I am afraid that the references to paragraphs in the Treasury papers in paragraph 4 of the Chancellor's minute of 13th July to the Prime Minister were not amended to take account of revisions to the papers.

The correct references should be:-

- i. 1C in the Annex to the Treasury paper on the gilts market;
- ii. paragraph 19 in the paper and comment 5C in the Annex;
- iii. paragraphs 11 and 18 in the paper.

There was also an error in the table in paragraph 7 of the Treasury note "Monetary Objectives and Prospects". The provision for sales of other public sector debt in the forecast for 1979-80 is £2 billion, not £3 billion.

Finally, I should explain the apparent discrepancy between the figures in that table for sales of gilts and other public sector debt in 1978-79 and those in table on Page 2 of the gilts paper. The difference is in the treatment of the National Savings Bank Investment Account. The former table follows the normal statistical convention of including its take-up of gilts in sales of gilts to the non-bank public, while in the latter the inflow into the account is included within National Savings.

Yours ever,
M.A.
(M.A. HALL)

T. P. Lankester, Esq.,
10 Downing Street,
LONDON. S. W. 1.

*cc AS/Sir John Hunt
PS/Financ
AS/Sir K. Berrill
Mr Mountfield*

Prime Minister

John Hunt will not,
after all, be
putting in a
separate brief.

CONFIDENTIAL

Qa 04194

To: MR LANKESTER ✓
From: SIR KENNETH BERRILL

12
1711

Monetary Seminar

1. For tomorrow's Monetary Seminar the Treasury has submitted a number of very thorough papers, and the Chancellor in his minute of 13 July listed a number of points which emerge from them. The Prime Minister may, however, find it useful to have a rather fuller annotated agenda - covering both the Chancellor's points and some of the more general issues which she may wish to raise.

2. The substance of the Treasury papers falls into two parts:

- (a) Monetary prospects, monetary targets and techniques of control;
- (b) The Gilts Market and funding the PSBR.

Monetary Prospects, Targets and Techniques

3. Under this heading the Prime Minister may like to raise four questions:

- (i) what are the immediate prospects?
- (ii) should the authorities adopt new techniques of monetary control?
- (iii) which monetary aggregates should the authorities seek to control?
- (iv) should the authorities move from annual targets to a medium term monetary programme?

(i) Current Prospects

4. The implications of strict monetary targets are that, whatever system of monetary control is chosen, interest rates must in the short term at least be permitted to fluctuate quite widely. The authorities cannot set both monetary targets and interest rates. They can take fiscal action (tax and

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public expenditure) which will produce a PSBR compatible in principle with their monetary and interest rate targets. But if, in the short term, the monetary target is to be maintained, interest rates must fluctuate accordingly.

5. It is clear from the Treasury paper 'Monetary Objectives and Prospects' that the Government's monetary target for this year is a tight one which is likely to require a very considerable 'monetary squeeze'. Interest rates are likely to remain high even if the Government achieves its target for the PSBR, and for the remainder of this year a critical factor in achieving the PSBR target will be ensuring that there is no breach of cash limits. For next year the Government's PSBR target (subject, of course, to wide margins of error) depends critically on achieving the public expenditure cuts for which the Chancellor has asked and on limiting the pay roll increases in the public sector. The Prime Minister will no doubt wish to have the views, particularly of the Governor, of what is likely to happen to interest rates - and the effect this may have on industry (a) if these PSBR targets are ~~not~~ met this year and next; and (b) if they are exceeded.

(ii) Monetary Base Control

6. There is at present widespread discussion of possible new techniques of monetary control. It has been proposed in particular that the authorities should switch from their present methods - notably the supplementary special deposits scheme which places a limit on the growth of banks' interest-bearing eligible liabilities (IBELs) - to the control of the monetary base (broadly the clearing banks' deposits with the Bank of England).

7. Control of this base might, as the Treasury economists' paper suggests, in the long run enable the authorities to get a firmer control of the monetary aggregates. It might also be more acceptable to the banks than present methods. But, as the Treasury paper makes plain, it would be a major change. It would take time for the authorities to

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learn how to work a new System (e. g. to know how quickly a change in the base might be expected to affect, say, £M3) and there would at the same time be a variety of disturbances and dislocations to well-established institutional arrangements. At a time when the Government is placing particular emphasis on its monetary targets, it would appear on the face of it dangerous to risk a change which could, in the transitional period at least, entail some loss of control of the monetary system. However, as suggested in the Treasury paper, there is every reason for work to continue on these proposals to try to evaluate more clearly how real the dangers are.

(iii) Which measure of 'money'?

8. The present target is, of course, set in terms of M3. Since a prime role for a monetary target is to influence expectations, it may not matter very much which 'M' is chosen for the target, provided the authorities have adequate techniques for controlling it and provided the market can be convinced that the authorities really are determined to stick to their published plans. Arguments can be advanced for a variety of measures of 'money' (M₀, M₁, M₂, M₃, etc.) and there is much to be said for the authorities keeping an eye on all of them: in part because they do not all move together and in part because the institutions will adapt to attempts to focus controls on any one of the 'Ms' by holding back on that and expanding in other directions. But although the authorities and the market will monitor all the 'Ms', attention is bound to focus largely on the Government's chosen target (in our case M₃) and, given the attention which the Government has itself put upon that variable, it would require strong argument to justify a transfer to another measure.

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(iv) A medium term monetary plan

9. The case for such a plan is straightforward: it is that if people are firmly convinced that the Government will achieve the planned reduction in the money supply then this will have a decisive effect on inflationary expectations. The case against is the practical one that a sustained reduction in the money supply may require action on public expenditure, tax, or interest rates which really is not tolerable. Then if the target is badly breached the credibility of the Government's overall economic strategy may be jeopardised.

The Gilts Market and Funding the PSBR

10. In this area the Prime Minister may like to raise the following points:

- (i) The Bank of England's article is a useful discussion document. Have the Bank had reactions from the City - particularly the insurance companies and pension funds who are the main purchasers of gilts?
- (ii) The Treasury paper makes out a good case in favour of issuing long-dated stocks, and we think a paper on these lines could usefully be published. The cost of the borrowing is not as high as it looks because the criticisms ignore the fact that relatively high inflation in the first few years greatly reduces the real value of subsequent interest payments and of the final capital repayment.
- (iii) Despite the wide variety of instruments for selling public sector debt, conditions of uncertainty periodically arise in which it is difficult to sell gilts. It can be argued that this should not be regarded as too important provided the markets

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are convinced of the determination of the Government to pursue strict monetary policies in the medium term, and hence that month-to-month fluctuations in debt sales, and therefore in the money supply, are not very significant. Fluctuations in the money supply also arise for other reasons such as short term intervention in the foreign exchange market.

If this were the position the Government would be able to ignore these short run 'gilt strikes'. But other things being equal, one would prefer to avoid these 'strikes' if possible, if only because if the 'strike' persists confidence may require action on interest rates (e. g. through the MLR) which goes further than the underlying market situation would warrant. Possible routes to improving the gilt markets which deserve further exploration include the following:

(a) Tendering. There are various means of raising long-term interest rates other than jacking up MLR, or waiting (perhaps for several weeks) for the market to set a new level sufficiently attractive to bring back the gilt investors. One possibility is, of course, a full tendering system. But, as the Bank point out, this might lead to even wider swings in interest rates if, in conditions of uncertainty, institutions were only willing to tender at extremely low prices. The Treasury hint (paragraph 18 of their note on Funding the PSBR) that there may be other ways of overcoming this problem: it would be useful to know what they have in mind.

(b) Indexation. The pros and cons of indexation are set out in the Treasury's comment on Suggestion 5c. Indexation would undoubtedly be a big step to take and the consequences, e. g. for industrial financing, are uncertain. If we were in the position of not being able to fund the PSBR by more conventional means

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we would have to take indexation very seriously. But this is not the case and our inclination is to be rather cautious. If it were to be pursued one possibility might be to devise an indexed stock which could be bought only by pension funds and, even then, only in limited quantities.

(c) Variable Rate Bonds. It has been suggested that more imaginative use might be made of a variable interest bond - with terms designed to provide a greater degree of capital stability than has been achieved by the issues to date (this instability of capital values has left institutions with variable rate bonds in their books showing significant capital losses). The Bank have been somewhat conservative in their approach to this type of instrument: the Prime Minister may wish to encourage them to look at the possibilities again.

(d) A new short-term instrument. When there is a 'gilts strike' the financial institutions hold that part of the inflow of funds eventually intended for the gilts market mainly in bank deposits. This creates an expansion of the money supply which further fuels expectations that interest rates will rise. This effect is optical in that the financial institutions (unlike individuals) are not considering whether to spend the funds but are waiting to invest them in gilts when interest rates rise. Nevertheless, the reserve base of the commercial banks will have been increased as a result of the authorities' need for residual finance, with the risk that there will be a further increase in the money supply, and increasing the expectation that interest rates will have to be increased. A new short-term instrument which did not count as a reserve asset would not have such perverse effects and should be attractive to the financial

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institutions. Both the Treasury and the Bank maintain that such an instrument would to an important extent be at the expense of local authority debt. But some of the institutions have told us that, provided it was priced correctly, it would attract funds primarily from bank deposits.

13. I am sending a copy of this minute to Sir John Hunt.

KB.

17 July 1979

Chancellor of the Exchequer

cc Financial Secretary
Sir Douglas Wass
Mr Bridgeman

MONETARY BASE

*- Practical
was held -*

1. I attach a paper for the Prime Minister's seminar on 18 July. The paper is by Treasury economists in the financial sector, and it considers the economic rather than the institutional implications of monetary base schemes.

2. The present system of control seems to be existing increasingly unhappily alongside a tight monetary target regime. The SSD scheme in particular is approaching the end of its useful life. The more importance the Government places on achieving its major objectives through control of the money supply, the more important it is to be sure that at the end of the day the targeted growth can be delivered if it is so desired. Monetary base control offers the prospect of a simplification and an improvement of the existing system. Therefore we must take it seriously. This means directing the discussion to a small number out of the multitude of potential schemes and exploring them in detail to test exhaustively their practical implications. We cannot, given the difficult task ahead, risk losing control by setting loose forces which we can neither understand nor control.

3. The paper assumes that the main use of the monetary base would be as a means of achieving a given £M3 target after fiscal policy had been determined within the context of a monetary target. This might be the right way to proceed in the first instance if a MBC scheme proves viable. So the Government still have to make the same strategic decisions about the PSBR and intervention in the foreign exchange markets when deciding on its monetary target. In particular:

a. Monetary base is not a substitute for an appropriate balance between monetary and fiscal instruments. If the PSBR is too high, if its composition is unhelpful and if the inflation rate is high in relation to the target growth of the money stock, interest rates will be high.

b. Monetary base is not a substitute for the appropriate policy in the foreign exchange markets. Unexpected heavy intervention will still be similar to an increase in the PSBR. It will have an expansionary effect on monetary conditions and make monetary management difficult. Interest rates have to adjust if these inflows are to be accommodated within a given monetary target.

c. Monetary base is not a way of controlling interest rates, it is a way of freeing them. If the Government finds the implications for interest rates of sticking to a particular target unacceptable, it will still have to consider fiscal action. In between fiscal changes, the interest rate changes which are the essence of monetary base control still need to take place.

Monetary base offers the prospect of a more efficient control - not a painless one.

E. K. Clarke

PP P E MIDDLETON
13 July 1979

Enc

MONETARY BASE CONTROL

1. This paper considers the arguments for moving towards a monetary base method of controlling the money supply. A number of commentators - both academics and in the City - have urged the authorities to move to such a system*. The Bank economists have published a paper in the June Quarterly Bulletin.
2. Three points should be noted at the outset. First, no-one has suggested that monetary base control (MBC) can soften the initial painful effects of restraining the growth of the money supply. Rather, it might enable the authorities to control the money stock more surely and minimise unnecessary fluctuations in monetary quantities and interest rates. The essence of the scheme is that interest rates must be free to adjust; it cannot work if they are not. Second, MBC has only been considered as a means of monetary control. Prudential regulation would have to be dealt with separately. Third, most proposals have not suggested that control can be achieved precisely on a day to day basis. The Bank economists' paper has shown clearly why a rigid version of MBC which attempted to do this would be unworkable. This paper therefore focuses on the question of whether MBC would give improved control over the money supply over a reasonable time horizon.
3. The paper is in two main parts: part one looks at the present system of controls and considers some of the main criticisms of it. Much of the impetus towards MBC derives from the apparent difficulties of the existing controls. Part two considers the advantages which might follow from MBC together with possible disadvantages of the versions that have been put forward recently. (Details of the main proposals are given in the Appendix). The conclusion is that there is a case for pressing ahead with a study in depth; this would involve setting out how a limited number of MBC schemes would be applied in practice, including their implications for different

*Amongst academic economists Professor Brian Griffiths and Geoffrey Wood of the City University are both about to publish papers advocating monetary base control while N W Duck and D K Sheppard proposed a similar system in the Economic Journal last year. In the City, Gordon Pepper of Greenwells has been prominent in pressing for monetary base control and he appears to have considerable support from other City commentators.

institutions and discussing their merits with those concerned in the financial markets - and more widely. It has been assumed throughout that £M3 is the monetary aggregate to be controlled, both much the same considerations would apply if a different aggregate became of primary concern.

I The Present Controls

4. The principal objective of the monetary authorities is to control £M3. They do this by operating on both the supply and demand for money. Fiscal policy, reflected in the size and composition of the PSBR, has to be consistent with the monetary target. But in between changes in fiscal policy, the authorities rely on monetary instruments to keep monetary growth within the target range. Under the present system the authorities try to achieve this objective mainly by acting upon the determinants of the demand for £M3. This technique has been reinforced at times by employing the Supplementary Special Deposit Scheme (SSDS) which is a supply side control.

5. In contrast either to reserve asset base methods or the SSD scheme, demand side control has evolved over a considerable time rather than being developed specifically to control a target aggregate. The procedure can be illustrated by reference to the following accounting identity.

$$\begin{array}{rcl}
 \text{Change in } \text{£M3} = & \text{Public Sector} & \text{Change in} & \text{Sales of} \\
 & \text{Borrowing} & \text{Bank Lending} & \text{Government} \\
 & \text{Requirement} & \text{to the} & \text{Debt to the} \\
 & & \text{Private} & \text{Non Banks} \\
 & & \text{Sector} & \\
 & + \text{External} & - \text{Change in Banks'} & \\
 & \text{Adjustments} & \text{Non-Deposit Liabilities} &
 \end{array}$$

6. Taking the public sector borrowing requirement as approximately given in the short run - say over a three to six month period - and similarly non-deposit liabilities, the authorities' problem becomes to control bank lending, sales of government debt to the non-banks and external influences on the money supply. Provided that official intervention in the foreign exchange market is limited, this last item should be moderately small so that the real problems facing the authorities are the control of bank lending and sales of government debt.

7. Under demand side control, the main weapon at the authorities disposal is interest rates, which they may change - particularly at the short end of the maturity spectrum - by administrative means, or by open market operations in government debt. A rise in interest rates, for example, will tend to increase the quantity of government debt demanded by the non-bank private sector while at the same time there will be a reduction in the private sector's demand for bank advances. Thus the effects on the money supply will be for a fall on both counts. Similarly a fall in interest rates would tend to have an expansive effect on the money supply.

8. There are a number of problems with this system of control:

a. The PSBR itself is neither entirely under the control of the authorities nor predictable in the short run. Indeed, the authorities' influence on the local authorities' and public corporations' borrowing requirements is tenuous at best and their knowledge of the contribution made by these components is usually belated. There can therefore be unpredicted shocks to the money supply from this source.

b. While there is some evidence of a tolerably stable relationship between interest rates and bank advances in the long run, the effect of interest rate changes in the short term appears, empirically, to be fairly weak. If, therefore, monetary control is threatened by a burst of bank lending, the authorities have little to combat this immediately on the demand side other than by putting moral suasion on the banks to restrain their activities. While the power of such suasion should not be underestimated, there is an element of arbitrariness involved in such moves which makes it undesirable.

c. The change in demand for public sector debt which will result from a given change in interest rates is very difficult to forecast. It will depend critically on the state of the market's expectations with regard to future interest rate changes and such expectations are notoriously difficult to predict, especially given their complex interaction with inflationary expectations. It is therefore difficult for the authorities to judge the amount and timing of interest rate changes necessary to achieve the monetary target.

d. There are problems involved in controlling debt purchase by the non-banks even in the most favourable circumstances. While the authorities know immediately how much public sector debt they have issued in total, they do not know until some time after the relevant open market operations how much debt they have succeeded in selling to the non-banks. Moreover, there may be direct transactions between the banks and non-banks which have the effect of prejudicing monetary control.

e. These problems of selling the necessary amount of gilts to the non-banks are made more severe when the authorities are committed in advance to a tight monetary target. This effect is greatest at those times when monetary growth appears to be exceeding the stated target, precisely those times when the authorities need most urgently to be able to exercise firm control. If it becomes clear to the market that the authorities will need shortly to organise large debt sales to the non-banks in order to restore control, it will also be apparent that an appreciable rise in interest rates will be imminent. Under these circumstances, the prospects for debt sales before the rise are limited.

f. Finally, external influences on the money supply are particularly difficult to control under this system. In principle, the authorities may be able to offset the monetary effects of an external flow by countervailing action on domestic credit expansion. In practice, they have great difficulty in carrying out this sterilisation because they do not know for some time what the monetary effects of a particular flow have been. Moreover, sterilisation requires discretionary action on the part of the authorities: there is no automatic mechanism in the system which might help them. These problems become greater if it is necessary to intervene to maintain a particular exchange rate.

9. Co-existing with the demand side control there are two existing supply-side systems of regulation. The first of these is based on the reserve asset requirements placed on the banks which were reformulated as part of Competition and Credit Control. A selection of assets, specifically bankers' balances, Treasury bills, tax

reserve certificates, money at call, British Government securities less than one year to maturity, eligible local authority bills and, up to 2% of eligible liabilities, eligible commercial bills, are demarcated as reserve assets. Banks are required to hold such assets to the extent of at least 12½% of their eligible liabilities. Originally, the scheme was intended to work by the authorities' creating reserve asset pressure. Because the authorities control the supply of most of the demarcated assets, they are able to push the banks towards the 12½% ratio. Since the banks are required to maintain this ratio, they were expected to react by reducing their eligible liabilities and hence the money stock.

10. In recent years, the scheme has not worked in this way though it has proved useful as a tool for influencing short term interest rates. It has not been used as a means of controlling the money supply. And the authorities have not generally attempted to control the total supply of reserve assets to the banks. To some extent the banks can manufacture reserve assets through their operations with the Discount Market. But, more importantly, the effect of reserve asset pressure in the short run can be to increase the money supply rather than to reduce it as desired.

11. For example, a single bank faced with a shortage of reserve assets may issue a Certificate of Deposit (CD) to obtain extra deposits and use the proceeds to purchase reserve assets from another source. Provided that such assets are available, the effect will be to expand the money supply. Individual banks may always do this and the banking system as a whole may also do it provided there are outside sources of such assets. In the process the rate of interest the banks have to pay to obtain the CD's rises and that they receive on the reserve assets falls. This represents an unprofitable situation for the banks and they will doubtless eventually react by reducing their earning assets - thus securing the desired fall in the money supply. But in the short run the effect on the money supply is perverse.

12. Since the end of 1973, the SSD scheme has been available to supplement demand side control. The scheme has not been applied continuously and there have been some differences of detail on the occasions that it has been applied. In general, however, banks

are called upon to confine the increase in their interest bearing eligible liabilities (IBELs) to below a specified rise from some particular base level. To the extent that banks are unable or unwilling to meet this constraint, they are required to place supplementary special deposits with the Bank of England on a proportion of the excess IBELs at zero rate of return. As the excess increases, so does the proportion and the effective marginal cost to the banks of finance rises sharply. Hence, in practice banks are only likely to trespass marginally into the forbidden zone.

13. Conceptually, the scheme has the merit of simplicity and, in combination with other measures, has had significant impact on monetary growth when it has been applied. On the other hand, it was not designed as a general scheme of monetary control but rather to counteract the "round-tripping" which occurred at the end of 1973 which artificially inflated the money supply at that time. As a general control on the money stock, it has a number of definite defects:

a. The control variable is IBELs which differs in a number of ways from any of the accepted definitions of money. In particular, as compared with £M3 , non-interest bearing deposits and cash are excluded while non-residents' sterling deposits are included in IBELs but not in £M3 .

b. While the scheme places a (slightly woolly) upper limit on the control aggregate, there is no penalty attached to the banks undershooting the allowed increase. On the other hand, since in the foreseeable future the authorities' minds are unlikely to be much exercised with stimulating the money supply this deficiency may not be very important in practice.

c. If the scheme bites, then because the scheme applies to each bank individually, competition between the banks is inhibited. // An efficient bank which is pressed against its upper limit is prevented from increasing its interest bearing deposits even if it can find profitable earning opportunities for those funds. Similarly an inefficient bank is given artificial aid in retaining its deposits which, in the absence of the scheme would be bid away from it by the efficient bank. Thus there is implicit taxation of the efficient and subsidisation

of the inefficient involved, quite the reverse of what would be desirable.

d. In practice, the exact effects of the control are unpredictable. In part, this is a reflection of the qualifications and offsets which are allowed under the scheme, particularly with regard to banks transactions with the Discount Market which is not subject to the control. In consequence, banks are often able to reduce their IBELs with no effect on the money supply though they may have to lose reserve assets to do so.

e. Even in the absence of these loopholes it would not be clear how the banks would reduce their assets if the authorities successfully reduced £M3. There may be effects on public sector debt holding, or external capital flows or on bank lending to the private sector. In large part, the banks' reaction to an SSDS will depend upon the degree of reserve asset pressure to which they are subject and, indeed, the banks' recourse to Discount Market loopholes depends critically on this. The precise nature of the interaction of an SSDS and reserve asset pressure is therefore complex and probably highly non-linear if expressed in mathematical terms. In many situations it is difficult to foretell what the effects of the authorities' policies will be.

f. Since the scheme has applied only intermittently, the banks have become adept at anticipating its application and forestalling its main effects by prior management of their balance sheets in order to give them a favourable base position. Moreover, in the short run this may imply a perverse rise in the observed money stock, so that an anticipated SSDS may make its application inevitable.

g. Finally, because of these loopholes and opportunities for cosmetic adjustments, the operation of the SSDS is likely to result in severe distortions to the recorded monetary statistics.

14. To sum up this section, then, the present systems of control are less than ideal. On the one side, there is a demand system

of control which has not proved capable of adequate regulation over a reasonable period of time. On the other side, the two supply side systems of control are both subject to serious defects. Neither gives very predictable results and the interaction of the two is complex.

15. The problems raised by this situation - for both the authorities and the financial system - has led some commentators, notably Greenwells, to suggest that the authorities should change their technique in favour of a monetary base control.

2. Monetary Base Control

16. One of the chief advantages of MBC is that, at least in theory, it is very simple. The classical version of MBC defines the monetary base as the monetary liabilities of the central bank which, in the United Kingdom, would be notes and coin plus bankers' balances at the Bank of England. Each bank is required to hold a certain proportion of its liabilities in the form of these assets. Since, in principle, the government has control over these assets, the government also controls the maximum level of the money stock. A leakage from the system is likely to occur insofar as the non-banks hold notes and coin. Faced with a shortage of base assets, the banks could attempt to attract notes and coin from the public to relieve the shortage without having to reduce their deposits. But those who propose this system usually assert that the possibilities of the banks' making use of this loophole are small and, moreover, that the implied flexibility in control is itself desirable.

17. Some of the recent proponents of MBC have suggested schemes which vary in detail from the classical scheme outlined above. For example, while, Wood and Griffiths propose a base with the traditional definition, Pepper would allow only bankers' balances with the central bank to qualify. Nevertheless, the various schemes have sufficient in common to allow discussion of their apparent strengths and weaknesses together. Details of the various proposals are given in the Appendix.

18. The MBC schemes which have been proposed have some or all of the following advantages as compared with the present system:

- a. because it is entirely a supply-side control the observed money stock could be controlled without any knowledge of the

demand for money function*, which empirically has proved very difficult to identify. Given the correct monetary target, this is an important advantage. Some knowledge of the demand for money is however still required to set the monetary target;

b. It is claimed that the authorities would not need to regulate quantities over which they have only imperfect control. This would not be true, however, in schemes where the monetary base included items such as cash or assets generated by the government's residual borrowing from the banking system. (See the next paragraph);

c. Banks would have much less opportunity for manufacturing base assets, a process which obstructs control in the existing reserve asset system;

d. All banks would compete on an equal footing in their bids to attract deposits so that the barriers to competition of the SSDS are avoided;

e. The system would be simpler than the existing controls so that both the authorities and the banks would be better aware of the direction of government policy.

19. Offsetting these potential advantages, there are also a number of potential difficulties:

a. The public's holding of currency has not shown great stability or predictability either secularly or in the short term. Those schemes, such as Wood's, which include cash in the base would imply monetary control was hostage to these unpredictable swings in the non-banks holdings. Because the proposed base/deposit ratios are usually fairly low, about 10%, banks would be forced to make multiple deposit contractions or be enabled to make multiple expansions in response to these swings independently of the authorities' wishes.

*The authorities do not control the money stock for its own sake but in order to create a stable monetary environment in which the real parts of the economy may function efficiently. The demand for money function provides the link between monetary growth and inflation and real output. It is thus important in deciding upon the target range for the growth of the money stock.

b. Other schemes, particularly those which see MBC as a self-imposed discipline on government expenditure and borrowing, as well as a pure money stock control, include assets in the base generated by the government's recourse to the banking sector as the residual source of finance. In practice the the authorities find it difficult to control at all accurately their need to this recourse over periods of much less than a few quarters. On the one hand, the PSBR is itself notoriously unpredictable; forecasts, even a day or two ahead are subject to an error of a few hundred million pounds. On the other hand, the government's ability to finance its deficit externally or by borrowing from the non-bank private sector is also unpredictable. Unless such disturbances were accommodated they would lead to multiple contractions and expansions of the money supply in the short run which would probably be of sufficient magnitude to make the scheme unacceptable.

c. Specifically, official intervention in the foreign exchange markets would be reflected in the monetary base and allow multiple contractions or expansions of the money stock. It would be difficult to sterilise the changes at all accurately by domestic instruments and the MBC as often proposed would rule out any significant official intervention for just this reason.

d. A rigidly enforced MBC would be inflexible probably leading to very sharp changes in interest rates in the short run. The Bank of England, rightly in our view, criticised this sort of scheme in the current Bank of England Quarterly Bulletin. MBC can however be made more flexible if desired. For example, the authorities could specify a permitted range for the base/deposit ratio with deviations subject to increasingly severe penalties. Alternatively, the authorities themselves could intervene as necessary to relieve excessive base asset pressure. So MBC does not have to be inherently inflexible.

e. Some schemes, that of Duck and Sheppard for example, involve far reaching changes in the day to day operation of the banking system. Not only would these schemes be

complicated to operate, they would also probably be institutionally unworkable.

20. To sum up this section, then, MBC does seem to offer a number of advantages as compared with the present controls. But there are also a number of pitfalls which would have to be avoided if MBC were to become the main instrument of monetary control.

3. The Negotiable Base Asset Scheme

21. It might be possible to devise a system which would retain the desirable features of MBC but remove some of the potential disadvantages. The skeleton of one such system is sketched out here.

22. As in the conventional MBC, banks would be required to maintain a specified base/deposit ratio. The base asset, however, would take the form of a specially designated Treasury bill which would be negotiable (and known as, say, an NBA). Not all Treasury bills issued each week would be designated NBAs so that the authorities would control the stock of NBAs in existence independently of their need to borrow from the banks.

23. When the authorities wished to restrain the money stock they would create less NBAs than would be needed to support existing deposits. NBAs would then trade at a premium as compared with other Treasury bills so that the marginal cost of deposits to banks would rise. Individual profit-maximizing banks will normally accept deposits just to the extent that the cost of obtaining their last deposit equals the return they can make in investing or on-lending that deposit. When NBAs are in short supply the cost of holding deposits increases and the banks will each be induced to cut back their least profitable investments and their deposit liabilities accordingly.

24. All banks will do this until deposits in total are reduced to the number supportable by the stock of NBAs. Since all banks face the same cost of obtaining an extra NBA, efficient banks who find profitable earnings opportunities will be able to maintain higher deposits than inefficient banks faced with only marginally profitable investment opportunities. These latter will be forced to cut back severely on both deposits and assets since the scheme

makes a large amount of their business unprofitable.

25. While being formally a monetary base control, this scheme has affinities with both the existing reserve asset controls and the SSDS. The worst problems of the former are removed in this system since only the authorities are able to supply the reserve asset. On the other hand, it might also be regarded as a modified SSDS, in that the authorities effectively fix the maximum growth in bank deposits, but in this case, leave it to the banks themselves to determine the allocation of those deposits by the normal competitive process.

26. This scheme would have the effect of transferring the onus of sterilizing external flows from the authorities to the banks themselves. If the banks as a whole were constrained in their total deposits, then an inflow could not increase deposits. Individual banks faced with the prospect of unprofitable inflows would lower their deposit rate to avoid them. In consequence, either existing bank deposits would be attracted into public sector debt or the lower domestic deposit rates would lead to capital outflows. In either case, the authorities would not have to take discretionary action. In this way, the scheme could help to minimize the disruptive impact of external flows on the money supply.

27. A scheme on these lines would seem sufficiently interesting to merit further consideration alongside those discussed in Section 2.

4. Conclusion

28. The various schemes for monetary base so far put forward all have defects. But they cannot be ruled out on this account. As the paper has shown, if perfection is to be the ideal, the existing system fails on many counts.

29. We have been living with monetary targets now since 1976. The present system of monetary control grew up in a very different environment. Possibly the main problem we have experienced has been in making timely adjustments to the money stock during the course of the year when - for a period at least - fiscal policy can be regarded as given and bank lending is difficult to influence. At times it has seemed that we do not have adequate instruments to deal with divergences, and the effect of the instruments we do

have is uncertain. And it is here that an overt supply side control like the monetary base offers the prospect of improvement.

30. One cannot say on the basis of this sort of paper that MBC would be an improvement - still less make a firm recommendation that we should go ahead and introduce it. The existing system has one great advantage - we think we understand it, know its blemishes, and can work it - even if the process is at times a messy one. The last thing we want is to make hasty changes to the system whose ramifications we do not understand, and which might result in a loss of control over the money supply at a time when monetary policy is at the forefront of the Government's economic strategy.

31. Several important questions have not even been considered in this paper. First, it is not clear how much disruption to the financial system particular schemes would cause, and what the implications for City institutions would be. We can however say with certainty that these might be considerable, especially for the Discount Market. Second, we need to consider carefully how monetary base control can be related to the various monetary aggregates which we at present use to monitor monetary conditions. Third, we need to be quite clear about how MBC would operate under different exchange rate regimes.

32. There is only one way to resolve these questions. A small number of schemes - perhaps those discussed in this paper - should be studied by the authorities in detail; there is as yet no complete analysis of any single scheme for the UK. Provided there were no market objections the next stage might therefore be the preparation of a paper detailing these schemes as a basis of further discussion, particularly with those affected in the all important area of practical banking.

33. This is not a proposal for delay. Not only are such discussions vital in their own right if MBC is thought worth pursuing, they would fit in with what might be an appropriate time for introducing changes in the system. This would ideally be when the government had made progress in its objective of reducing the inflation rate and achieving a better balance between fiscal policy and interest rates within the declining £M3 target.

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APPENDIX

SOME SPECIFIC PROPOSALS FOR MONETARY BASE CONTROLS

1. Gordon Pepper: "A Monetary Base for the UK: A Practical Proposal" (in Supplement to W Greenwell's Special Bulletin of 2 March 1979)

The monetary base would consist of bankers' balances at the Bank of England. All banks would be required to hold a fixed proportion of their deposits in the form of this asset, which would carry interest. The proportion would be the same for all controlled institutions but the level of interest paid might vary depending on the nature of the deposits concerned. Penalties would be applied to banks which failed to meet the required ratio depending upon the seriousness and frequency of the offence.

This system is close to a classical MBC except that the possibility of leakage through the non-banks' holding of notes and coin is eliminated. On the other hand, the monetary base would effectively be the government's residual source of finance. It would reflect any foreign exchange intervention, any day-to-day variation in the excess of government's expenditure over income or variations in sales of debt to the non-bank private sector.

2. G E Wood: "Cash Base Control and Institutional Change in the UK Financial System" (forthcoming in "The Banker")

The monetary base would consist of notes and coin plus bankers' balances at the Bank of England. There would not necessarily have to be a required minimum ratio since the banks would naturally hold a minimum amount of such assets for their own prudential and commercial reasons. However, it would aid the predictability of the system in the initial stages for a minimum ratio to be imposed. This scheme is the classical MBC. As such, it has all the potential advantages and disadvantages discussed in the main body of this note.

3. Professor Brian Griffiths: "Controlling the UK Money Supply" (forthcoming in the Lloyds Bank Review).

This scheme is identical to that of Wood except that Griffiths would not wish to impose a minimum base asset ratio, except, possibly for prudential reasons.

4. N W Duck, D K Sheppard: "A Proposal for the Control of the UK Money Supply" (in the Economic Journal, March 1978)

The authorities would create a new asset, the Reserve Deposit, which would be sold to banks only - initially in proportion to their individual holdings of balances at the Bank of England. Interest at the market rate would be paid on these assets which would in fact be deposits at the Bank of England. At the end of each day's clearing the Bank would allocate extra Reserve Deposits to banks whose ordinary bankers' balances showed they had gained net deposits and remove the appropriate amount from banks who had lost net deposits.

Banks would be required to hold a fixed Reserve Deposit/deposit ratio with an increasing scale of penalties for deviant banks. Restraint on the money supply would be exercised by the authorities unilaterally converting a certain proportion of Reserve Deposits held by the banks into ordinary bankers' balances which would not count as reserve assets. To avoid penalty the banking system as a whole would have to contract its deposits in these circumstances.

This scheme has the least affinity with the classical MBC of those considered. It thus avoids the potential drawbacks of MBC but retains some of the advantages. It would, however, be extremely complex to administer and probably unworkable. In particular, the Bank of England would not know whether the increase in a particular bank's ordinary balance reflected the drawing down of a deposit with another bank (ie no increase in the money supply) or the increase of an overdraft with another bank (ie a net addition to the money supply). It would not therefore know how to allocate the Reserve Deposits.

5. The Negotiable Base Asset Scheme (outlined in this note).

A proportion of all Treasury bills would be designated Negotiable Base Assets (NBAs) and sold at the weekly tender. Only banks would be allowed to buy these assets but they would otherwise be fully negotiable. Banks would be required to maintain a minimum MBA/deposit ratio with an increasing tariff of penalties for offenders. Except for having this reserve asset status, NBAs would otherwise be identical to existing Treasury bills.

When the authorities wished to restrict the money supply, they would create less NBAs than needed to support the existing deposits.

NBAs would then be in short supply and trade at a premium as compared with ordinary Treasury bills. Thus the marginal cost of finance to banks would rise and they would reduce their least profitable earnings assets together with their deposits. Efficient banks with profitable investments would not do this to the same extent as inefficient banks whose assets were invested in low return projects.

This scheme would avoid the obvious potential defects of the classical MBC but would retain most of its advantages. On the other hand, the full implications of the system have not been worked out.

PRIME MINISTER

MONETARY SEMINAR

After your meeting with him this afternoon, the Governor asked if he could bring one or two Bank officials with him to the Seminar next Wednesday. He feels this is only reasonable if the Chancellor is going to have, as you have already agreed, Sir Douglas Wass and Messrs. Bridgeman and Middleton with him. Agree?

Sir John Hunt and Sir Kenneth Berrill would also like to attend. Sir John intends to put in a brief for the meeting, and Sir Kenneth thinks he ought to attend simply because the subject is one of strategic importance - and he does have ideas, particularly on the gilts market, which are less conventional than the Bank's and the Treasury's. It has also been suggested that we have a Cabinet Office notetaker, although I am perfectly prepared to do the note if you wish. Agree? *Yes*

~~///~~ The Chancellor also wonders if Adam Ridley could attend in view of his links with Gordon Pepper and others in the City. Agree?

J. B. Hunt.

pp. TPL

Yes with - I don't want - a mass meeting.

There are already far too many

out

13 July 1979

cc Mr. Whitmore

cc Econ Pl, Disposal of
Assets
Euro Pl, EMS
Master

NOTE OF A MEETING BETWEEN THE PRIME MINISTER AND THE GOVERNOR OF
THE BANK OF ENGLAND ON FRIDAY 13 JULY 1979 AT 1630 HOURS

The following are the main points which came up when the Governor called on the Prime Minister:

I. EMS

The Prime Minister commented that, had the UK joined the Exchange Rate Regime, we would have been forced to change sterling parity in relation to the grid. The Governor said that this was not necessarily the case. There would certainly have been upward pressure against sterling's maximum limit; on the other hand, this pressure might have been limited to some extent by the fact that market operators would have thought it unlikely that sterling's parity would have moved so soon. On the other hand he thought that against the current background of turbulence in the exchange markets, which was likely to continue for a while, it was best that the UK had not joined the Regime.

II. June Banking Figures

The Prime Minister commented that the June figures were even worse than the Governor had predicted at the meeting on the mortgage rate the previous week. The Governor said that this was so - including the "acceptance leak", lending to the private sector had been £1,250 million against £1,200 million which he had forecast. The high figure seemed to be due primarily to the June spending spree, which was now reflected in the provisional retail figures. The Prime Minister said that she continued to be concerned about the stock relief provisions, which tended to exaggerate the need for working capital since there was an incentive for businesses to build up their industries; she was also concerned about the tax provisions on leasing which also stimulated bank lending. The Governor replied that the leasing provisions did encourage investment; however, he understood that the Inland Revenue were looking at them.

III. Interest Rates

The Prime Minister said that she was worried at the prospect of interest rates having to stay high, though she fully accepted that - while the banking figures continued bad - there was no alternative. The Governor commented that the future level of

/ interest rates

interest rates depended very much on what happened to wages. If wage inflation accelerated, interest rates would inevitably stay high. In addition, interest rates in other countries were moving up. The Germans had just announced a 1% increase in their discount rate, even though Dr. Emminger had been implored - at the recent Central Bankers meeting in Basle - to avoid this. The Dutch and the Belgians had been obliged to follow. The Germans were clearly trying to fight inflation by keeping the DM up.

IV. The U.S.

The Governor said that the US economy was almost bound to go into recession after four years of rapid growth and with inflation slowing the economy down. Inflation over the last six months was running at an annual rate of 14% - this was partly due to the oil price increase, but food prices were also rising rapidly partly because of fears about the Russian harvest. It was uncertain what the Administration would do. With the election coming up, they would be under pressure to reflate and relax interest rates. But if they did, the dollar would certainly slide.

V. Gilts

The Governor said that the authorities had sold sufficient gilts to cover the Government's financing needs up to the end of August; but it would be important to make further substantial sales so as to bring in funds in September. A new short tap was being issued that day; it would be for decision the following week whether a new long tap should be issued.

VI. Sale of BP Shares

The Prime Minister said that she had stopped the sale of the BP shares in July. The alternative options needed to be considered more carefully, and in any case a sale later in the year might well produce larger proceeds. She had also been concerned that the Treasury were pressing to sell in New York and Frankfurt as well as in London. For political reasons, even though foreigners might buy in the secondary market, it was important to limit the sale to London. One further consideration was that the Lords' decision on Burmah might go against the Government. (The Governor commented that a final decision on Burmah could not be expected until October 1980.) One alternative to selling off BP shares was for

BNOC's assets to be sold virtually in their entirety. This was being considered. Asked whether the sale of BP shares to the institutions would be additional to their purchase of gilts, the Governor replied that there would be some substitution, but on the whole, purchases should be additional.

R.

16 July 1979



Dom Mint

12

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

MONETARY SEMINAR

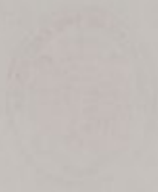
I now enclose the three Treasury papers on this foreshadowed in my Private Secretary's letter of 3rd July, namely:-

- (i) the paper on monetary base control by Treasury economists;
- (ii) a paper on funding the PSBR, which has as an annex a summary of the various proposals for changes in the gilts market, and comments on them - particularly drawn from the Bank's paper;
- (iii) a short general paper on the Government's monetary objectives and prospects.

2. You may like to start the seminar by a discussion of the monetary prospect and the implications for monetary control set out in the third Treasury paper and then turn to the main papers on the gilt-edged market and monetary base.

3. The proposals for changes in these two papers vary very much in the time span in which they could be put into effect. Some are of immediate relevance - particularly whether we should be continuing to issue long stocks, and whether they should go into the next century. At the other extreme, the switch to a monetary base system of control would take several years.

/It would



Faint, illegible text, possibly a header or title, located below the top stamp.

13 JUL 1979



COMPTON



Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

It would involve a change in the financial system at least as fundamental as was involved in "Competition and Credit Control", and it would require considerable periods for each of drawing up the proposals in detail, consultation with the various groups of institutions affected, revision of the proposals, and implementation.

4. I would therefore suggest that we might take the main issues which arise on the papers in sequence. They appear to be:-

- (i) whether we should continue to issue long dated stock; (1C in the Annex to the Treasury paper)
- (ii) whether the attractions of an index-linked stock appear to outweigh the general objections to the further spread of indexation sufficiently to justify preparing and evaluating a detailed proposal, including considering the implications for taxation; (paragraph 19 and 5C in the Annex to the Treasury paper)
- (iii) whether the Bank consider that there is any other way out of the present situation in which we lack a means of raising the level of long term interest rates; (paragraphs 24¹¹⁻¹² of the Treasury paper).
- (iv) whether we accept the conclusions of the Treasury economists' paper that there is sufficient

/attraction in

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attraction in the monetary base control as
a way of achieving the necessary changes in shorter
term interest rates to justify the further
study in depth of some particular options.

5. I am sending copies of this minute to the Governor
and Sir John Hunt.

A handwritten signature in dark ink, appearing to be "G.H.", written in a cursive style.

13 July, 1979

(G.H.)

Monetary base control

This article has been prepared mainly by M.D.K.W. Foot, C.A.E. Goodhart and A.C. Hotson of the Bank's Economic Intelligence Department.

Introduction

1 This article considers whether monetary base control should be the means by which the authorities control the monetary aggregates. We have approached this subject as economists rather than as representatives of the Bank of England, and we seek to contribute to what has hitherto in the United Kingdom been only a limited discussion. Many of the subjects raised in the discussion are candidates for detailed consideration on both a theoretical and a practical level. Moreover, the various proponents of monetary base control often have widely differing proposals in mind, a fact which significantly increases the scope of the analysis required. What follows in this article, therefore, is not intended to be an exhaustive treatment of the subject. In particular, it concentrates on the more theoretical, economic issues and only raises in passing some of the implications of the various proposals for the structure of existing financial markets and for the authorities' present methods of operation.

2 To this end, a brief background for the subject is provided in paragraphs 3-4. The monetary base is then defined (paragraphs 5-8), its historical relevance in the United Kingdom noted (paragraphs 9-12), and its possible theoretical relevance briefly set out (paragraphs 13-21). The various possible forms of control as we understand them are then considered; the implications of strict forms of control are outlined in paragraphs 22-42, and more relaxed versions are discussed in paragraphs 43-50. A brief summary of our views is provided in paragraph 51. There is also an appendix which discusses briefly certain aspects of the financial system in some major countries where the monetary base is rather more familiar than in the United Kingdom.

The background

3 In a number of countries, there are now formal monetary targets. Even where there are not, it is probably much more widely recognised than was the case, say, ten years ago that movements in the stock of money have considerable economic relevance, although the form and extent of this relevance are hotly debated.

4 Among those who believe that 'money matters', there is a group which considers that an appropriate degree of control over the rate of monetary growth can only be obtained by operating primarily to control the rate of growth of the monetary base.[1] To some in this group, current attempts in the United Kingdom to

control sterling M_3 are wrongly directed, because the authorities are said to lack the means at present to achieve an adequate degree of short-term control over sterling M_3 . The alternative proposed is that the authorities should seek to ensure the desired growth of whichever monetary aggregate they consider most appropriate by operating on the monetary base. Others in the group would go further and suggest that the monetary base—as well as being the means of control—could also be the appropriate target rather than (as in the United Kingdom, France or Western Germany) a broad monetary aggregate such as sterling M_3 or (as in Canada) a narrower monetary aggregate, M_1 .

What is the monetary base?

5 In current economic literature, there is a generally accepted concept of 'high-powered money', which is thought of as the sum of the balance-sheet liabilities of the central bank (strictly speaking, the monetary authorities[2]) to the private sector. Thus, anything which leads the central bank to have reduced liabilities to the private sector (for example—and assuming that the Government banks with the central bank, as it does in the United Kingdom—an excess of tax receipts over expenditure, or net sales of government debt) acts to reduce the volume of high-powered money. The phrases 'high-powered money' and 'monetary base' are often used interchangeably. In this article, however, we should like to adopt a more precise terminology and use the phrase 'monetary base' to describe that set of the liabilities of the monetary authorities which they may seek particularly to control.

6 Exactly which liabilities should go into this set is no easy problem. In essence, the issue boils down to asking which set of their liabilities the monetary authorities think that they should control. Among the candidates for inclusion are:

- (a) notes and coin in circulation with the public;
- (b) notes and coin held by banks (vault cash);
- (c) bankers' balances at the Bank of England:[3] and
- (d) potential liabilities of the Bank of England, i.e. liabilities incurred as the counterpart to the assets that the Bank may have to assume because of commitments previously given or because of 'automatic' borrowing rights of others (in particular, the lender of last resort facilities to the discount market).

[1] There are also those who consider the relevance of the monetary base to be its value as a leading indicator rather than its potential as a control device. This view is considered further in paragraphs 44-6.

[2] For example, in the United Kingdom, the Bank of England issues notes, but coin is issued by a quite separate body (the Royal Mint).

[3] We have deliberately ignored the comparatively small balances held at the Bank of England by the non-bank sector.

7 The definitions actually adopted by those countries where the base is considered relevant vary quite widely (see appendix). In this article, we prefer to begin with a definition that covers just (b) and (c) of the above list, on the view that this pair—or alternatively (c) by itself[1]—might be operationally most relevant in the United Kingdom and also with the hope that this will make the subsequent discussion easier to handle without losing its general relevance. Thus, for example, the size of the base would be greatly increased by the inclusion of (a), notes and coin with the public. But the amount of currency so held is hardly a variable over which the authorities would (or could) seek control. In any case, if the aim is to influence some monetary aggregate consisting primarily of bank deposits, the relevant variable would seem to be that definition of the base—(b) and (c) or (c) alone—directly related to the assets of the banks. Otherwise variations in the non-bank private sector's demand for currency could lead to undesirable fluctuations in the growth of the monetary aggregates.

8 The argument over whether (d) should be included is rather different. Under strict forms of base control, such facilities would not exist and therefore the problem would not arise. However, where such facilities did exist, their inclusion would imply a relationship between the base and the *potential* rather than the actual stock of money. In general, proponents of base control have argued against a definition of this type and, although it has been adopted in certain countries at certain times, it is not considered further here.

The historical relevance of the monetary base in the United Kingdom

9 A banking system as we know it could not have developed had banks not learned how to make loans without collapsing, through want of liquidity, if some depositors wanted their money back. The first line of defence for any bank against such illiquidity was traditionally provided by holding a stock of generally acceptable assets—coin or notes 'behind the counter'. The second consisted of balances with other banks that could be used to obtain additional generally acceptable notes. As the Bank of England became increasingly important as a note issuer and as a 'central bank', it became increasingly convenient to hold Bank of England notes and balances at the Bank.

10 Over time, the liquidity of the banking system came to be increasingly assured by the Bank's extension of lender of last resort facilities to the discount houses

(for then banks could safely make secured short-term deposits with the houses and have no doubts about the liquidity of these funds) and also by the extension of markets in liquid financial assets, notably Treasury bills. Thus, when we now think of the liquidity of a single bank, we consider the liquidity provided by the existence of markets on which it can quickly raise new debt or sell existing assets and not just of the level of its holdings of cash and balances at the Bank of England. Similarly, for the liquidity of the banking system as a whole, the relevant point is the preparedness of the central bank to provide unlimited support to the system in times of crisis, not banks' aggregate holdings of cash and bankers' balances.

11 Thus, when it became accepted practice after the Second World War for the London clearing banks to keep a minimum ratio of 8% of cash to deposits,[2] no operational relevance (in the sense of using the Bank's potential control over the supply of cash to restrict the level of bank deposits) was attributed to the ratio; in so far as the requirement had justification, it was prudential. Instead, the authorities were primarily concerned with the level and structure of interest rates, and they were consequently willing to ensure that the clearing banks did not go short of cash.[3] As a result, the clearing banks did not need to hold sizable excess cash reserves, and the recorded ratio was generally very close to 8%.

12 After 1971, even the 8% cash ratio was abolished, but the London clearing banks instead agreed to keep an average of 1½% of their eligible liabilities[4] in the form of non-interest-bearing balances at the Bank.[5] Even more obviously than with the 8% cash ratio, there has been no attempt to use this ratio as a device for imposing a ceiling on the stock of eligible liabilities. As before, the Bank of England has chosen—through its open-market operations and lender of last resort facilities—to concentrate on influencing short-term interest rates, being prepared always to provide funds requested by the banking system but on interest-rate terms of its own choosing.

Why the monetary base may be relevant

13 If banks have to maintain a minimum ratio of cash to deposits and if the central bank exercises sufficiently vigorously its undoubted potential power as 'the' source of cash, then clearly the size of the high-powered money base imposes a ceiling on the level of bank deposits and thus, indirectly, on the stock of money, however defined.

[1] The question of whether or not to include banks' holdings of vault cash in the definition of the monetary base raises a number of difficult questions. Since banks with differing kinds of business have differing operational needs to hold vault cash in the normal course of business, the issue of equity as between banks arises. If vault cash were to be excluded from the defined monetary base, however, banks could seek to adjust to their required cash ratio by making otherwise unnecessary transfers between vault cash and bankers' balances at the Bank. Such unnecessary transfers would have implications both for the Bank's ability to control the monetary base tightly and for costs.

[2] See paragraph 351 of the *Report of the Committee on the Working of the Monetary System* (the Radcliffe Committee), Cmnd. 827, (H.M. Stationery Office, 1959). The ratio could be met by any combination of vault cash and balances at the Bank.

[3] See 'The management of money day by day' in the March 1963 *Bulletin*, page 15.

[4] Broadly, for any bank, these equal sterling deposits excluding those with an original maturity of over two years, plus sterling resources obtained by switching foreign currency into sterling, less the bank's net holdings of claims on the rest of the banking system.

[5] The commitment by the clearing banks in banking month *t* relates to the level of their eligible liabilities on the make-up day in banking month *t-1*. There is no requirement that the ratio be maintained strictly on a day-to-day basis; daily deviations from the 1½% ratio can be averaged over the banking month and shortfalls or excesses carried forward.

14 More formally and at its simplest, we can write

$$M \equiv C + D \quad (1)$$

where:

- M = the stock of money
 C = notes and coin in circulation with the non-bank private sector
 D = the deposit liabilities of the banks

and

$$H \equiv R + C \quad (2)$$

where:

- H = the high-powered money base
 R = the banks' reserves (say, vault cash plus balances at the Bank of England).

Both (1) and (2) are identities, not behavioural equations, and by simple manipulation they can be made to yield a third identity.

$$M \equiv H \left[\frac{1 + \frac{C}{D}}{\frac{R}{D} + \frac{C}{D}} \right] \quad (3)$$

15 In other words, if the authorities act so as to fix H [1] at some predetermined level, if the ratio of currency to deposits is constant and if the ratio of banks' reserves to deposits is constant, then the size of M is determined by H . For example, let us assume that:

- all banks always maintain 4% of deposits as vault cash to meet immediate operating needs and 1½% in balances at the Bank of England;
- this 5½% of deposits constitutes the monetary base and that the banks begin with no excess reserves;
- notes and coin in circulation with the public always amount to 15% of deposits; and
- the balance sheets of the Exchange Equalisation Account (EEA) and the overseas sector have been omitted and those of the Issue and Banking Departments of the Bank of England consolidated.

16 Let us suppose then that, in a given period, the public sector is a net recipient of one unit from the non-bank private sector (because, say, tax receipts have exceeded government disbursements). The resulting changes in the equilibrium positions of the Bank of England, the banking system and the non-bank private sector are shown in the two halves of the table below.

17 Before the change, the base stood at 5.5 (vault cash 4, bankers' balances 1.5), permitting banks to take deposits of 100. In the final equilibrium position, the base stands at 5.13 (vault cash 3.73, bankers' balances 1.4), again exactly 5.5% of total deposits (93.3). The payment of 1 by the non-bank private sector has actually been accomplished by a fall of 0.9 in the notes they hold, plus a 0.1 reduction in bankers' balances at the Bank; the corresponding gain of course accrues to the public sector, whose deposits at the Bank rise from 5 to 6.

18 For the banking system, however, the process has been altogether more significant, because the decline of 0.37 in the base has necessitated a multiple contraction of deposits of 6.7 (i.e. $0.37 \times 100/5.5$). Nothing so far in this article has, however, shown how this contraction occurs, and this major question is considered in the next section.

19 The presentation of the determination of the money stock in this fashion has a distinguished academic pedigree, which includes contributions from Phillips, Keynes and Meade.[2] As we have seen, the authorities have not, however, attempted to control H or R . Nor is it the case that the ratio of currency in circulation to deposits necessarily stays constant over time. Obviously this ratio may be affected by technological change (for example the development of credit cards), but also, from a theoretical point of view, there is no obvious reason why the ratio of currency to bank deposits should stay constant over time, at least when the latter are defined broadly to include both transactions and savings balances. Finally, there is no reason under the present arrangements why banks'

	Bank of England		Banking sector		Non-bank private sector	
	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets
Position before the change						
Bankers' balances	1.5					100.0
Vault cash in commercial banks	4.0		100.0		Equity holdings in banks	10.0
Notes in circulation with non-bank private sector	15.0		10.0	1.5	Notes	15.0
Public sector deposits at Bank of England	5.0			4.0		
				104.5		
	25.5	25.5	110.0	110.0		125.0
Position after the change						
Bankers' balances	1.4					93.0
Vault cash in commercial banks	3.73		93.3	1.41	Equity holdings in banks	10.0
Notes in circulation with non-bank private sector	14.1		10.00	3.73	Notes	14.1
Public sector deposits at Bank of England	6.0			98.17		
	25.23	25.23	103.3	103.3		117.4

[1] Earlier, in paragraph 7, it was argued that the authorities should take as their monetary base all or some of the reserves available to the banking system, i.e. R , rather than the total of high-powered money which also includes currency in the hands of the non-bank public, C . The above identity, of course, holds irrespective of how the authorities operate, but focus on the banks' reserve base, R , would reduce the effect on the money stock of fluctuations in the non-bank public's desired cash holdings (the C/D ratio in the above identity).

[2] C. A. Phillips, *Bank Credit*, (New York: Macmillan, 1920); J. M. Keynes, *A treatise on money* (London: Macmillan, 1930); J. E. Meade, 'The Amount of Money and the Banking System', *The Economic Journal*, vol. XLIV (1934), pages 77-83.

reserves of cash and bankers' balances should show a close relation to any particular monetary aggregate. Only the clearing banks maintain the 1½% ratio, and even that requirement is over a period of time rather than for any particular day and is related to eligible liabilities rather than directly to deposits as recorded in the monetary aggregates.

20 It follows, not surprisingly, that, given present arrangements, there is no close relationship in the United Kingdom between changes in the monetary base and those in any other monetary aggregate. Indeed, to the extent that there has been any causal relationship, it could reasonably be argued that it has run *from* money to the base, rather than the other way round, a causality exemplified by the fact that the 1½% ratio relates to the previous month's eligible liabilities and that the authorities have always chosen to provide, at a price, the base money required. Nor has there been any close relationship between movements in the base and in nominal incomes. Indeed with high-powered money (*H*) largely consisting of currency in the hands of the public (*C*), and the latter being demand-determined, (according to our econometric estimates largely in response to current and past changes in consumers' expenditure) the direction of causation runs clearly from nominal income to notes and coin in circulation (*C*) and high-powered money (*H*).

21 The relevant question, however, is what would happen if present attitudes and institutional features were changed and the authorities sought to use the base rather than interest rates as a means of controlling the rate of growth of the monetary aggregates. Unfortunately, as noted in the introduction, the answer is related to the form, in particular the time horizon, of the monetary base régime in question. Further complications are added by the existence of a number of other issues that are not of major theoretical relevance in their own right but which represent awkward technical problems to be tackled before at least some forms of base control could be considered in practice.

A strict control of money

22 First we examine the implications of seeking to control the money stock strictly on a short-term basis. Even if it were universally accepted that strict short-term control of the monetary aggregates was undesirable, if not impractical, it would still be useful to consider the implications of strict control as an expositional device in order to clarify the issues. Moreover, there are a number of proponents of strict short-term control of the monetary aggregates, and of these some advocate the use of monetary base control to achieve this end. Of course it is possible to envisage ways in which banks' deposit liabilities might be subject to strict short-term control other than through regulation of the base. Bank deposits could be forced to grow at a pre-determined rate by government fiat, or by

the imposition of some form of permanent supplementary special deposits scheme, with penalties on those banks whose deposit liabilities grew too slowly as well as on those whose liabilities grew too fast.

23 Returning to control via the monetary base, the most extreme form of regulation imaginable is one where the operations of the central bank were such as to predetermine the monetary base (for some of the problems involved see paragraphs 37–42) and where the banks were required to achieve their reserve ratio requirement exactly on a daily basis. If short-term control of the monetary base were to be translated into equivalent short-term control of the monetary aggregates, the ability of the banks to vary their actual (free) reserve holdings relative to their required level would have to be limited, for example by penalties applying to both excess and deficient reserves. Examination rapidly suggests that the idea of such tight management is impracticable but, as it throws up a number of points of general relevance to any attempt to control the base over any period, the arguments are worth considering.

24 The most appropriate starting point is perhaps the mechanism by which banks are supposed to adjust to, say, a shortfall of reserves (i.e. the base provided does not permit them to meet their reserve requirements on their existing level of deposits). When considered at all, the mechanism is usually held to be that the banks cut back on lending or sell off marketable assets. However, while this may improve the relative position of one bank, such action only eases the reserve position of the banking system as a whole fractionally, with that fraction depending on the required reserve ratio. Thus *unless the authorities relent and choose to provide more base money*, the only ways that the banks as a whole can overcome their reserve asset shortage are:

- (a) to reduce their assets and liabilities by a multiple of the initial shortage of base money;
- (b) to attract notes and coin from the public (which would be difficult to do, unless banks were to offer a variable premium for currency, thereby breaking convertibility between currency and deposits); or
- (c) if there were lower reserve requirements on time than on sight deposits (as in the United States), to induce customers—by adjusting relative yields—to switch funds from sight to time deposits.

25 To illustrate this essential point, suppose that a bank sells off its Treasury bill holdings. Its balances with the Bank of England will rise, i.e. it will receive more reserve assets; the banks of those who buy the bills will lose an equal amount.[1] Only if the Bank of England steps into the market to buy the bills will the base be increased.

26 A similar conclusion follows with regard to the effect of foreign exchange transactions on the monetary base. As the banks try to improve their individual

[1] Provided the non-bank private sector does not purchase Treasury bills with notes and coin, the bank will receive net claims on other banks; its balances at the Bank of England will thus rise and those of other banks fall correspondingly.

position by selling assets, they will force up interest rates. Other things being equal, this will increase the demand for sterling by foreigners who now wish to obtain sterling assets, the rate of interest on which has become more attractive. However, the stock of monetary base will remain unaffected and under the control of the authorities if either the exchange rate is allowed to appreciate freely, or, if this is unacceptable, the inflow of capital is sterilised. A rise in the exchange rate might be forestalled without increasing the monetary base if, when the authorities purchase foreign currencies with sterling and accumulate international reserves in the EEA, they then finance these purchases by the sale of Treasury bills or some other debt instrument which is not included in the definition of the monetary base. Nevertheless, the sale of these debt instruments may raise interest rates further and also maintain monetary tightness, thereby attracting continuing inflows from abroad. This could lead to an unstable situation with persistently rising reserves together with rising domestic interest rates.

27 The same conclusion follows if the banks make what is now the more likely response to reserve pressure of bidding for funds (so-called liability management) by, for example, issuing certificates of deposit. Again, the effect will be to push up interest rates without increasing the base [except in so far as (b) or (c) in paragraph 24 apply]. But, this time, there could be an additional difficulty if the authorities have a broad money aggregate in mind as an intermediate target, in that liability management can have a perverse effect on the adjustment process of the banking system as a whole, since it tends to raise the yield offered on bank deposits relative to the yields on other liquid assets. This could accelerate the interest-rate spiral likely to develop as banks come under reserve pressure and, if rates of interest on bank lending do not keep pace with the rise in market interest rates, actually increase the demand for credit by making it attractive to borrow funds to on-lend in the wholesale money markets.

28 These problems might be mitigated if the reserve requirements on time deposits were lower than those on sight deposits. Then, as interest rates rose—increasing the opportunity cost of holding sight deposits[1]—holders would, over a period of time, switch their funds from sight to time accounts, progressively reducing the banks' overall need for reserves. However, the authorities would presumably only seek to control the monetary aggregates with a differential reserve requirement, in which sight deposits were given a higher weighting than time deposits, if they attached greater importance to the rate of growth of sight deposits than to that of time deposits. In the extreme case where the authorities attached no weight to the rate of growth of time deposits, they could set an M_1 target and only impose reserve requirements on sight deposits. Nevertheless, even with an M_1 target, the

speed of adjustment of the non-bank private sector's asset portfolio in response to changes in the differential between sight and time deposit rates might not be fast enough for the banks to be able to meet their reserve requirements at all quickly. As a result, an interest-rate spiral might still emerge.

29 The conclusion of this line of argument is that strict control of the base (which would, of course, imply an end to all the present lender of last resort facilities) would continually threaten frequent and potentially massive movements in interest rates, if not complete instability. Changes in the base would inevitably carry implications for interest rates, and the greater the emphasis on control of the base the less the possibility that the central bank could intervene to ameliorate any interest-rate fluctuations. In the strictest form of control (the day-to-day regulation noted earlier), the problem would, of course, be at its most acute as no adjustment time (e.g. for the banks to curtail their loans to the non-bank public) would be available. Indeed it is highly dubious whether such a system could possibly work, mainly because of the time it would take for markets to adjust to the interest-rate changes induced by the banks in their attempts to meet their reserve requirements. But even for control over longer periods of time, strict control of the base would throw onto financial markets the whole burden of adjustment at present 'shared' by the Bank of England's lender of last resort facilities, its open-market operations, its foreign exchange intervention, and the permitted short-term variability in the level of balances held by the clearing banks at the Bank of England.

Structural adjustments in response to strict control

30 In extreme form, then, base control could imply enormous potential pressure on financial markets. It is a moot point as to how far they would develop to meet the burden. Other reactions would also be likely.[2] We now explore some of these on the assumption that the transitional problems of adjusting to the new system had been overcome.

31 One development might well be the sharp curtailment or disappearance of the overdraft system, indeed the curtailment or disappearance of any exposure, whether by formal or informal commitment, to an obligation to extend loans at some future time. At present, banks extend facilities to customers that in aggregate are roughly only half-used at any time. This is an element of flexibility provided by the banking system which most observers would regard as highly desirable. Even under the present supplementary special deposits scheme, the existence of these facilities may be an embarrassment to a bank, particularly as most empirical work on the demand for bank credit in the United Kingdom suggests that a bank's major defence in such circumstances—to raise the cost of borrowing—may not have a large (and certainly does not have a rapid) effect

[1] This assumes that the implicit or explicit return on sight deposits is either constant or at least not quickly responsive to changes in market interest rates.

[2] They would indeed follow from any short-term strict control over the money stock.

on the demand for credit.[1] It follows that the stricter the control of money (whatever the form of that control) the more risky it would be for banks to provide overdraft facilities in their present form.

32 A related development likely to occur would be that the banks would come to hold a larger proportion of their portfolio in easily-saleable assets, or, in so far as this was allowed, in excess reserves, correspondingly reducing relatively illiquid lending to the private sector. Similarly the non-bank private sector, being less able to obtain bank facilities, might also seek to hold larger amounts of liquid assets.

33 Such conclusions follow from the fact that the more tightly controlled the banking system the greater the short-term risk of illiquidity for all concerned. In the longer term, when such a system was fully established, it would seem to exhibit a certain inefficiency—with more risk than strictly necessary, balanced by larger liquidity holdings—but otherwise it could conceivably be workable. Such an approach would, however, appear to carry a higher risk of disturbances to the banking system reminiscent in some respects of those in the United Kingdom in the nineteenth century and in the United States before the establishment of the Federal Reserve System. Even under a monetary base control régime, the Bank of England would have to retain the right to use lender of last resort facilities to forestall a banking crisis, and assistance might have to be extended to individual banks more frequently than in the past. In the short run, any sudden change to the new system, with a possibly large but unpredictable increase in the demand for liquid assets in response to the increased risk perceived, would make assessment and management of the overall economic situation more difficult.

34 A third likely development would be the growth of holders of liquid assets not subject to cash ratio requirements, who would arbitrage between short-term liquid assets (such as Treasury bills) and bank deposits,[2] thereby reducing the extent of interest-rate fluctuation. Similarly, the banks might be able, at times of their own choosing, to rearrange some of their on-balance-sheet advances as off-balance-sheet acceptances, so that although they would resell some of their holdings of commercial bills to the non-bank private sector, they would guarantee the ultimate holders of these commercial bills against default by the original issuers. The rapid increase in acceptances almost immediately after the reimposition of the supplementary special deposits scheme in June 1978 suggests that the banks are able to rearrange their portfolios to some extent in this way.

35 Equally, however, such structural developments, resulting in an expansion of near-money liquid assets and an increased elasticity of response in velocity to changes in interest rates, would reduce the significance of a tight control over the money stock and also the

monetary base. The financial system evolves continuously to meet the needs of the economy and will, in time, find ways round artificial road blocks.

36 All these developments would be likely to follow from any strict form of base control, though the 'adjustment problem' in each case would be worse, and the speed of the developments faster, the shorter the time horizon over which control was attempted.

Some technical and operational changes required

37 As noted in paragraph 23, day-to-day control of the base is very difficult to envisage. Under present institutional arrangements, there are unforeseen swings into and out of central government balances of up to several hundred million pounds a day, and the first requirement for day-to-day control would be either that the Government moved its business to the commercial banks or that the banking system moved to a next day settlement basis for all transactions. The logic of the first change is that unexpected flows—say from the non-bank private sector to the Government—would then leave bankers' balances at the Bank of England unaffected; at present, as noted earlier, the result of such flows is to alter these balances. The logic of the second change, which in administrative terms at least would constitute a retrograde step, is that the authorities would then have one day's notice of unexpected movements of funds.

38 Even then, however, the authorities would not have any advance warning of shifts in the public's demand for currency, which even on a daily basis can be large. The Bank of England already forecasts the demand for currency on a daily basis, as part of its projection of key factors affecting money markets, and, on occasion, errors here have been of the order of £100 million and are frequently £25-30 million.

39 Further, whatever the length of period over which control of the base is desired, the authorities' predetermined path would have to be set in non-seasonally-adjusted form. As presumably their objective would be to obtain a smooth seasonally-adjusted growth in the base or in some monetary aggregate, they would need to work from a seasonally-adjusted to an unadjusted projection of the base. Given the complexities and uncertainties of the seasonal-adjustment process for financial series, such a procedure could be sensible for, say, quarterly projections, but daily forecasts on such a basis would be subject to very large margins of error. Any attempt to control the banking system strictly on a very short-term basis would, therefore, result in unintended gyrations in the level of deposits.

40 A final difficulty with any form of very short-term control arises out of the question of the appropriate accounting basis for the banks. A lagged accounting

[1] Peter Spenger and Colin Mowl, 'The Model of the Domestic Monetary System' part one of *A Financial Sector for the Treasury Model* [Government Economic Service, Working Paper No. 17 (Treasury Working Paper No. 8), December 1978.]

[2] One requirement for such arbitrage to occur is that liability management of the kind described in paragraph 27 did not prevent Treasury bill yields from rising faster in response to reserve asset pressure than the deposit rates offered by banks.

basis is used for the purpose of calculating required reserves in virtually all countries, and is indeed suitable when the purpose of the reserve ratios is to provide a fulcrum for money-market operations to control interest rates. Virtually by definition, however, when the total of required reserves is related to the past level of deposits and where there are no excess reserves at the outset in the system, changes in deposits must cause the authorities to allow changes in bank reserves, and not vice versa, so that monetary base movements can hardly either control, cause or even indicate future movements in bank deposits.

41 One possibility would be to move on to a current accounting basis, with required reserves related to current liabilities. Even in this case, delays in obtaining current information on movements in liabilities (and, depending on the form of the required reserve base, delays also in information on movements of vault cash held at branches), would tend to mean that the banks would simply not be in a position to know what adjustments would be necessary during the course of the day to try to meet their required ratios.

42 It would be more in the spirit of monetary base control, though we do not know of any case where this has been applied, for the reserve ratio to be put on a lead accounting basis, that is to say that the liabilities of a bank at some future time, $t + n$, should be related through a required ratio to its current reserve base at time t . The strictness of the monetary base control régime would then relate to the adjustment time allowed, the averaging procedures adopted and the penalties imposed for non-compliance.

More relaxed versions of monetary base control

43 A number of the operational changes described above could be avoided and the problems of adjustment substantially mitigated with a more relaxed form of base control. Thus, the authorities could perhaps have a desired level for the base over, say, a six-month period but not insist that the base average out exactly at that level and not withdraw the lender of last resort and other facilities which at present avoid sharp short-term instability in financial markets.

44 Indeed at the limit, i.e. with no penalties for failing to meet a particular ratio, in effect with no *required* reserve ratio at all, movements in the monetary base could be regarded primarily as another monetary aggregate, possibly a leading indicator, movements in which could convey information on future developments. (Under present institutional arrangements, as explained earlier, the monetary base in the United Kingdom does *not* act as a useful leading indicator.) However, even with a long run of data, the monetary base series might not come to be a satisfactory leading indicator. Banks might wish to hold additional excess reserves, perhaps as a counterpart to a

decline in the demand for bank credit, or an increase in their demand for liquidity. Accordingly, the rate of growth of banks' reserve holdings might not provide a good index of how expansionary the monetary stance was at the time. It has been argued, not least by monetarists, that the attention paid, for example, in the late 1930s by the Federal Reserve Board in the United States to the banking system's excess reserves was misdirected.

45 If the nature of the monetary base series were changed, say with banks required to hold a uniform reserve ratio [1] and a current or lead accounting basis, then it is possible, subject to the comment above, that the series could come to convey more useful information. After such a structural change, however, it would be several years before enough experience, e.g. of seasonal fluctuations, was amassed to enable such movements to be interpreted adequately. Thus, under the changed system banks would most likely have a greater incentive to hold excess cash reserves, depending on the costs involved in holding such excess reserves as against the costs and risks to each bank of finding itself short of cash reserves. It would be some time before any regular pattern of behaviour would be established and discernible.

46 Moreover, the Bank already obtains weekly monetary data from a sample of banks. While this experience is revealing only too clearly the difficulties of interpreting movements in a new series, such weekly data may in time come to provide the authorities with prompt information on monetary developments. Only if the movements in the monetary base should provide a reliable *leading* indicator of monetary developments would the series help the authorities to assess developments.

47 In practice, the phrase 'monetary base control' is not tightly defined; it can range from an attempt to control certain monetary aggregates on a tight day-to-day basis through to a generalised concern with the series as a potentially useful leading indicator, possibly among others, of future monetary developments. Between these two polar positions exists a relatively unexplored territory of gradations from tighter to easier control.

48 The purpose of paragraphs 22-42 is to show that an attempt to use monetary base control rigorously over short periods would be neither desirable nor feasible. The same objections do not hold, at least not to anything like the same extent, to proposals for considerably more relaxed versions of this approach, in which proper and sufficient adjustment time is given to the banking system. Indeed, because it is the rôle of the banking system to absorb and to meet shocks occurring in the demand or supply of money and credit within the economy, the search for tight short-term control of the money stock, for example on a week-by-week basis, would seem to be misguided. This is *not*, however, to

[1] As already noted in footnote [1] on page 150, the fact that banks do differing kinds of business and have differing balance-sheet structures makes any approach to 'uniformity' rather difficult in practice.

deny the possibility of improving control techniques for financing monetary developments over a longer horizon measured, say, in terms of four to six months.

49 In this respect there are perhaps two main ways in which the adoption of a 'relaxed' monetary base system, which did *not* aim to force the banking system into unduly rapid adjustment by imposing penalties on short-term divergences from a required ratio (for example such relaxation could be obtained by some combination of generous averaging procedures, gentle initial penalties or even an absence of a *required* cash ratio) might improve the authorities' control over the system. *First*, if movements in the monetary base did prove to be an informative leading indicator of future developments, it would provide the authorities with information with which to respond more quickly and firmly to diverging monetary trends than they are now able to do. The experience of Switzerland indicates that this may be the case.^[1] Indeed, with such a monetary base approach—assuming that it did prove to be a reliable leading indicator—there would perhaps be some presumption that firmer action might be taken more quickly, as the authorities reacted to movements in the monetary base. Nevertheless, against such putative longer-term benefits would have to be set the costs of structural changes involving disturbances and dislocations to well-established arrangements. Moreover, for several years while the system was adjusting to the structural change, it would be virtually impossible for the authorities to glean any worthwhile information from the new series. Furthermore it must be emphasised that the use of the monetary base as an adjunct for improving control over monetary developments is *not* an alternative to varying interest rates for that purpose, but indeed a means of trying to ensure that interest rates vary sufficiently quickly and widely to achieve such greater control.

50 The *second* possible source of benefit from the adoption of monetary base control might occur if such a

system entailed or encouraged a change in the structure of financial markets which allowed the authorities to control the volume of debt sales to the non-bank public more closely and effectively; for control of the broad monetary aggregates e.g. sterling M₁, whether with monetary base control or not, must involve sales of sufficient debt by the authorities to offset other factors (for example, the budget deficit) tending to augment monetary growth. Indeed, some proponents of monetary base may see the main advantage of a move in this direction, not in any way as providing any mechanical or 'multiplier' method of monetary control, but rather as a means of forcing or stimulating the growth and development of debt markets, particularly short-term debt markets, in a way that might give the authorities greater control over the total debt sold to the non-bank public in any period. This would, however, be a very round-about way of trying to achieve changes in the structure and nature of such markets, for such changes do not logically require the adoption of a move to monetary base control and could be considered directly on their own merits; some aspects of this latter subject are further discussed in the article on the gilt-edged market on page 137.

51 To summarise: the critics of the authorities' present approach to monetary management often contrast this with what might be obtained if the authorities were instead to adopt monetary base control. One purpose of this article is to show that there are several variants of monetary base control (an imprecise term) and to indicate reasons why *rigid* monetary base control would be unacceptable. More relaxed versions of such a control system might be accompanied by changes in the functioning of certain debt markets, though any such changes should perhaps be considered on their own merits quite separately, and might provide the authorities with additional information to allow prompt and firmer countervailing action. Any such putative benefits would, however, have to be weighed against the costs of making major structural changes in the system.

[1] See page 158.

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FUNDING THE PSBR AND THE GILTS MARKET

Note by HM Treasury

This note briefly describes the range of ways in which the PSBR is financed, so that the discussion of the gilt-edged market can be placed in a wider context. Annex 1 summarises the main suggestions which have been made for changes in the gilt-edged market, together with comments on them, referring to the recent Bank of England Quarterly Bulletin article where appropriate. Annex 2 is that article, with paragraphs numbered for ease of reference.

The Domestic Financing Requirement

2. When discussing the financing of the PSBR, it is probably more helpful to regard the sterling counterpart of the foreign exchange transactions of the Exchange Equalisation Account as an addition to, or deduction from, that financing requirement rather than as a method of financing the PSBR - we do not run down the reserves in order to finance the PSBR! If we intervene by buying foreign exchange, we have to pay sterling for it, so the authorities need for sterling finance is increased. Conversely if we intervene buying pounds, and selling foreign exchange, the authorities' need for sterling finance is reduced. The attached table therefore takes together the PSBR and the sterling counterpart of changes in the reserves to arrive at a "domestic financing requirement". It then shows how it has been financed in the last 5 years. (Foreign currency borrowing by nationalised industries or local authorities - or its repayment - affects the level of reserves but leaves this domestic financing requirement unchanged.)

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- 2 -

	£ billion				
	1974-75	1975-76	1976-77	1977-78	1978-79
1. PSBR					
Central Government	5.1	8.8	5.9	4.4	8.0
Other Public Sector	2.9	1.8	2.6	1.1	1.2
Total	<u>7.9</u>	<u>10.6</u>	<u>8.5</u>	<u>5.6</u>	<u>9.2</u>
2. External Finance	-2.6	-1.2	-1.1	+4.3	-0.6
3. TOTAL DOMESTIC FINANCING REQUIREMENT	5.3	9.4	7.4	9.9	8.6
<u>Financed by</u>					
A. MONETARY MEANS					
4. Notes and Coin	0.9	0.5	0.9	1.2	1.2
5. Public Sector Borrowing in £ from banks	0.1	3.4	-0.6	2.1	-1.2
B. PURCHASES OF PUBLIC SECTOR DEBT BY PRIVATE SECTOR (OTHER THAN BANKS)					
6. Central Government					
Gilts	2.3	3.9	5.7	4.5	6.0
National Savings	0.2	0.5	1.0	1.6	1.7
Tax Instruments	-	-	-	0.4	1.0
Other (eg Treasury Bills)	0.1	1.0	-0.3	0.3	-0.5
7. Other Public Sector	<u>1.7</u>	<u>0.1</u>	<u>0.7</u>	<u>-0.2</u>	<u>0.4</u>
Total	4.3	5.5	7.1	6.6	8.6
TOTAL FINANCING	5.3	9.4	7.4	9.8	8.6

3. As the paper on monetary control points out, it will only be possible to achieve the present monetary target, and provide room for the needs of the private sector for bank finance, if the public sector is financed largely outside the banking system.

Sources outside banks and the gilts market

4. There are four significant sources of domestic finance for the public sector outside the banks and the gilts market, namely:

National Savings
Tax Instruments - currently the
Certificate of Tax Deposit
Treasury Bills etc
Local Authority Debt

Notes and coin are also a source of finance from outside the banking system, but they are of course within the money supply.

a. National Savings

5. For two decades, National Savings had a declining role as a means of securing funds from the personal sector to finance the PSBR: the increase in the building societies share of the market for relatively liquid personal savings has been largely at the expense of National Savings. But in the last 3 years or so, since the 16th Issue of National Savings Certificates, the terms have been pitched more competitively and that trend has been reversed. There are two grounds for seeking to continue this. First, the total cost of borrowing will tend to be lower, the wider the range of markets we can tap. Second, the inflow from National Savings may help to bridge the gap when there is a hiatus in sales in the gilts market. Against this, the National Savings investments tend to be somewhat inflexible, because of the large number of points of sale, because of the geographical dispersal of the Department into 3 centres specialising in particular forms of investment, and because of the limited computer facilities at some centres.

6. Treasury Ministers are at present reviewing the range of National Savings investment offered, particularly in relation to the exercise on civil service numbers, to establish whether the desired financing of the PSBR could be achieved more cost-effectively with a smaller range of investments.

b. Certificates of Tax Deposit

7. The Certificate of Tax Deposit has also been developed over the last two years as a means of bringing tax receipts forward in time. But because of its limited life and its purpose we cannot expect the stock outstanding to increase indefinitely. It will therefore tend to be more a way of bringing forward tax receipts, and hopefully smoothing the path through the year, than a way of securing a major net contribution to financing the PSBR year after year. However it is not a cheap form of borrowing, and it is necessary to guard against the risk of arbitrage, with companies borrowing from banks to finance purchases of CTDs.

c. Treasury Bills etc

8. There does not appear to be a very large market for Treasury Bills outside the banking system - bank deposits usually offer a higher yield and greater convenience. However on occasion relative interest rates are such that they are bought by companies or financial institutions. (This line of figures also includes the net effect of purchases and sales of commercial bills by the Issue Department as part of its money market management.)

d. Local Authority Debt

9. Local authorities secure their financing partly from Central Government (through the Public Works Loan Board) and partly direct from the market: the proportion varies, partly because of the limits set by central government for borrowing from the FWLB and partly according to local authority treasurers' views on the path of interest rates. The justification for this "hybrid" approach is that

local authorities, with their diverse range of borrowing instruments, which are not explicitly guaranteed by central government, can tap distinct markets which are not tapped at present by Central Government: to the extent that they do this it can reduce the total costs of borrowing by the public sector. Their market borrowing is now mainly for less than 5 years, and they use a sufficient range of instruments to cover the market. There is therefore advantage in continual local authority borrowing direct from the market. On the other hand there are limits to how far local authorities can be expected to increase their borrowing from the market without either increasing their borrowing from the banks, or shortening the maturity structure of their debt, which has been a cause of concern to the local and monetary authorities in recent years.

The Gilt-edged Market

a. New Issues

10. While these other non-monetary forms of financing can help reduce the load put on the gilt-edged market, and give some flexibility in relation to timing, the sale of gilts is likely to remain the main form of financing the PSBR outside the banking system, for as long as the PSBR is significant - in each of the last 4 years it has provided more than two thirds of the total. This has been achieved by sales on an unprecedented scale even allowing for inflation. In the 5 calendar years 1969-73 total gilt sales to the non-bank public were £4.2 billion; in the next 5 years, 1974-78, they were £21.2 billion. This has only happened because the institutional investors have doubled the proportion of their new investment put into gilts. It has been achieved almost entirely by the issue of conventional stock by conventional methods, with one exception, the variable interest bond, which was issued in a slightly different way.

*alternative?
variable interest*

11. The main difficulty has been that gilt sales have tended to be irregular, proceeding by fits and starts. Market conditions can develop in which investors are more than usually uncertain about the future: they are not sufficiently certain that existing yields are appropriate to buy, but they are not sufficiently certain that they ought to be higher that they seek to sell at existing prices so

forcing up yields. The market yields then tend to drift slowly upwards on very light trading. This situation can feed on itself since the absence of gilt sales tends to produce high figures for the growth of the monetary aggregates, which reinforces the uncertainty and perhaps the hiatus on sales.

12. The authorities have made a number of innovations in the last 2 years to help with this:-

- i. part-paid stocks, which enable us to take advantage of favourable market conditions to secure receipts from gilt sales in future periods;
- ii. variable interest rate stocks.

The recently introduced provision for applications for new issues at above the specified price, described in the Annex, may also help by increasing slightly the risk for investors in staying out of the market while it is falling.

b. The Secondary Market

13. The various suggestions for change reviewed in the Annexes are intended to be for improvements to the way in which the authorities issue stock, either direct to purchasers on initial application, or by sales of the tap stock subsequently through the market - under the present single capacity system of the Stock Exchange, the Government Broker sells stock held by the Issue Department, to jobbers who then sell through other brokers to the ultimate buyer: as with equities and the existing gilts the jobbers deal on their own account, making a market, while the brokers act as agents for those selling stock or buying it.

14. However, in assessing such proposals it is necessary to take account of any potential effect on the secondary market in gilts, since one of the attractions of gilt-edged stock to the potential investor

is the ease with which he can sell it, either outright or to switch into a stock with a different maturity which suits his needs better. As the Bank point out in paragraph 26 of their paper, at present a holder of gilts knows that he will normally be able to deal almost instantly at his own initiative in large amounts of stock of any maturity at - or at something very close to - a known market price. This liquidity, provided by the gilt-edged jobbing system, remains an important element in the attraction of gilt-edged investment. A reduction in the effectiveness of the secondary market would reduce this attraction and so affect the price or scale on which investors were willing to apply for new stock.

c. Foreign Buyers

15. The Annex is directed to suggestions for improving the methods of sale to domestic buyers, and does not deal with the question of whether we should do more or less to attract foreign buyers of gilts, since that is primarily a question of external debt management rather than funding the PSBR. A purchase of gilts by an overseas buyer, which is matched by an increase in the reserves, has no direct domestic monetary effect: he and the authorities have effectively just swapped foreign exchange and a gilt-edged stock. They can therefore generally be regarded as a relatively expensive and possibly volatile, way of augmenting the reserves: for this reason, since 1977 new issues have not had two features which had made them attractive to some foreign buyers - dividends paid gross to non-residents and availability in bearer form.

16. In practice, net sales of gilts to non-residents have been relatively small. As the table at the foot of the first page of the BEQB article shows, in only one year of the last seven (1977) have they been significant - nearly £1 billion: net sales over the seven years taken together were less than £300 million. However, it would appear that purchases by non-residents can have a catalytic effect on the domestic market: on a number of recent occasions Press reports of foreign interest in gilts - which usually overstate the amounts involved - appear to have triggered much more substantial purchases by domestic investors.

d. Future Changes

17. Further evolution of the methods of marketing and ranges of instruments will almost certainly be necessary as markets develop and circumstances change. It is possible to identify now from the Annex some of the areas where changes could prove desirable, although it is not certain that they will do so, for example:-

- i. changes in the form of the limited tender provision on issue. (Suggestion 2A)
- ii. the placing of some new issues direct into the Issue Department. (Suggestion 1A)
- iii. the issue of a convertible stock. (Suggestion 4C)

18. The real question is whether there should be a more fundamental change, whether in methods of marketing or in ranges of stock. There seems to be little case for making a fundamental change on the grounds that we cannot secure an adequate level of sales over a period. But there is the problem of hiatuses of sales: putting it another way, it does seem to be a drawback of the present system that, at a time when we are operating a system of monetary targets, the authorities lack a means of raising the level of long term interest rates, other than by first raising MLR or by waiting, for what may be a considerable period, for the market to move the rates. While the Bank's objections to the proposals so far made by others to get over this difficulty, whether in terms of operating tactics or of a switch to a tender system, appear well founded, it would seem worth considering further whether there is not any less objectionable way of overcoming the problem.

19. Similarly, Ministers may wish to consider whether there is a sufficient prima facie case in favour of issuing some index-linked stocks, on the grounds that it would be cheaper, to justify a detailed examination of its pros and cons and of how it might be achieved.

POSSIBLE CHANGES IN THE GILT EDGED MARKET

This note summarises the main suggestions for changes in the gilt-edged market, together with comments on them by the Treasury or the Bank: the comments of the Bank are set out more fully in the article "The Gilt-edged Market" in the June issue of the Bank of England Quarterly Bulletin. (For ease of reference the article is attached as Annex 2 with the paragraphs numbered.)

The suggestions for changes in the gilt-edged market are variously directed to one or more of:-

- i. reducing the cost at which the present level of gilt sales is achieved;
- ii. securing a more even pattern of sales over the year, so smoothing the variations in the rate of growth of the money stock;
- iii. reducing the swings in interest rates.

Most commentators accept that all these objectives are relative rather than absolutes. The variations in the growth of £M3 from month to month stem from a number of factors apart from irregularity in the pattern of gilt sales, so smoothing the latter will not produce a steady path for £M3 . Similarly, all accept that an inevitable consequence of a monetary target is that interest rates must change sufficiently to achieve that control - some consider however that the present system leads to wider oscillations than are necessary.

The suggestions fall into three main groups:-

- a. changes in methods of marketing;
- b. changes in tactics while using existing methods of marketing and existing instruments;

- c. changes in the range of securities offered.

This distinction is not absolute since, for example, changes in the range of instruments can affect the marketing tactics.

A CHANGES IN THE METHODS OF ISSUE

The present method of marketing gilts consists of:-

- a. the Bank announcing a new issue, on behalf of the Treasury, at a price closely in line with the market at the time of announcement - which is usually on a Friday;
- b. applications, supported by cash, being received by the Bank on application day, the following Wednesday or Thursday;
- c. the balance of the stock not taken up being taken by the Issue Department, and sold from there as a "tap", through the market. (This is described in section B.)

Three changes in the method of issue have been made in recent years:-

- i. some stocks have been issued on a part-paid basis: only part of the price is payable on application with the balance paid in one or two further instalments, usually in later banking months; this enables the authorities to take advantage of a strong gilt-edged market to secure funding in these later months;
- ii. applications are now invited for new issues at a minimum price, or over, rather than at a single price: the minimum price is fixed, like the former single price, as being fairly close to the market at the time of announcement. Stock is then allotted in order of prices tendered, the highest first: however the price paid for all the stock sold is that which "clears the market", ie the price at or above which there are sufficient tenders

to take up all the stock offered: on only one occasion so far has this been higher than the named minimum price. This is a limited form of tender system designed to secure some benefit to the Exchequer, and not just to the stags, if market prices rise sharply between the time of the announcement and the time of subscription. (It is not however the system which most advocates of the tender or auction system have in mind - see suggestion 3A below.)

- iii. the variable interest stocks have not been advertised for public subscription, but have been placed direct in the Issue Department: the Bank have then been open to bids through the Government Broker.

(BEQB paragraphs 30-36)

Suggestion 1A The time between announcement and issue of stock should be reduced, so avoiding the risk of losing an opportunity for sales, and avoiding the effect of changes in the market price during the intervening period, which can either leave the tap "high and dry" if prices fall, or under-priced, and so unnecessarily generous, if they rise.

Comment 1A This time lag could be avoided by using the method adopted for the variable interest bonds, namely placing the stock at an undisclosed price in the Issue Department which is open for bids on the next trading day. The arguments against making this practice general are:-

- i. the public could only buy it through the market - so paying the brokers' fees and jobbers mark-up - and have no opportunity to buy direct; it was not thought that there would be any significant applications for the variable interest bond from the general public;
- ii. to meet i. by retaining the present procedure with public applications for some stock and placing in the Issue Department in only some cases, might seem to indicate an unseemly haste to sell on the part of the authorities in the latter cases, and so depress the market;

- iii. there is little evidence that in the past there has been a net loss of sales over a period by adhering to the general practice of allowing time for advertisement and direct public subscriptions - the sales "lost" in the intervening days have been made up later;
- iv. the problem caused by a rise in the market in the intervening period has been met by the recent provision for applications at over the minimum price, which should secure at least some of the benefits to the Exchequer.

The case for or against adopting the practice more generally is fairly evenly balanced. It should be kept in mind either for the introduction of new types of stock for which it is hard to establish a price "in line with the market" and also for a conventional stock in strong market conditions.

Suggestion 2A

The "limited" tender system recently introduced should be modified so that all bids at above the market clearing price are allotted in full at the price tendered, rather than, as now, at the "market clearing price". This method, which is used for the Treasury Bill tender, could secure a better price for the Exchequer, even though it would restrain some of the higher bids now made

Comment 2A

The present method was introduced in March as a way of securing that at least some of any upward movement in prices between the day of announcement and applications accrued to the Exchequer rather than to the stags. The particular form of tender was adopted in order to facilitate bids by small investors who might have difficulty in determining a reasonable price for their tender: if they bid "too high", they get their allotment, but at the market clearing price, so the Exchequer cannot be said to be making a profit at their expense. In practice the ability to make high bids without having to pay correspondingly appears to have

been used by sophisticated, but not necessarily very large, bidders to secure allotment in full: the price at which stock has been allotted has only been above the minimum on one occasion so far.

The Bank and Treasury will be reviewing the working of this system in the light of experience in, say, the first 6 months. It is certainly arguable that the needs of the "small" purchaser have been given too much weight in determining the form of the system.

Suggestion 3A

The authorities should adopt a full tender system for the sale of gilts in order to secure a more even flow of sales and a more rapid adjustment of interest rates when that is needed. The essential difference from the present limited tender system is that there would not be a minimum price set in line with the market: its advocates see it as a way of bringing about the adjustment of interest rates necessary to secure the desired level of sales. (This proposal is more favoured by academic and journalist commentators, eg Griffiths and Harris, than by most of those in the market.)

Comment 3A

There are a number of conceivable variants of this, both as to the form of tender and the scale of the tender in relation to total gilt sales. At one extreme all future gilts issues would be offered for tender, or auction. At the other, a tender would only be used if there were a hiatus of sales in the gilts market, as a means of precipitating the change in prices. In between, there might be a programme of sales by tender for a proportion of the borrowing requirement, with conventional methods used for the balance.

The two main variants are discussed in BEQB paragraphs 37-42. The Bank in particular highlights the difference between the United Kingdom market and the United States market which is frequently quoted by advocates of the tender system. The Bank see the following difficulties in a total switch to a tender system:-

- i. if not underwritten at all, it could lead to wider swings in interest rates, since in some conditions of uncertainty - when the institutions are holding out of the market, neither buying or selling - they might only be willing to commit themselves to buying at extremely low prices;

- ii. if underwritten by the institutions, it would require a new relationship with them - and even this would not necessarily avoid wide swings in interest rates, since they would only be prepared to underwrite in conditions of unusual uncertainty at a low price;

- iii. it would lead to major, and so not entirely predictable, structural changes in the securities market, since the jobbers do not have the capital resources to be able to bid on a sufficient scale to cover the tender and institutions would have to bid direct: quite apart from the disruption during any transitional phase - which might end with the appearance of US style "dealers in securities" - it is open to question whether the final pattern would be a more effective market;

- iv. in particular, the ending of the tap system would significantly reduce the ability of the authorities to influence interest rates between tenders.

The use of "ad hoc" tenders just to break hiatuses in the gilts market, or a programme of tenders for only part of the total issue, might avoid some of the problems with a general tender system - such as the changes in market structure. But, as the Bank point out in paragraph 42, they might add to uncertainty, rather than reduce it. Once there had been an "ad hoc" tender, there would be fears that it would be repeated whenever the market faltered, so accentuating the tendency for buyers to stay out of the market as soon as prices begin to fall. Similarly, a programme of tenders for only part of the total would cause buyers in the conventional market to hang back in the weeks preceding each tender and so might hinder total sales, rather than help.

B CHANGES IN MARKET TACTICS

The "tap" arrangement is that the Government Broker stands ready to respond to bids from the market. The Government Broker, acting under instructions from the Bank, may accept or reject a bid at a particular price. If he accept it, he then either remains open for bids at that price, or indicates that he will do so at a new higher price.

The question of whether to move up the price after accepting a bid, and if so by how much, is decided by the Chief Cashier and the Government Broker, the former, of course, taking account of the Government's financing needs and monetary policy requirements in striking the balance between volume and price of sales. On the other hand, if market prices fall, the Bank do not immediately lower the tap price, so the tap effectively becomes inoperative. Prices may come back after a period, in which case the tap becomes operative again as soon as someone makes a bid at the original price. If market prices do not recover, the Bank will generally establish a new lower price, by meeting bids from the market, when they are reasonably satisfied that the market has established a new level and that the recovery in demand

is sufficiently robust for the market not to be discouraged by the authorities re-opening the tap, so increasing the available supply. This, in particular, means that the Bank do not usually re-open the tap at a new lower level until they are faced with a bid for a substantial amount.

Suggestion 1B The authorities' practice in bringing new taps should be less predictable: if they always bring a new tap, or re-open the existing tap, as soon as the gilt-edged market turns up, the investor has a one-sided risk in staying out of a falling market - he knows that he will be able to get in very soon after the market turns. (Greenwells)

Comment 1B This is one aspect of the tactical disadvantages imposed by the authorities being in a buyers' market, rather than a sellers' market, for gilts, given a PSBR which is large in relation to the flow of funds into the capital market. We accept that there would be advantage in being less predictable in the timing of taps, and would like to take an opportunity of staying out of the market. But we have not felt able to take the risk in the last 3 or 4 years, since it can involve both forgoing an opportunity for immediate sales and the risk of allowing market interest rates to fall to a level at which sales might not be resumed: markets do not, of themselves, necessarily produce the interest rates necessary to achieve the monetary target. It should be possible to be more flexible when the size of the PSBR is reduced.

(BEQB paragraph 35)

Greenwells' May Bulletin correctly pointed out that the introduction of part-paid stocks and, more recently, the inclusion of a tender clause for new offers, has reduced (but not eliminated) the one-sidedness of the risk: since part-paid stocks are frequently sold out on application, and the tender provision means that prices may be higher, the investor can be less certain that he

will be able to secure the stock he wants at a price near to the bottom of the market if he waits until the market has turned.

Suggestion 2B

It has been argued by Greenwells, Anthony Harris and others that the Bank should be more flexible in adjusting the price of tap stocks. At present, as explained above, when market prices start to fall, and the "tap stock" becomes inoperative at its old price, the Bank do not normally adjust their price downward until the yield adjustment is complete and the market has stabilised. The new tap price is then established by the Bank accepting a bid from the market at a new price which it considers acceptable: they normally look for a fairly substantial bid to satisfy themselves that the market has stabilised.

The various suggestions intended to produce a quicker adjustment in yields, and/or a shorter hiatus in sales, in such a bear market have included:-

- i. the Bank should pre-empt the downward movement by fixing a new price below the level already reached by the market;
- ii. the Bank should not move ahead of the market, but should be ready to accept more modest bids in line with the market, even if they are not satisfied that the downward adjustment has been completed.

Comment 2B

The Bank argue against the first that:-

- i. such action by the authorities could compound the uncertainties in the market, and lead investors to hold off in the hope that the authorities would lower their price still further - it could therefore lengthen the hiatus in sales and increase the size of the interest rate changes rather than reduce them;
- ii. the risk of such "unilateral" action by the authorities - imposing losses on those who had recently bought gilts (notably the jobbers) - would lead to jobbers reducing the amounts in which

they were prepared to trade when such action was in prospect: this could damage the market in the long term, since one of the attractions of gilts to investors is the ability to deal in large amounts. (BEQB paragraphs 30-36)

The Bank would argue on the second that to re-open the tap prematurely on a falling market would again tend to accentuate the fall in prices, and possibly delay further the resumption of substantial sales. This is because it would provoke selling of some of the stock overhanging the market before there was a sufficient demand from potential buyers to absorb it.

Suggestion 3B Conversely, in a bull market, the Bank should be readier to move prices upwards more rapidly. If the Bank did this often, investors would not be so ready to stay out of the market when it was falling.

Comment 3B This can be, and has been, done on occasion. But the Bank point out that in recent years the opportunity has been restricted by the need to maximise sales for funding the PSBR, and often by the need to keep prices from rising, and yields from falling, to levels at which there would be little prospect of the further sustained sales required to fund the PSBR. These are two aspects of the general points made above that:-

- i. the authorities' freedom of tactical manoeuvre in the gilts market is circumscribed if they have to sell very large volumes of gilt-edged stock;
- ii. the market, left to itself, will not necessarily generate the combination of price/yield which may be necessary to secure the level of sales required to achieve the monetary target.

C CHANGES IN THE RANGE OF SECURITIES OFFERED

Suggestion 1C The Government should not offer long dated stocks at current high nominal yields - it should confine stocks to shorts and mediums. (Greenwells, Vickers de Costa, Anthony Harris and others.)

Comment 1C This argument is usually based on the premises first that investors require a "premium" to offset the greater risks involved in lending long - so borrowing long will tend to be more expensive - and second that the real interest rate on borrowing, say, into the next century will be determined by the average difference between the nominal interest rate and the rate of inflation over the period and so that it would only be justified if inflation were expected to continue into double figures into the 1990s. Both premises may be overstated, if not wrong. On the first, the long term investing institutions, particularly the life offices who have long term liabilities denominated in money terms, may be able to minimise their risks by investing in longer stocks which more nearly match the pattern of their liabilities, so for that section of the market the "risk premium" may work the other way.

The second premise ignores the effect of inflation in the first few years on the real value of subsequent interest payments and of the final capital repayment. Even on relatively optimistic assumptions about the future rate of inflation the real cost of borrowing at present yields of just over 12% nominal for 20 years is about 3% and for 10 years is about 2%. Both of these yields are at or below what has been calculated to be the historic average level for the real cost of borrowing - about 3% - so borrowing long is not necessarily intrinsically expensive. These figures do however suggest that there could be a long term cost advantage in borrowing for 10 years rather than 20 years, since there must be a reasonable prospect of refinancing in

10 years time at a real rate which made the average for 20 years less than borrowing now for 20 years. (With the present profile of interest rates, there is little or no public expenditure advantage in the first few years, since the coupons would be virtually identical.) However if there were any significant shift in the balance of issues between medium and longs the yields on 10 year stock would rise and could easily eliminate the present apparent slight cost advantage. Moreover given the institutions' portfolio preference referred to above, any gain on cost might be at the expense of speed of sale - a further point where the need to secure very substantial sales of gilts in order to control the money supply constrains the authorities' freedom of action.

Analysis on this basis was done last year, before stocks were issued maturing in the next century. At that time nominal yields on stock maturing in the next century were below those maturing in the 1990s: calculations by the Government Broker and Treasury showed that, on almost any assumption about the cost of refunding in the 1990s, it would be cheaper overall to borrow now until the later date. (Yields on stocks maturing in the next century are still lower by about $\frac{1}{4}\%$.)

While, therefore, there is a clear need to monitor the relative costs of borrowing medium and long, as yields and inflationary expectations change, and possibly to change the present balance between medium and long term borrowing somewhat, the proposal to stay out of the long term market goes too far; it would make it difficult to secure the necessary scale of funding outside the banking system and, by forcing up medium term yields, would make the financing more expensive not less so.

Suggestion 2C The Government should issue a new short term instrument, which would not count as a reserve asset for banks. (Congdon and Harris)

Comment 2C

This area of the market is currently tapped by local authorities with a wide range of instruments (£4 billion outstanding, half outside the banking system) and by central government through two classes of specialist instruments - certificates of tax deposit and national savings. So it is questionable how far additional funds would be attracted to the public sector, rather than switched.

The present pattern of holdings of short term assets by industrial companies and others would suggest that a new instrument would need to be very close in character to a bank deposit if it was to attract substantial additional funds. If it were of this character, and so very liquid, there would be justifiable criticism from Greenwells and others that the instrument merely changed the monetary statistics without affecting the liquidity of the economy

(BEQB paragraphs 49-53)

If there were a redefinition of reserve assets, possibly as part of a move towards a monetary base system of control, the question of the means of securing residual finance for the Government would have to be re-examined.

Suggestion 3C The Government should make variable interest bonds more attractive, increasing the margin offered over Treasury Bill Rate, or by changing the formula on which the yield is calculated. This would lead to a more even flow of funds.

Comment 3C

The variable interest bonds were issued as an experiment to see whether they might be attractive to the institutions in times of uncertainty when they were reluctant to buy gilts. They have been a limited

success, with about half of the holdings held by the banking system. Some of the other holdings, eg by the building societies, has probably similarly displaced other public sector debt.

It is doubtful whether they would prove more attractive to the institutions if their terms were changed in either of the ways suggested. The fact that the bonds are currently at a discount means that the effective margin offered over Treasury Bill rate is greater than that provided for in the prospectus. Local authorities issuing variable stocks have tried various other formulae for determining the rate paid, but have found even less sales outside the banking system.

The bonds are therefore not proving to be a very effective means of smoothing sales of gilts to the long term investing institutions, which are not really interested in them. Instead they are tending to be a somewhat expensive form of borrowing from the banking system (including the discount market).

(BEQB paragraph 24)

Suggestion 4C Further convertible stocks should be issued, in periods of market uncertainty. This would involve offering investors a short dated stock, with an option to convert them into a long stock at a yield predetermined at the date of issue: the initial yield is set at a level close to current market yields for stock maturing at about the option date, and the overall yield close to the then yield for long stocks. It gives the investor an option against the Government - he will presumably stay in at the option date if market rates have fallen, but opt out if they have risen.

Comment 4C Such a stock was tried in 1973, but was not a great success. There could be circumstances in which the differing expectations of the market and the authorities made it a useful proposition again. But experience of the last year would suggest that such circumstances are not frequent, in which it would both be justifiable to

offer investors a one sided option against the Government, and they would be attracted to it.

(BEQB paragraph 24)

Suggestion 5C

The Government should issue indexed stock: it would reduce the PSBR (by reducing interest payments) and possibly also the real cost of borrowing, and would prove more attractive than conventional stock in times of uncertainty about future rates of inflation. (Anthony Harris and others.)

Comment 5C

The arguments for and against index linked stock are as much a matter of the general attitude of the Government to the spread of indexation in the economy as to the particular question of indexation in the capital markets.

In terms of debt management the arguments for issuing Government indexed stock are:-

- i. it would, in general, be attractive to the pension funds, whose future liabilities depend on the rate of inflation (but less so to the life offices who have liabilities fixed in money terms);
- ii. borrowing by indexed stock would, in particular, be a "good buy" for the Government if it was convinced that inflation rates in future would be lower than was implicit in the current yields on conventional gilts: it would be cheaper than meeting the institutions demand for, say, 20 year stocks by issuing conventional stocks. (See 1C above.)
- iii. by removing one source of uncertainty which can affect the capital markets - about inflation - it should secure more steady sales than conventional stocks can;

- iv. it would reduce the nominal PSBR, by lowering debt interest payments. This would be a presentational advantage. (The monetary effect would be limited to any impact the change of the nominal PSBR had on the money supply: the fall in the PSBR would be matched by a fall in the demand for gilts since both the income of holders of indexed stock and their future need to take-up further gilts to achieve a given capital value of gilt holdings would be correspondingly lower.

The arguments against are:-

- i. although the total burden of Government borrowing on financial markets would, for a given fiscal stance, remain unchanged, the changes in the relative attractiveness of different securities could have wide ranging effects on the structure of financial markets and the pattern of financial flows, the precise effects of which are difficult to predict: in particular indexed stocks would compete with equities far more directly than conventional gilts do.
- ii. industrial borrowers might be reluctant to take the risks associated with the open-ended commitment involved in index-linked borrowing;
- iii. unless and until the structure of CGT is changed so that it does not tax nominal gains due to inflation, the introduction of indexation would increase sharply the relative advantage of Government issues over comparable issues (index-linked) by companies and local authorities, to which the CGT exemption and the special arrangements for gilts issued at deep discounts do not at present apply;

- iv. indexation in the capital markets would increase pressure for its extension in other parts of the economy, and be tantamount to an admission by Government that a substantial degree of inflation was likely to be with us for some years to come.

The balance of the arguments has been shifting over time. The critical issues now are whether it is right to make a change which could have fairly profound, but unpredictable changes in the capital markets at a time when the Government is committed to bring down inflation sharply; and whether it would be possible to convince people that it was a sensible move at this juncture - for the second reason in favour - and not an admission by the Government that inflation was here to stay.

The gilt-edged market

1. The principles on which the marketing and management of marketable government debt other than Treasury bills (gilt-edged stocks) are at present based have been long established and may be summarised as follows.
 - Investors and traders are free to determine the size and composition of their gilt-edged portfolios in the light of their own assessment of current and prospective economic and financial conditions, and of the prices and yields determined by a market made in the stock exchange by jobbers.
 - The Bank deals or is prepared to deal continuously in this market within a well-defined and well-known framework, an essential element of which is that the Bank operates at prices close to those determined by the general body of transactions in the market.
 - The Bank issues periodically on behalf of the Government new stocks which normally are intended to replenish the portfolio which is available for market operations, although recently some issues have been fully or nearly fully subscribed on application. The terms of new issues too are pitched so as to offer yields very close to those prevailing in the market at the time of the announcement of the issue.
2. An article in the June 1966 *Bulletin*[1] described the objectives and techniques of the Bank's management of the gilt-edged market within the above framework. The present article describes subsequent changes in those objectives and the consequent adaptation of techniques and instruments, and considers, against that background, a number of proposals for further change that have been the subject of recent public discussion.

The evolution of objectives and techniques

3. In the 1966 article, the main objective of gilt-edged management was stated to be to maximise the long-run

desire of investors at home and abroad to hold British government debt. This main objective followed from the Government's continuing need for large amounts of long-term finance both to meet its current borrowing requirement (at that time for new capital investment by the public sector) and to replace maturing debt. Other aims of gilt-edged management which were seen as important from time to time were to assist economic policy by promoting or sustaining the most appropriate pattern of interest rates, and to assist credit policy by limiting government borrowing from the banking system. These two aims were regarded as shorter-term and were clearly subsidiary to the longer-run aim of preserving the attraction of government stocks and sustaining the health and capacity of the market.

4. This concern to maintain the longer-run, structural health of the market has remained an important objective of gilt-edged management. Since 1966, however, as the main emphasis of monetary policy has shifted to controlling the trend in the growth of the money supply (and in particular, in recent years, the growth of sterling M_3), the raising of government finance from domestic investors outside the banking system has become an increasingly important shorter-term objective of gilt-edged market management. This change of emphasis came about by stages and was accompanied by adaptations of the Bank's operating techniques.

5. In 1966, the principal quantitative objective of monetary policy was limitation of the growth of bank lending in sterling to the domestic private sector, and the principal method of achieving that objective was quantitative rationing. The short-term development of bank lending to the public sector was not a principal consideration. Finance for the Government could be obtained as necessary from the banking system—through the tender for Treasury bills and the Bank's financing operations in the money market—and this left

Net official sales of gilt-edged stock

£ millions

	Total net official sales(+)	Purchased by:							
		Other public sector	Banking sector	Non-bank private sector				Overseas sector	
				Savings banks	Insurance companies and pension funds	Other financial institutions	Industrial and commercial companies		Persons (residual)
1972	519	- 1	-1,114	193	305	- 68	16	- 21	173
1973	1,543	- 13	- 35	113	509	79	39	735	116
1974	974	- 29	- 146	- 4	201	97	- 39	603	- 19
1975	5,118	- 5	812	31	2,503	776	92	1,895	- 6
1976	5,792	4	68	270	2,976	81	123	1,741	130
1977	7,203	2	708	579	3,346	764	88	822	964
1978	5,052	108	- 60	519	3,958	310	- 2	319	- 100
Total	24,640	66	233	1,701	17,798	2,642	317	5,265	1,278

[1] Page 141.

a degree of flexibility over the timing of government lending in the gilt-edged market, which allowed the Bank, consistently with, and indeed in pursuit of, its main aim of strengthening demand for government stocks in the longer term, to seek to moderate changes in yields arising from changes in market sentiment.

6. The essence of the technique of gilt-edged management employed at that time was summarised by the phrase 'jobber of last resort'. Thus the Bank was prepared to deal in gilt-edged stocks of all maturities at prices close to the market level, prime considerations being to preserve the almost unlimited marketability of gilt-edged stocks and, to that end, to limit the pressures experienced from time to time by the gilt-edged jobbers. This technique did not and could not preclude, as a part of interest-rate policy, changes in prices and yields in response to market developments, but it was considered that sharp changes, other than any that might be consequent on a change in Bank rate, would be likely to be disruptive to the market and liable to impair the demand for gilt-edged stocks over the longer term.

7. Starting in 1968, more importance came to be attached to a wider quantitative aggregate than bank lending as a target for the conduct of monetary policy. In 1968 and 1969, in agreement with the International Monetary Fund, quantitative limits were set for domestic credit expansion (DCE). This step was of limited importance for the management of the gilt-edged market, however, partly because the Government's requirement for finance was quite small at that time and partly because it was not then regarded as a lasting change in the objectives of monetary policy. The basic technique described above remained unchanged but the Bank, while still concerned to avoid disruptive volatility in the market, tended to move more quickly the prices at which it was prepared to deal.

8. A more significant step was taken in 1971 when direct quantitative control of bank lending was abandoned, and the arrangements for credit control were modified, with the broader aim of regulating the growth of the money supply, principally by variations in interest rates. This new emphasis on the money supply, rather than on interest rates *per se*, as the immediate goal of monetary policy has been carried further since, leading to the public announcement, from 1976, of quantitative targets for the growth of a particular monetary aggregate—sterling M_1 , in the last two years—for periods of twelve months ahead.

9. In May 1971, preparatory to the change in credit control arrangements which took place the following September, the extent of the Bank's operations in the gilt-edged market was modified; and the Bank's position in relation to the market was codified as follows.

- The Bank is not prepared, as a general rule, to buy stock outright except in the case of stocks with one year or less to run to maturity.

- It reserves the right to make outright purchases of stock with more than a year to run solely at its discretion and initiative.
- It is prepared to undertake, at prices of its own choosing, exchanges of stock with the market except those which unduly shorten the life of the debt.
- It is prepared to respond to bids for the sale to the market of tap stocks and of such other stocks held by the Bank as it may wish to sell.

This remains the framework of the Bank's operations.

10. These adaptations of technique were primarily intended to improve the effectiveness of monetary control. It was clear that the ability of banks and other investors to sell to the Bank large quantities of stock at moments of their own choosing, at prices not far removed from those ruling in the market at the time, was incompatible with monetary policy in its modified form. The principal change was therefore that the Bank ceased to be prepared to respond to requests to buy stock outright, except in the case of stocks with one year or less to run to maturity.

11. Inevitably this change implied greater short-term fluctuations in gilt-edged prices and some reduction in marketability. It was not felt, however, that the longer-term health of the market need suffer in consequence. It had become clear by 1971 that the Bank's willingness to deal at prices close to the market level allowed speculation too large and too easy a rôle in the management of portfolios; it often meant that in practice the Bank provided the counterpart to dealings by the rest of the market. The curtailment of the Bank's operations therefore made room in the market for others to operate in more realistic conditions.

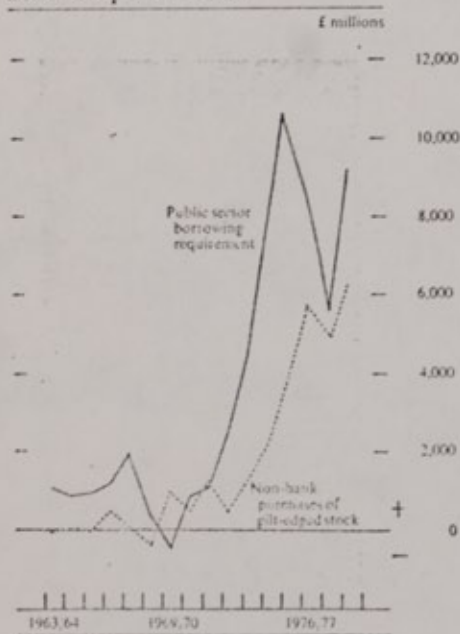
12. Nevertheless, tension for gilt-edged market management can arise between the objectives of shorter-term monetary control and of sustaining the longer-term health of the market. And this tension became more marked during the 1970s as the emphasis on control of the broader money supply increased.

13. The choice of the broader monetary aggregates, DCE and sterling M_1 , as the immediate target for monetary policy has tended to concentrate attention on the rôle of gilt-edged market management in implementing monetary policy, in a way that has become increasingly evident. An important characteristic of such broader aggregates—which does not apply to narrower measures of the money supply such as M_1 —is that they can be closely analysed, in an accounting sense, in terms of their credit counterparts. Properly interpreted, and allowing for the inter-relationship between the counterparts, this has the considerable advantage that it can help in understanding the factors contributing to monetary growth. It highlights the extent to which the public sector borrowing requirement (PSBR)—and, indeed, other sources of monetary growth such as bank lending to the private sector or inflows from abroad—are offset by sales of government debt, and more

particularly of gilt-edged stocks, to domestic investors outside the banking system. This direct accounting link between the gilt-edged market and the behaviour of the broader money supply, month by month, means that the extent to which the momentum of official sales of stock is being maintained has assumed much more significance—both for the authorities and for the general public—as an indicator of how far monetary policy is succeeding in its quantitative objective than was the case when the link was seen to be with the liquidity of the banking system.

14. This development has occurred against the background of a sharply higher government borrowing requirement and of a higher and more variable rate of inflation. In the eight years to 1970, the PSBR averaged a little over £3 billion (2% of GDP at current market prices). Since then, it has averaged £6 billion (6% of GDP), with a peak of over £10½ billion (10½% of GDP) in 1975. This huge expansion of government borrowing took place during a period in which not only the rate of inflation but also its variability from year to year increased sharply. In the eight years to 1970, inflation—measured by the increase in the monthly retail price index over the previous twelve months—averaged 4%, ranging from under 1% to 8%; in the eight years since then inflation has averaged just over 13%, ranging from 7½% to 27%. Nominal interest rates have naturally been not only higher but also more volatile as a result, and this volatility, and the associated volatility of expectations about the future rate of inflation, have greatly added to the problems of gilt-edged market management.

Public sector borrowing requirement and purchases of gilt-edged stock by non-bank private sector



15. Despite the unfavourable background, management of the gilt-edged market on the basis described above has proved capable of raising finance for the Government on a very large scale indeed over a prolonged period, as is shown in the accompanying chart. And this has

helped to contain the trend in the growth of the money supply in the last five years to a rate that has been generally consistent with official policy objectives. Thus, sterling M_1 increased at a rate of around 10% in most calendar years since 1974, which has been well below the rate of growth of nominal national income. This has not been without a cost in terms of high nominal interest rates. Inflation, and the scale of government borrowing, have necessitated high nominal yields, which—given the uncertainties regarding the future rate of inflation—have largely excluded potential private borrowers on fixed-interest terms from the capital market.

Adaptations to deal with the effect of uncertainty
16. Government finance on this scale involves continuous borrowing. From time to time, however, investors may lack confidence in the outlook, for example in respect of wage demands and industrial disturbance and their implications for future inflation, and in the economic and financial policies being pursued. Some uncertainty and risk are of course always present, and it is for investors and their advisers to assess them. At times, the uncertainties are such that investors cannot be confident that the level of interest rates will not rise, and hence do not feel justified in committing the funds they manage—generally in the interest of others—to investment in fixed-interest securities at that time. Sometimes the extent of uncertainty may be such that some investors are disposed to sell their existing holdings of gilt-edged stocks, keeping the proceeds liquid, and this, within the framework of the Bank's operations described earlier, is allowed to bring about whatever rise in yields may arise from market transactions. Once such an adjustment is completed—and how long that takes will depend upon the degree of uncertainty and the range of investors affected by it—the Bank is then able to resume the Government's funding programme on the higher yield basis. But at other times, perhaps when it is less clear which way a situation will develop, investors generally may lack the conviction to sell their existing holdings but still decide to keep their accruing funds in liquid form. In such situations, while prices in the gilt-edged market may remain relatively stable for some time, turnover contracts, and the market effectively becomes immobilised until the way ahead becomes clearer.

17. The principal effect of such periods of uncertainty, given the present emphasis of monetary policy on controlling the behaviour of sterling M_1 , is to interrupt the contribution which sales of gilt-edged stocks outside the banking system make to that control. It should be noted, however, that the other factors affecting the growth of sterling M_1 are also subject to similarly large and erratic short-term fluctuations: the PSBR, the growth of bank lending, and the impact of external transactions can all vary from month to month by amounts which are very large in relation to the average monthly increase in the money supply that is consistent with the monetary target. And such variations are predictable—even for just a short period ahead—only with large margins of error. The short-term interruption

Variability of the main credit counterparts of the money stock (sterling M_3)¹

£ millions, seasonally adjusted

	Financial year ^(b)			
	1975/76	1976/77	1977/78	1978/79
Central government borrowing requirement	490	260	409	700
Other public sector	70	200	270	350
Purchases of gilt-edged stock by non-bank private sector	520	650	530	480
Sterling lending to the private sector	120	260	250	310
External finance	240	370	450	360
Money stock (sterling M_3)	420	460	291	500

^(a) The table shows root mean squares of first differences which indicate the general magnitude of month-to-month changes for each year.

^(b) Banking May to banking April, except for 1975/76 where the figures are for banking July to banking April 1975.

of the flow of official gilt-edged sales is therefore not the only reason why there may from time to time be random month-to-month fluctuations in the growth of the money supply; and even if a more regular flow of sales could be achieved, this would not in itself be enough to remove such fluctuations arising from other factors.

18. The purely temporary divergence of the growth of the particular target aggregate, sterling M_3 , from the intended trend—whatever the origin of the divergence—is not in itself a cause for concern, in the sense that such erratic fluctuations are unlikely to have any significant effect either on the real economy or on inflation. This is more especially true when the origin of the divergence is a temporary interruption of the gilt-edged funding programme, since in this case the additional monetary balances which result are, in some large part, held by long-term investment institutions awaiting commitment in the capital market, and so are not in any direct sense available to finance transactions in goods and services. If, therefore, one could be confident in any particular case that a funding pause would indeed prove to be short-lived, the proper course would be simply to ride it out:

19. In practice, however, a central difficulty—for financial analysts generally, including investors in the gilt-edged market, no less than for the authorities—is to determine at the time whether an incipient divergence of sterling M_3 from the intended trend is merely erratic or whether it marks the beginning of an important acceleration of monetary growth in some more fundamental sense. Although, as noted above, interruption of official gilt-edged sales is not the only possible cause of short-term fluctuations in the growth of the money supply, any uncertainty on the part of investors in the gilt-edged market is likely in present circumstances to pose this question quite quickly. The size of the PSBR, and the continuous, heavy funding programme it involves, mean that if investors delay their purchases of gilt-edged stocks for only a month or two there is likely to be a noticeable upturn in the growth of sterling M_3 . The authorities then have to assess—in the light of the causes of uncertainty and of other developments (including, for example, the behaviour of other aggregates, such as M_1 , and particularly the non-interest-bearing element of M_1 , which are much less directly affected from month to month by the timing of gilt-edged investment

decisions)—the significance of this upturn and whether it is likely to continue. They may decide that the hesitation on the part of investors generally is well-founded and make policy changes; or they may decide that policy changes are not necessary. If, in either case, a sufficient body of investors remains unpersuaded, sterling M_3 will continue to grow above the required trend, and this can lead to more active selling in the gilt-edged market, until yields eventually rise to a point where investors come back into the market and the funding programme can be resumed.

20. In many cases, such a yield adjustment (or the policy action taken to forestall it) may be accepted in retrospect as having been necessary in the light of outside circumstances to maintain monetary control. But in other cases it may appear to have been part of a self-generating spiral, with the initial uncertainty causing an acceleration in sterling M_3 which in turn affects expectations about interest (and possibly exchange) rates, leading eventually to upward adjustments of yields which are in excess of those justified by the underlying situation and which may subsequently therefore be reversed. The danger of such unnecessary disturbance and interest-rate fluctuations would be reduced if a somewhat smoother pattern of sales of gilt-edged stocks to the non-bank private sector could be achieved in the first place.

Partly-paid stocks

21. Faced with this problem, the Treasury and Bank introduced an adaptation in their issue technique in March 1977 by providing for only part of the subscription money for a new issue to be paid at the time of application with the balance being payable in instalments timed by reference to the Government's expected funding need. This adaptation, which has been used with varying degrees of success on a number of subsequent occasions, was designed to smooth the flow of funds from outside the banking system into gilt-edged stocks by staging the calls to correspond with the expected funding requirements in successive banking months.

22. In addition, new gilt-edged instruments have been introduced which were designed to be attractive in conditions of uncertainty.

Convertible stocks

23. Even before the recent concern, namely in March 1973, a convertible stock, 9% Treasury Convertible Stock 1980, was issued, which offers holders an option, in 1980, to convert at predetermined terms into a stock maturing in the year 2000. With this type of security, investors are offered a short-dated stock at close to the current market yield for that maturity at the time of issue, with an option to convert at a later date into longer-dated stock at a yield close to that prevailing for the longer maturity at the time when the convertible short-dated stock was issued. Such a security gives the investor the option of holding a short-dated stock to maturity, or, by exercising the conversion right, of moving into the long end of the market at a specified

later date (or dates) on terms which are known in advance and which may then no longer be available in the market. The attractiveness of a stock of this kind depends in part upon the relationship between short-term and long-term yields at the time of issue. The attractiveness of the conversion option in particular depends on investors' assessment of the likely course, beyond the immediate future, of long-term interest rates. If they judge that there is a good chance that long-term interest rates will be lower by the time the conversion option may be exercised, they will find the option attractive. To the extent that it does, in the event, produce an advantage to the investor, it will of course prove correspondingly expensive to the Government, although this risk may be worthwhile if it enables the momentum of the funding programme to be maintained without a rise in interest rates. There are a number of possible variations on this general theme.

Variable rate stocks

24. The second instrument designed to cater for conditions of uncertainty is the Treasury Variable Rate Stock, of which three issues have been made, maturing in 1981, 1982 and 1983. These stocks offer investors a degree of insurance against rising short-term interest rates, always provided that their market price is relatively stable. The insurance takes the form of six-monthly interest payments based on the average discount rate for Treasury bills over the preceding six months. At par, the interest rate payable is a half per cent over the Treasury bill discount rate, and for every one point discount on par the prospective capital gain to maturity effectively widens the margin over the Treasury bill rate, if the stock were held to redemption, by about a quarter per cent. In practice none of these stocks has traded at par, so that the effective margin over the Treasury bill discount rate has always been larger than a half per cent. The variable rate stocks have not yet, however, proved to be more than modestly attractive to investors outside the banking system as stocks to be held; they have not been very actively traded in the market, and, partly as a result, they have not perhaps so far enjoyed sufficient price stability. They have none

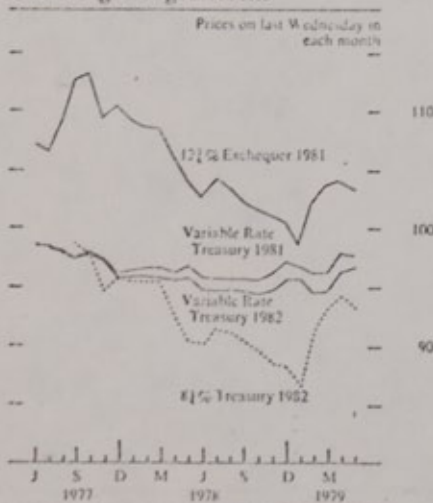
the less played some small part in smoothing the flow of funds to the Government, coming into demand when the outlook for interest rates seemed particularly uncertain and when official sales of conventional stocks were depressed, and being bought back by the Bank, against sales of conventional stocks, at other times. This rôle could grow with increasing market experience of the stocks. In the case of variable rate stocks, too, a number of variants are possible. One such variant that has already been adopted by a number of local authorities has the interest rate set half-yearly at a fixed margin above the six-month inter-bank deposit rate ruling at the beginning of each interest period, though these stocks too have yet to establish any significant market outside the banking system.

Some suggested possible further changes in technique and instruments

25. The adaptations so far described have not involved any departure from the established principles on which official management of the gilt-edged market has been based. It remains the case, however, that uncertainty among investors continues to cause occasional interruptions to the Government's funding programme. The rest of this article, therefore, considers a number of possible further changes—some more radical than others—which, it has been suggested, might be introduced to achieve a smoother path of official sales, despite recurrent periods of uncertainty attributable to factors external to the gilt-edged market itself. These would involve changes, either of operating technique, or in the range of gilt-edged instruments.

26. A number of these changes could have significant implications for the structure of the gilt-edged market, and in particular for the market-making mechanism. Despite the developments since 1971 described above, a gilt-edged investor is still normally able to deal almost instantly at his own initiative in large amounts of stock of any maturity at—or at something very close to—a known market price; and this liquidity, provided by the gilt-edged jobbing system, remains an important element in the attraction of gilt-edged investment. It is difficult to avoid the conclusion that the present market-making mechanism would be seriously affected by some of the changes that have been advocated, but it is not easy to predict what alternative mechanism might emerge and how effective such an alternative might be. These questions are touched upon in the discussion that follows, but they would need to be very fully considered in a complete analysis of the proposals.

Prices of variable rate and other selected gilt-edged stocks



Changes in technique

27. In the area of technique, the changes that have been suggested fall into two main groups. The first group of suggestions would involve sharper changes in the prices and yields at which gilt-edged stocks are made available. The second group would involve some form of more direct relationship between the authorities and major investors through which the amounts, the timing and the terms of gilt-edged stocks to be taken up would be determined in advance.

28. Suggestions for greater flexibility in the price at which government stock is marketed are based on the proposition that a sufficient fall in the price at which the stock is obtainable will, in any surrounding circumstances and without any associated policy action, produce the required demand. In the Bank's judgment this proposition needs qualification, as is explained below.

29. These suggestions for greater price flexibility are of two kinds. The first relates to the prices at which the Bank markets stock out of its own portfolio through transactions on the stock exchange, where the initiative for varying the price would fall upon the Bank. The second relates to the method of public issue of government stocks, where proposals have been made for issues by tender (or auction) which, in this variant, would not be underwritten, and under which the variation in price would be determined entirely by the investors.

The pricing of tap stocks

30. At present, a new stock is normally issued at a price closely in line with the prices of other comparable stocks already in the market, and the amount of the stock not taken up by the public—usually a large proportion—is taken into the Bank's own portfolio, with the Bank acting in effect as an underwriter. If the market remains firm, this tap stock is subsequently sold by the Bank through the market at prices raised in fractional steps above the issue price. If, on the other hand, as a result of a change in conditions giving rise to uncertainty among investors, demand for the stock does not develop, the Bank does not immediately reduce the price at which it is known to be prepared to sell. Instead, the Bank waits until the market recovers or, if the market generally weakens, until the yield adjustment is completed and the market has stabilised, when the tap price will be lowered in a single step in response to bids from the market. This established practice provides assurance to investors who subscribe for stock on issue, or purchase it through the market soon afterwards, that, short of a general weakening in the market, their position will not be undermined by the Bank's supplies being subsequently made available at lower prices.

31. The main suggestion that has been made in relation to more flexible pricing of stocks from the Bank's own portfolio is that, in order to maintain the momentum of sales through periods of uncertainty caused by changes in outside circumstances, the Bank should be more willing to lower the tap price in one step, going beyond the fall in market prices generally, or in smaller steps, in line with the decline in the market, without necessarily waiting until the market yield adjustment is completed. A difficulty with this approach is that such behaviour, in the conditions of weakening confidence where it would be relevant, could tend to add to, rather than diminish, the uncertainties in the minds of investors.

32. If the Bank—as by far the largest seller in the market, and with earlier knowledge of some important

developments likely to affect the market, such as imminent policy steps, statistics, etc.—had had to reduce its price once, why should it not do so again shortly thereafter? Given this evidence of official urgency to sell stock, investors might well conclude that, by waiting, they might obtain still higher yields. There could be a danger that prices in the market would move away from the Bank, simply falling further in response to each successive reduction of the official price of the tap stock. At some point one must presume that this process would stop, and that yields would reach a level at which investors were prepared to commit the required funds; but the increase in yields might need to be unnecessarily large in these conditions, and, in the case of the proposal for a single step change, it would be difficult to arrive at a reasoned judgment in advance as to the tap price which would ultimately need to be set. In these circumstances, it could, as a practical matter, become necessary to find other means of establishing an appropriate price, perhaps through tenders or through a process of negotiation with major investors, with the further implications discussed below.

33. The argument has been put that the authorities already act on prices in the gilt-edged market by changing minimum lending rate (MLR), and that shifts in the tap price would only differ in degree. But the difference in degree would be very considerable. Changes in MLR are made as a result of varying considerations, not necessarily immediately related to developments in the gilt-edged market, and their effect on gilt-edged prices is indirect and may be greater or smaller depending on the surrounding market circumstances. Furthermore, a change in the yield on a three-month bill from, for example, 9½% to 10% changes its price by only one tenth of one percentage point, while to secure a similar change in the yield on a 20-year stock would require a change in price of about 5%. Such changes in price imposed unilaterally by the authorities would involve heavy capital losses which operators would be likely to regard as beyond the normal hazards of business; and the only defence for the market-makers against such behaviour on the part of the authorities would be to narrow the market drastically whenever such conduct appeared to be in prospect.

34. A modified version of this suggestion is that the Bank should lower the tap price at which it is prepared to sell during periods of a weakening market, but by less than the full extent of the fall in prices generally, so keeping the price a little way above the market as a whole. The intention would be that, because investors would have greater certainty as to the price at which they could re-enter the market, they would be encouraged to sell their holdings and so accelerate the yield adjustment. It would seem, however, that such a policy would in practice be almost indistinguishable from the previous suggestion, and that the Bank's price adjustments would have much the same effects upon market expectations.

35. More generally it has been suggested that the Bank's technique in pricing tap stocks is too easily predictable: investors, it is argued, can, if they are uncertain, postpone their purchases of stock in the knowledge that if prices should improve, they will not, while a tap stock is active, move ahead too rapidly so that the cost of delay is likely to be small. This argument sometimes prompts the suggestion that the Treasury and the Bank could price a new issue some way ahead of the market, or that the Bank could adjust its selling price of the tap stock upwards by larger amounts, so encouraging investors to accelerate their purchases in the immediate situation and weakening their complacency over the longer term. There are circumstances where, within generally rather narrow limits, this tactic can be—and indeed has been—used. But it can only be used where the Bank is reasonably confident that the surrounding conditions in fact justify an unusually sharp decline in yields and where this prospect is likely to carry conviction with investors. If used where the overall circumstances did not in fact justify a fall in yields to the extent implied by the pricing decision, the tactic would be likely to induce an otherwise unnecessary interruption of the funding programme as yields subsequently adjusted back to more appropriate levels. In a similar way, it has been suggested that the authorities should vary their tactics in introducing new stock issues, by periodically standing aside from the market, but this possibility has been largely precluded by the recent size of the funding programme, which has involved more or less continuous borrowing.

36. In considering these various proposals for a more active pricing policy, the Bank is conscious that a securities market cannot function satisfactorily if there is an operator in a position to exercise overwhelming influence who is liable to enter the market unpredictably both as to timing and behaviour. All of the proposals would—if carried very far—introduce an important new element of uncertainty into the determination of gilt-edged prices. This in turn would seriously impede the making of a market, in any size, in gilt-edged stocks—whether by jobbers, as at present, or under some different institutional arrangement. The restriction on marketability which could then result would tend to reduce one of the principal attractions of the gilt-edged market for investors, damaging its long-term capacity.

Tenders

37. A different kind of suggestion for achieving a smoother pattern of gilt-edged sales through greater price flexibility is for the adoption of a tender system for new issues. Again there are a number of possible variants, but a common element would involve the Government announcing from time to time the volume of securities it wanted to sell on particular dates, or in a given period, and then leaving it to investors to determine the price and yield at which they were prepared to buy it. As with the suggestion for a more active policy of lowering of the tap price, the object would be to enable the authorities to sell the amounts of stock expected to be required in any given period to achieve shorter-term

control over the growth of sterling M_3 , unhampered by interruptions in government funding arising from changes in outside circumstances. (This would of course still leave sterling M_3 subject to erratic short-run fluctuation arising from unpredicted variations in the other credit counterparts, as mentioned earlier.) The proposal may derive in part from the regular use of the tender technique for new issues of US government securities by the US Treasury. In considering it, however, one needs to bear in mind that there are substantial differences in the size and structure, and in the rôle, of the government bond market in the two countries.

38. In the United States, the \$330 billion of government bonds outstanding are equivalent to only some 16% of GNP, whereas the £57 billion of gilt-edged stocks outstanding is equivalent to some 42% of GNP in this country. Although government borrowing has increased in the United States—as in the United Kingdom—in recent years, government bonds have not dominated the capital markets to the same extent: in 1977 government bonds absorbed only some 30% of the total funds raised in the US domestic capital market, whereas the comparable figure for the United Kingdom was nearly 90%. In the United States, too, government bonds are typically of much shorter maturity. They include a large proportion of two-year issues, and only about 16% have a life beyond eight years; whereas in this country gilt-edged stocks are rarely issued for less than four to five years, and some 60% are of more than eight years' maturity. This results in an average maturity of US government bond issues of about five years, compared with about twelve years for gilt-edged stocks in this country. Finally, the institutional arrangements in the two government bond markets differ: prices are made in the US market, for example, by dealers in government securities rather than through the stock exchange as in this country. Such differences suggest the need for considerable caution before one can conclude that arrangements found helpful in the United States would be similarly effective in the United Kingdom.

39. A major difference in the present context is that the US Treasury's debt management objectives are not the same as the present objectives of debt management in this country as described above. In particular, the US Treasury is not directly involved in the implementation of monetary policy and its use of the tender technique for new stock issues is not primarily directed to the achievement of short-term monetary control. In the United States, the main emphasis of monetary policy in recent years has been on controlling the narrower monetary aggregates, which the Federal Reserve authorities influence essentially through management of the level of short-term interest rates. There is consequently not the same direct link between government debt management and the chosen monetary target in the United States as there is here, and debt management policy can therefore be directed to a far greater degree to the narrower objective of providing finance for the Government at the lowest cost consistent with maintaining an appropriate maturity

structure. In this context, the use of the tender technique would seem to be designed to deal with the difficulty that can at times arise with a fixed-price offering if market sentiment should change (in either direction) between the announcement of terms and subscription, rather than as a means of keeping up the volume of sales in circumstances of uncertainty without regard to the effect on market yields. On the contrary, in framing its programme of debt sales, the US Treasury pays considerable regard to the advice given by the Federal Reserve authorities, and by the main government securities dealers (who effectively underwrite the tenders and act as intermediaries in on-selling a large part of new issues to final investors) on the capacity of the market to absorb new issues—particularly of longer maturities—without an undue effect on market prices.

40. A form of tender technique, with a minimum tender price set in line with market yields at the time of announcement of the issue and designed to secure for the Government—through a lower borrowing cost—a part of the benefit from any sharp improvement in market sentiment between the announcement of terms and the date for subscription, was in fact adopted by the Treasury and the Bank for a new issue (12½% Exchequer Stock 1999) in March 1979. This followed the uniquely heavy oversubscription, resulting from an abrupt reversal in market expectations about the future course of interest rates, of two stocks issued a month earlier. The use of the tender technique for this purpose, however, is basically different from its use to achieve greater short-term control over the growth of the money supply by ensuring the necessary volume of gilt-edged sales in any given period. If that were the objective, it would at times involve pressing ahead with an issue even in a market which was unsettled by outside conditions, and accepting the resulting yield; the objective would in such conditions be likely to be frustrated if there were a minimum tender price, unless it were set on a yield basis substantially higher than the prevailing market level. A change to this method of issue would not of itself help to diminish investors' uncertainties about the future, nor make it easier for them to make a judgment about the future course of yields, and hence about the yield at which they should commit any large volume of funds to long-term fixed-interest investment. Given that they would still have open to them the possibility of buying stock in the secondary market or—because of the continuous nature of the Government's borrowing need—of entering a subsequent tender, by which time the particular uncertainty might have lessened, they could, in uncertain conditions, continue to find it more prudent to stay short and wait. Investors would, therefore, not necessarily enter a tender even of this sort, in the required volume, at the times when it mattered. And to the extent that they did so, it would probably be at prices and yields that discounted an unfavourable outcome in those areas that were the source of uncertainty.

41. The effect of tenders of this second kind, in terms at least of short-term price volatility, might be somewhat

similar to that of a more active policy of moving the official tap price, with similar longer-run implications for the capacity of the market. Used with the object of selling a predetermined volume of stock, the tender technique would have a further corollary. It would run counter to this objective for the Bank itself to enter the tender on any substantial scale; the Bank's own dealings in the market would, therefore, be curtailed and would no longer provide a reservoir for adjusting the level of sales to the level of investor demand as under the present tap arrangements. At the same time, as things stand at present, the gilt-edged jobbers do not have the resources to bid regularly at tenders in amounts that would enable them to assume this function. If the tenders were to be successful, therefore, given the present institutional arrangements in the United Kingdom, virtually all the stock offered would have to be taken up directly by investors—whatever the state of market confidence happened to be—with no large intermediary to cushion the impact on prices. In part, the gap left by the implied change in the Bank's rôle might be filled if the capacity of the present jobbers were to increase or if new intermediaries emerged, perhaps of the kind of short-term dealer in government securities that exists in the United States. Such a development would be unlikely to come about overnight, and the market in gilt-edged stocks could be severely affected in the meantime. But even in the longer term, the change in market structure and the greater short-term price volatility that could result from the tender technique—if used to achieve closer short-term monetary control—might well lead to both reduced marketability and a significant shortening of the maturity structure of government debt. In the conditions envisaged, market-makers might be prepared to run a sizable book in short-dated stocks, but they are less likely to be prepared to take in the longer maturities on the same scale because of the higher risks. Any development in this direction would involve a considerable change in the management of the government debt, in view of the already heavy burden of annual maturities that have to be refinanced.

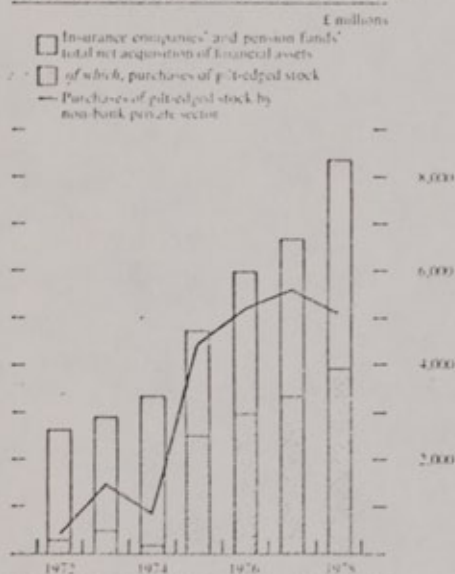
42. Because of structural changes in the gilt-edged market that could result from a general shift to tenders, some commentators have alternatively suggested that tender issues might be made on occasion, at times of particular uncertainty rather than as the normal method of issue. This more modest step might still, however, have the disadvantage that it would tend to increase rather than diminish uncertainty. There would be the danger that once the tender technique had been used in the manner suggested, the possibility that it would be used again could damage confidence in a hesitant market on subsequent occasions: prospective buyers might be deterred from investing when they would otherwise have done so, by the fear that a subsequent tender would impose capital losses on them. Experimentation in this area is not, therefore, wholly straightforward.

43. A more direct relationship with the major investors. The suggestions for possible changes in technique discussed so far would maintain the traditional arms-

length nature of the relationship between the authorities and investors in gilt-edged stocks. An entirely different approach would involve a more direct relationship between the Government, as borrower, and major investors, for example, the larger pension funds and life assurance companies. Suggestions under this heading include:

- the negotiation of underwriting of government stock issues by the long-term investment institutions, rather than by the Bank as at present (whether such issues were on a fixed-price or tender basis); and
- the negotiation of direct placings of government stock with the institutions.

Purchases of gilt-edged stock by insurance companies and pension funds



44. The rôle of the long-term investment institutions in the gilt-edged market has grown rapidly in recent years. Even so, these institutions do not generally account for more than about half of all net purchases of gilt-edged stocks by investors outside the banking system, and their combined holdings of gilt-edged stocks still amounted to only a third of the total nominal amount outstanding at the end of 1977. The institutions do not represent the small, tightly-knit grouping that is sometimes supposed: at the end of 1977 there were some 300 life assurance companies and over 2,000 pension funds in the United Kingdom, with over 100 institutions with assets of over £100 million accounting for two thirds to three quarters of the total long-term institutional investment. Thus, while suggestions of this kind might in principle be applied to a significant part of the Government's gilt-edged market borrowing, they would not of themselves provide a total solution to the funding problem.

45. A key question—as in the case of the proposal for tenders—is whether the suggested change in new issue technique would in itself make it easier for the long-term investment institutions to maintain their purchases of gilt-edged stocks through periods of uncertainty, without wide fluctuations in interest rates. Other things being equal, there is little reason to suppose that

institutional investors would be willing to commit their funds—at times of uncertainty—to fixed-interest stocks offered by way of a placement where they were not prepared to buy the same stock offered by way of a public issue, unless they were given the inducement of a significantly higher yield. Nor is it clear that the institutions could prudently, in the interest of their pension fund members or insurance policyholders, take on the very considerable risks of loss that would be involved in the regular underwriting of government stock issues (which are at present underwritten by the Issue Department of the Bank) on anything like the recent scale, unless they were free to move the underwriting price quite widely to protect themselves in adverse conditions. While, therefore, it is possible to see how this approach could function in market conditions that were reasonably favourable—when the present technique is satisfactory—it is hard to see that arrangements of this sort could be freely negotiated in those conditions where they would be most helpful, without producing much the same effect of greater short-term price fluctuations that would result from the earlier suggestions.

46. Some suggestions for a more direct relationship between the authorities and major investors would go some way towards displacing a free market and would involve varying degrees of government influence over the decisions taken by the major investors. In the extreme this could extend to statutory direction. It is beyond the scope of this article to discuss the general arguments for and against such an extension of government influence. It is reasonable to assume, however, that the use of such influence would tend, in the first instance, to hold yields on gilt-edged stocks below the level that would otherwise be established in the market; and that this in turn would tend to reduce the attraction of investment in gilt-edged stocks to other investors not subject to similar influence or control. Though it might be possible to achieve in this way a smoother flow of investment in gilt-edged stocks by the major institutions, it would not necessarily follow that gilt-edged sales to the non-bank private sector as a whole would be more regular; nor perhaps that a higher overall volume of sales would be achieved.

47. The last three suggestions considered—for tenders; for negotiated underwriting of government issues by the institutions; and for some element of direction by the Government of the institutions' investment—have been discussed separately, as logically distinct proposals. In practice, however, this distinction could prove difficult to maintain. The pressures on the Government could tend to lead to a progressive development: in order to avoid the disturbance to interest rates that might be expected to result from the adoption of tenders, there would be a temptation to look for some underpinning of the tenders by institutional investors, and, in negotiating the terms of such underpinning, the Government would need to exercise considerable restraint if a free market was to be preserved. To this extent, therefore, the implications of the various proposals in these areas need to be looked at together.

New forms of gilt-edged instrument

48. Suggestions advanced for possible new types of gilt-edged stocks fall into two main groups. First, there have been various proposals for new short-term marketable government debt instruments, with maturities ranging from perhaps three months up to about two years. Secondly, some commentators have advocated the introduction of a marketable government stock indexed in some way against inflation.

Short-term instruments

49. The short-term instruments suggested are principally designed to attract into government debt institutional funds awaiting investment (including longer-term investment in the gilt-edged market) and some part of the liquid resources of industrial and commercial companies currently held with the banking system and so forming a part of the money supply. They could also appeal to personal investors, though in this area particularly they would compete with the range of (non-52. marketable) national savings instruments already offered by the Government.

50. At present, there are two marketable short-term central government debt instruments generally available to investors: Treasury bills and gilt-edged stocks approaching maturity. Both Treasury bills and gilt-edged stocks with less than one year to run to maturity are eligible reserve assets for the banking system. They consequently have a particular value to banks as compared with most other short-term assets with which they compete, and their yield, therefore, tends, on occasion, to be bid down to a level unattractive to investors outside the banking system. The suggestion has, therefore, been made that a new instrument could be issued which would not be an eligible reserve asset, and in relation to which—because of the short maturity—a more active pricing policy could be

adopted without the implications such a policy would have if adopted in relation to the gilt-edged market generally.

51. Although there is no central government instrument of this kind available to the market, it is an area which is already quite heavily drawn upon by local authorities, through deposits, mortgages and negotiable bonds, none of which is eligible as a reserve asset. The total of such temporary local authority debt outstanding is around £4 billion, of which some £1½ billion is held by non-bank financial institutions and about £½ billion by industrial and commercial companies and persons taken together. If the central government raised additional funds from outside the banking system by marketing a new short-term instrument, it would be in competition with local authority short-term borrowing; this would tend to limit the net additional inflow of funds to the public sector as a whole.

52. It is difficult to establish how large a market, outside the banking system, there would be for a new short-term central government debt instrument of the kind proposed. The behaviour of the groups of potential investors identified above suggests a strong preference for holding their short-term assets in the form of conventional bank deposits which are both highly liquid and wholly capital-certain. For example, industrial and commercial companies' holdings of certificates of deposit amount to only some 5% of their holdings of conventional bank deposits; and the long-term investment institutions typically wish to keep their liquid resources available for immediate investment when they perceive an appropriate opportunity. This might suggest that there would be little demand for any short-term central government instrument that was not a close substitute for bank deposits. If the Government offered such a close substitute, this would not produce a meaningful reduction in the liquidity of the economy. If

Local authority short-term debt by type of holder^[a]

£ millions: amount outstanding at end-year

	Total	of which ^[b]						
		Banking sector	Building societies	Insurance companies	Other financial institutions	Industrial and commercial companies	Personal sector	Other
1972	2,408	475	298	83	329	359	294	330
1973	3,274	660	346	236	460	483	266	541
1974	3,976	376	741	582	465	484	242	704
1975	3,758	371	649	362	524	459	211	746
1976	4,549	497	452	407	768	579	243	974
1977	3,013	332	642	269	110	229	203	585
1978	3,872	632		1,405		387	233	716

[a] Includes all loans repayable within one year of their inception.

[b] Excluding revenue LTB.

Distribution of main sterling liquid asset holdings at end-1978

£ millions

	Bank deposits	Building societies	Other financial institutions	National savings	Local authority debt	Tax instruments	Treasury bills and gilt-edged stocks
Holders							
Persons	24,174	36,616	4,578	11,238	233	146	—
Industrial and commercial companies	11,504 ^[a]	337	230	—	665	763	509
Insurance companies ^[b]	1,537		139	—	269	—	10 ^[c]

— not available.

[a] of which, certificates of deposit £440 million.

[b] 1977 book value (net).

[c] Treasury bills only.

Holdings of the new instrument were excluded from the definition of sterling M_3 (which does include certificates of deposit issued by banks), the growth in sterling M_3 might statistically be reduced; but this effect would be seen by the financial markets as largely optical.

53. To attract such liquid funds into a less liquid asset, the Government would need to offer a higher yield. Indeed, action has already been taken to make both national savings instruments and certificates of tax deposit more attractive. The contribution that a new general-purpose, short-term, marketable security could make would depend in part on how far this higher cost was regarded as acceptable.

Indexation

54. The final suggestion to be considered is some form of index-linked marketable government security. There is little doubt that an appropriately priced, inflation-proofed marketable security could be attractive to a wide range of investors. This is not because it would necessarily yield a higher return to maturity than a conventional fixed-rate security—that would be difficult to judge in advance and would depend upon whether, in the event, the future rate of inflation proved to be greater or less than the rate presently discounted in nominal market yields. (By the same token, the real cost to the borrower would also be difficult to predict in advance and might prove to be greater or less than on a conventional stock.) The attraction would be that the 'real' rate of return to maturity would be fairly clear; this would provide a measure of protection to investors, and would be particularly attractive to institutional investors such as pension funds whose liabilities also rise with inflation. It would also mean that investors would be substantially protected against capital loss as a result of a fall in the market price arising from an upward shift in inflationary expectations (though not from price fluctuations associated with changes in real interest rates). This characteristic particularly means that indexed gilt-edged stocks would remain attractive to investors when they feared accelerating inflation, which is the predominant cause of interruption to the government funding programme at present. The introduction of indexed stocks almost certainly could in principle, therefore, make an important contribution to smoothing the pattern of official gilt-edged sales.

55. The question of an indexed stock cannot, however, be looked at solely in this narrow context. Frequent recourse to an instrument of this type—and once a start had been made down this road it would be difficult to draw back in future conditions of uncertainty—would create considerable pressure for indexation in the capital markets more generally. There is room for differences of view about how far the introduction of indexed gilt-edged stocks would lead to the spread of indexation through the economy as a whole. But if this were a significant possibility, the authorities would need to be assured that the implications of indexation (e.g. for the tax structure, for the financing of industry, etc.) were fully understood and that the economic and social consequences were acceptable. Whether or not the

generalisation of indexation through the economy would be advantageous is a question that probably cannot be answered in an absolute sense: it would depend to a considerable extent upon the prospect for the development of the economy, in the light of the other available policy options, at the time. But it is not the purpose of this article to discuss that much wider question: the immediate point is that the argument for indexed gilt-edged stocks needs to be made in that wider context, and not considered solely as an expedient to facilitate gilt-edged market management.

Conclusion

56. The purpose of this article has been to explain the evolution of the rôle of gilt-edged market management, and of the techniques and instruments employed, during the past decade or so; and to contribute to the public discussion of certain possible further developments.

57. Present policies have enabled the funding in the gilt-edged market of the Government's borrowing requirement—which has itself been very large—to make an important contribution to the objective of controlling the trend in the growth of the money supply over the past years. Closer month-by-month control over the growth of sterling M_3 is not, however, achievable. One reason for this—but one reason only among others—is because the contribution of gilt-edged funding can be interrupted from time to time as a result of a weakening of confidence among investors, particularly relating to the outlook for inflation and the adequacy of economic and financial policies to contain it, which makes yields seem unattractive. Steps have, however, been taken to secure a smoother flow of government funding and to moderate the effect of such interruptions.

58. The latter part of the article has discussed various suggestions for further change put forward with the aim of improving the authorities' capacity for short-term monetary control, and of reducing the risk of the authorities having to accept interest-rate fluctuations, or to take preventive policy action, not justified by the underlying economic circumstances. Some at least of these suggestions would seem likely to add to, rather than diminish, the short-term volatility of interest rates without necessarily leading to greater stability, or to lower interest rates, over the somewhat longer term. Most of the suggestions that have been put forward would be likely to have far-reaching implications—for the structure and capacity of the gilt-edged market in the longer term, for the nature of the relationship between the Government and the major institutional investors, or for economic management in general—and the question arises whether the objectives aimed at justify such possible consequences.

59. As noted earlier, erratic, short-run, month-to-month fluctuations in the rate of growth of sterling M_3 , or indeed of any other monetary aggregate, may derive

from a number of causes, and are not likely in themselves to be important. Monetary control is therefore properly directed to the trend of monetary growth over a longer period. As this emphasis becomes more widely understood, and provided that investors are convinced that the authorities are prepared to take the steps necessary to maintain this control, unjustified reaction in the gilt-edged market to erratic short-term

fluctuations in monetary growth may diminish. While there may, nevertheless, be scope for further technical changes in gilt-edged market management, which are designed to improve the authorities' capacity for shorter-term monetary control, one cannot properly expect that such changes will serve in place of substantive policy changes that become necessary from time to time in other areas.

MONETARY OBJECTIVES AND PROSPECTS

Note by HM Treasury

This note sets out the Government's present monetary objectives, and some of the implications of seeking to achieve them.

Monetary Objectives

2. The Government is committed to reducing progressively the target rate of monetary growth as the main means of controlling inflation.
3. No one monetary aggregate can satisfactorily measure all aspects of monetary conditions. Moreover, there is an almost inevitable tendency for any aggregate selected as the target to be distorted by the very fact of becoming the target. Nevertheless, there are advantages in selecting one aggregate for which there is a publicly announced target: at present £M3 remains the most suitable for the purpose. But account must be taken of the other measures, M1, M3, DCE, wider liquidity etc, especially given the risks of distortion just referred to, which can affect the £M3 statistic without affecting underlying conditions.
4. As a first step, the Chancellor set a target range of 7-11% pa for the growth of £M3 in the 10 months ending on the April 1980 banking make-up day. We now know that the growth in the first two months of 1979-80 was 2.3%: achieving the mid-point of the range for the following 10 months would give a growth of 9.9% in the year as a whole - virtually the same as the post-Budget forecast of 10.1%.
5. This target is undoubtedly a tight one and was deliberately so chosen. A tight monetary policy is self-evidently one in which the intention is to make money scarce, and necessarily involves holding its price - the rate of interest - high relative to what it would otherwise be. One effect of so doing is to make people more economical in the use of money ie finance their

transactions with less liquidity and thus increase the "velocity of circulation". The change in velocity of circulation implied by the relationship anticipated between the rate of monetary expansion and the rate of growth of GDP in current prices is a good, though imperfect, guide to the increase in the tightening of monetary policy: the post-Budget forecast envisaged growth of the former by about 18.3% and of the latter by about 10%, implying a rise in the velocity of circulation of 8%. While such a change in velocity is not unprecedented, the velocity has already grown substantially over the last 5 years, from the low level to under 2.4 in the first quarter of 1974 to 3.3 at the end of 1978: by the first quarter of 1980 it is forecast to reach 3.5, which is a record.

6. An alternative is to compare the growth of private sector gross financial wealth with the growth of the money supply within that. The greater the deviation from the normal split between monetary and non-monetary wealth the greater the inducement (higher interest rates) will need to be. Total wealth is forecast to grow by about 12%, while the growth of the monetary element in the total is to be kept to 10%. Here again the task is made more difficult by the fact that the change is required after five successive years in which £M3 has grown by less than gross private sector financial wealth: in early 1974 it represented 58% of such wealth while it now represents only 51%.

The Components

7. The "post-Budget" financial forecast envisaged that the components of £M3 in the year might be broadly as follows:-

	£ billion	
	Year 1978-79	Year 1979-80
Public sector borrowing requirement	9.2	8.3 -
Sales (-) of gilts to the non-bank private sector	-6.2	-6.4 -
Sales (-) of other public sector debt to the non-bank private sector	-2.3	-2.0 -
Bank lending in £ to private and overseas sector	<u>6.7</u>	<u>7.0</u>
Domestic Credit Expansion	7.5	6.9

	£ billion	
	Year 1978-79	Year 1979-80
Domestic credit expansion	7.5	6.9
External adjustments	-1.1	-0.5
Increase in banks' net non-deposit liabilities etc	-1.1	-1.1
Increase in £M3	5.4	5.3
% increase	11.6%	10.1%

As the Treasury note on the monetary base explains the above table reflects the accounting identity linking the PSBR, gilt sales, bank lending and external factors to the money supply, and the causal relationship between them is complex. However the critical fact remains that to the extent that there is an overshoot on one element, there will have to be offsetting changes on others if the target is to be achieved. For example there may be some scope for offsetting an overshoot on bank lending by higher gilt sales: the cost would be, of course, yet higher interest rates - and the increase may have to be quite sharp as we are already looking to a high proportion of the inflows into the capital markets to be applied to financing the PSBR, or acquiring the public sector assets to be disposed of. As comes out at a number of points in the papers on the gilt-edged market, the larger the amount to be financed through that market, the less, other things being equal, the freedom of tactical manoeuvre which the Bank has to achieve the funding in the most cost-effective way.

8. A similar point arises in relation to intervention in the foreign exchange market. Although the relationship is not exact, the greater the degree of intervention to reduce upward pressure on sterling, the greater the inflows which add to £M3. (Broadly speaking, it is the inflow into the non-bank private sector which adds to £M3). So if there were significant intervention over the year, it would have to be offset in one or more of the other components.

Interest Rates

9. It is implicit in the decision to have a monetary target that the Government then has to accept the interest rates to go with it: this is no more than the basic economic proposition that one cannot control both the quantity and the price of a good. The interest rates required to achieve the target will be affected by the fiscal stance. Other things being equal, the cuts in public expenditure should, as they take effect, reduce the interest rates which will be required to achieve the target.

10. It is not possible to forecast at all accurately what interest rates will be necessary to achieve a particular target since so much depends on market expectations - about inflation, about future interest rates and about the Government's resolve to carry through its policies. The forecasters best guess at the time of the Budget was that by the end of the year short rates might be somewhat lower than now, and long rates slightly higher. Whether short term rates will fall and if so when, will depend critically on whether bank lending declines as anticipated, and on whether the expected reduction in the PSBR occurs in the second half of the year, with cash limits holding.

11. Direct monetary controls - existing or proposed - are not an alternative to interest rate changes. For example, the extent to which banks can control borrowing from them by rationing, particularly under existing facilities, is limited - they have to rely primarily on the rates they charge. Both the existing Supplementary Special Deposit Scheme, and the proposed monetary base scheme, have to be seen, as the Bank's paper points out, as a means of ensuring that the structure and levels of interest rates vary sufficiently quickly and widely to achieve the control of the monetary targets. Similarly direct controls on bank lending, such as attempted by the Labour Government in the later 1960's, would drive up interest rates at time of pressure.

12. Indeed, the critical limitation of the present gilt-edged market techniques that emerges from the discussion in the other papers is that we at present lack a means of bringing about a shift in long term interest rates when that may appear to be desirable.

Conclusion

13. To sum up:-

- i. while £M3 is the target variable, account will need to be taken of the development of the other monetary aggregates;
- ii. the target set for £M3 this year is a tight one, which will require a "monetary squeeze";
- iii. once the Government has decided on its fiscal stance for the year, and on the monetary target, it has to be ready to move interest rates to the levels which may prove necessary to achieve the target - such interest rates will not always be generated automatically by the markets;
- iv. there may be some scope to accommodate limited changes in one of the components - say higher bank lending or greater intervention in the foreign exchange markets - by offsetting changes in others - say higher gilt sales - but at a cost in terms of higher interest rates;
- v. the prospects for lower short term interest rates later this year depend on the expected declines in bank lending and the size of the PSBR;
- vi. other monetary controls, such as the "corset" and the monetary base control, if there were one, have to be regarded as ways for bringing about the necessary changes in the level and structure of interest rates, not as an alternative to them.

Evan Pt.

PRIME MINISTER

Meeting with Mr. Gordon Richardson: 1630,
Friday, 13 July

You are seeing the Governor tomorrow to have a general chat. You will not want to anticipate too much the Monetary Seminar next Wednesday which of course the Governor will be attending. The Seminar will be considering methods of controlling the monetary aggregates, and in particular the "monetary base" method suggested by Gordon Pepper; and methods of funding the borrowing requirement, particularly the operation of the gilts market. The Bank have recently published articles on the monetary base, and on the gilts market. These are at Flag A; they will be on the agenda for next Wednesday, along with Gordon Pepper's own paper, and papers by the Treasury.

You might like to raise the following issues:-

- (i) Interest rates. Gordon Pepper is expecting that interest rates will fall substantially next year. The Treasury, on the other hand, supported I believe by the Governor, are not so hopeful: the post-budget forecast, which assumes expenditure cuts on the scale the Chancellor is looking for, shows interest rates continuing at Present levels, and even possibly rising a little. The Treasury arguments for this are that high rates will be needed if the Authorities are to sell enough gilts, and in order to persuade people to hold smaller monetary balances against a background of GDP in money terms growing roughly twice as fast as the money supply.

/ (ii)

- (ii) EMS. The Governor will of course be aware that we are reviewing our position on the exchange rate regime. He is likely to favour our joining, whereas the Chancellor has very considerable doubts because of the straightjacket which it would put us in.
- (iii) The overall economic strategy. I am sure the Governor fully supports the Chancellor's efforts to get expenditure back to 1978/79 levels in 1980/81 - though he will probably not be aware of the precise amount that the Chancellor is looking for. You might ask what will be the consequences of not achieving substantial cuts. Is it possible, as even Mr. Nott has argued, that - because sterling is now a "petro-currency" - we could live with a slightly higher PSBR, and still achieve our monetary and other objectives?
- (iv) Asset disposals. How will the Markets react if we sell up, say, £600 m of BP shares in the autumn?
- (v) The effectiveness of the "corset". Gordon Pepper argues that it is both ineffective in holding back Bank lending to the private sector, and that it also distorts the financial system.

One point which the Governor may raise with you is the Stock Exchange's request for exemption from the Restrictive Trade Practices Legislation. This was refused by the Labour Administration, and the Director General of Fair Trading has referred the Stock Exchange Agreement to the Restrictive Practices Court.

/ Mr. Goodison

Mr. Goodison has now applied again to be exempted; and I believe he has the Governor's support. Mr. Nott has so far taken the view - which you have endorsed - that it would be hard to justify not having the Stock Exchange investigated by the Court. The Chancellor, however, has argued that it would be better if there were to be an Inquiry by some other body.

The Chancellor and Mr. Nott are due to discuss the matter shortly. If the Governor does raise it, I suggest it would be best for you to be non-committal.

As background to the meeting, you may wish to glance at my record of your two meetings with Gordon Pepper since the Election (Flag B).

R
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12 July, 1979.

CONTROLLING THE UK MONEY SUPPLY

BY

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CENTRE FOR BANKING AND INTERNATIONAL FINANCE

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Ever since the UK left the gold standard the determination of the UK money supply and its control by the monetary authorities has been a matter of controversy. Under the gold standard the money supply was firmly anchored to the country's gold stock, so that changes in the domestic money supply were related to changes in the gold reserves. Since the UK left the gold standard in 1931, the UK monetary authorities have never attempted to control the money supply by restricting the amount of cash available to the banking system. Rather control has been indirect through the authorities' manipulation of interest rates with cash being supplied to the banking system to meet the banks' needs.

Over the past few years this whole system of control has been called into serious question. Money supply growth has varied widely from quarter to quarter and interest rates have moved rapidly and by large amounts, as shown in Chart I. While variations in money supply growth on a daily or weekly basis are inevitable in view of the large transactions into and out of the Exchequer's account at the Bank of England, Chart I shows, that even when one uses a three month moving average, deviations from the trend rate of growth are disturbingly large. Chart 2 is a comparison of money supply growth variance in the UK and the US showing that deviations about the mean rate of growth are very much greater in the UK than the US. On at least three occasions over the past few years (the summer of 1976, February 1978 and February-March 1979) it has been widely argued that interest rate instability has been compounded because of 'buyers strikes' in the gilt-edged market, which in turn allegedly results partly from the authorities choice of 'tap' prices in gilts and partly from the method of issue.

Such instability is undesirable not just because of the direct effect of unintended excess money creation but also because the published money supply growth rate has become an important indicator of the expected rate of

inflation, with important repercussions in the fixed interest and foreign exchange markets. Because of the problems with the present method of control, two major kinds of proposals for reform have been put forward over the last few years:-

1. Proposals within the present system of control:
 - (a) greater flexibility in fixing tap stock prices, minimum lending rate and the exchange rate;
 - (b) the introduction of new forms of debt, such as longer dated Treasury Bills or index linked stock;
 - (c) replacing the 'tap' system of issuing gilt-edged stock by regular auctions.

2. Proposals for changing the system of control:
 - (d) changing the definition of reserve assets in the banking system so that the Bank of England is able to target the monetary base.

This paper is an examination of the money supply process in the UK and an evaluation of these various reforms. The next section examines various criteria by which we might decide whether or not a particular system of monetary control is efficient. Then we examine the 'official' view of UK

monetary control followed by some of its shortcomings. After that we
examine the various options for reform concluding that there is a
fairly strong case for moving to a monetary base method of control.

1. Efficiency in Money Supply Control

Various criteria might be used for deciding whether a particular system of money supply control was efficient. Three, however, would command fairly widespread support:-

- (i) predicatability;
- (ii) minimum distortions of financial markets;
- (iii) reliance on markets rather than administrative decisions.

A predictable system of monetary control is one in which the authorities know with a high degree of probability that by changing the level of a particular control variable, such as selling a certain amount of gilt-edged stock or calling for an increase in special deposits, they are able to change the growth of the money supply by a specified amount. In an uncertain world the authorities can never be sure of the effects of their actions but some instruments of control tend systematically to have greater predictability in terms of monetary growth than others. The second criterion was the basis for the reforms introduced in the UK banking system in 1971: *Ceteris paribus*, it is more efficient and equitable for the central bank to adopt a method of money supply control which does not create distortions in the financial markets. Distortions imply that resources are being misallocated, that the institutions which bear the brunt of such regulation are effectively being subjected to a form of taxation and that these, taken together, will provide an incentive for institutions to devise ways of getting around the regulations which are socially wasteful. The case for relying on markets (eg.

through purchases and sales of debt) rather than administrative decisions (through reserve requirement changes, the imposition of ceilings on the growth of certain bank assets and liabilities, ceilings on interest rate levels) in conducting monetary policy is that the use of markets leads to less distortion of the monetary time series and permits much greater fine tuning in the adjustment of the monetary base.

2. The Money Supply Process in the UK

The present method of control was stated very lucidly by the Governor of the Bank of England in his Mais Lecture of 1978. The authorities start with some estimate of the public's demand for money and the way it is influenced by income and interest rates. Increases in income raise the demand for money while increases in interest rates reduce it. On the assumption that, in the short term at least, the level of income is given, the authorities seek to change the stock of money by changing interest rates. The process is shown in a simplified and static form in Chart 3, in which the demand for money relative to income is shown as a decreasing function of the rate of interest. If the authorities wished to obtain a money stock of M_0 , they would attempt to move interest rates to r_0 , while if they wished the money stock to increase to M_1 , they would allow interest rates to fall to r_1 . The problem the authorities face in using this approach, however, is that they do not know precisely the amount of money demanded at any given interest rate. In terms of Chart 3, even with a stable demand for money relationship, they can only predict the likely quantity demanded within a range: for example by fixing a rate of r_0 they may be 95% certain of achieving a money supply figure only within the range $\left(\frac{M_2}{Y} \right) - \left(\frac{M_3}{Y} \right)$; what makes matters worse, however, is that on a quarterly basis many estimated demand for money equations have turned out to be more unstable than expected and hence the margin of error is that much greater. Hence for any set of interest rates the resulting money stock will be within a very large range indeed, far too large, for example, to achieve stable money growth within the context of the present governments monetary targets.

As a consequence the authorities fall back on trying to predict at a given level of interest rates and exchange rates the growth of those assets held by the consolidated banking system which are the counterparts to the money supply - which in practice means the size of the Public Sector Borrowing Requirement, public sector debt taken up by the non-bank public, the volume of bank lending to the private sector and external flows to the private sector. The precise relationship between money supply (M_3) growth and those assets which back the money supply can be written as follows:-

$$\text{Change in } M_3 = \text{PSBR} - \text{increase in public sector lending debt held by non-bank public} + \text{bank - external flows to (1) private sector}$$

If the forecast for the growth of these items taken together implies excessive money supply growth, the authorities will have to take action by allowing either interest rates or foreign exchange rates to change. For example, assume that on the basis of such a forecast the authorities decide that M_3 is growing too rapidly. If the cause of the rapid increase is an inflow of foreign currency they will have to allow the exchange to appreciate; if on the other hand it is an inability to sell gilt-edged stock to the non-bank private sector, they will have to raise interest rates and/or call for Special Deposits; while if it is a rapid and sustained rise in the volume of bank lending they can re-impose the 'corset' or make its existing imposition more effective. Within this framework, "the essence of monetary management as I see it, is to act to offset divergences from forecast in these sources of monetary expansion -

difficult to predict and control - as soon as it becomes reasonably clear that inaction is likely to undermine achievement of the monetary target." (Governor of the Bank of England, Mais Lecture, 1978). The task is difficult partly because of the time which it takes to identify deviations from forecasts (largely because of delays in obtaining statistical records) and partly because of the "sheer erratic variability" of the numbers involved. This should not come as a surprise because the instability of these items on the right hand side of equation (1) is simply a mirror image of those factors reflecting the instability of the demand for money.

3. Defects of the Present System

The present system fails rather badly to meet the criteria set out above for an efficient method of control. The first defect of the system is its lack of predictability. Unstable money supply growth and fluctuating interest rates are endemic to the present system of control because of the authorities' difficulties in predicting both the demand for money and the size of the PSBR, also the amount of gilt-edged sales to the non-bank private sector at given 'tap' prices, the change in the volume of bank lending and external flows to the banking sector.

From the authorities' point of view the case for choosing M_3 as the monetary variable to be controlled is that monetary policy is then easily related to fiscal policy (the size of the PSBR), debt management policy (interest rate levels which affects not only sales of public sector debt to the non-bank private sector but also the rise in bank lending) and exchange rate policy (which affects foreign currency assets and deposits). In the short term, however, it is debt management and the level of interest rates which bears the brunt of the adjustment to ensure control of the monetary aggregate in monetary control. For example, if M_3 is rising too rapidly because the authorities are not able to influence the size of the PSBR in the short term, and because the effects of exchange rate changes on currency flows are exceptionally difficult to determine (assuming of course that the exchange rate can be considered exogenous), the major instrument of policy must of necessity be the level of interest rates.

average error in forecasting the gilts demand in any quarter with 95% probability will be in the range $\pm 5.6\%$ - i.e. \pm £2.1 billion! i.e., the authorities can know with 95% probability that if they set a certain price for gilts they can sell a certain amount, plus or minus £2.1 billion. A sale of new debt to the non-bank private sector can be forecast within a band of \pm £½ billion with a probability of only 70%.

The volatility of gilt-edged sales to the non-bank private sector can be seen in Table 1 and Chart 4. Within a particular month gilt-edged sales have varied from £1700 m (January 1977) to net purchases by the authorities of £218 m (April 1977). Chart 4 also shows the effect of the volatility of gilt-edged sales to the non-bank private sector on money supply growth. As can be seen this is especially pronounced at times of so-called "buyers strikes" (summer 1976, April 1977, April 1978) which result in rapid money supply growth, and at times of large sales of gilt-edged stock (December 1976 - January 1977, summer 1978), which result in slow monetary growth and even in early 1977 of an actual fall in the money stock.

Because of the authorities inability to estimate with great precision the non-bank private sector's demand for gilts, the need to ensure that money supply growth is under control forces the authorities to take exaggerated action on the level of interest rates. For example, assume that M_3 is growing too rapidly and that as a consequence the pound is weakening and interest rates begin to rise. For the authorities to bring M_3 growth under control they must induce the non-bank private sector to purchase debt. If they raise interest rates by a small amount they are uncertain of the result. To be sure that

they can sell sufficient debt they must ensure that rates are raised to such a level that they cannot but fall consequently and that, therefore, investors will buy. Which is precisely what happened in December 1976 and February 1979.

A second defect of the present system is the distortion which it creates in financial markets and in particular the need for some form of direct control over bank lending to the private sector. If the monetary authorities do not control the amount of cash in the banking system then the banks can, in principle, increase their lending to the private sector and in turn the total of deposits without limit. This problem becomes acute during a period when the economy is in the upswing of the business cycle and the demand for bank borrowing is rising. At such a time the authorities are faced with a difficult choice: either they allow interest rates to rise to whatever level is necessary in order to choke off the demand for bank loans or else they attempt to limit directly the banking system's ability to make loans.

It is no accident that ever since the UK economy emerged from the Great Depression of the 1930's the banking system has always been subject to some form of non-market to restrict its control over its ability to lend to the private sector.

- during the Second World War the banks were asked to restrict advances except for defense purposes and to avoid credit expansion which would "contribute to any general rise in prices"

- in the immediate post-war years, under both Dalton and Cripps, the banks were asked to restrict credit facilities to conform with government policy
- between 1955-8 there were numerous attempts to control the growth of bank advances including specific requests
- the technique of Special Deposits was introduced in 1958 as a way "to restrain an increase in total bank advances"
- in the 1960's quantitative controls were introduced on three occasions and were in operation for most of the decade
- although Competition and Credit Control was an attempt to dispense with controls over bank lending they were reintroduced in December 1973 in the form of the Special Supplementary Deposit Scheme - the 'corset', which has been introduced twice since then and is still in operation.

The evidence of the UK over this period confirms a simple proposition of money supply theory, namely that unless the authorities are prepared to control the total amount of cash held in the economy (the monetary base) and if they wish to keep the rate of inflation under control, it is impossible for them to avoid placing direct controls over the growth of bank lending.

The distortions created by direct controls over bank lending can be seen in the workings of present 'corset'. The 'corset' is a device which sets an effective limit on banks' ability to expand their interest bearing deposits. Under this scheme all banks in

the UK which observe the 12½% reserve assets ratio are required to make Special Supplementary Deposits at the Bank of England (which pay no interest) if the growth of their interest - bearing eligible liabilities (IBELS) - exceeds a stipulated guideline set by the Bank. The scheme has been put into effect on three occasions: December 1973 - February 1975, November 1976 - August 1977 and June 1978 to the present. It is effectively a device which restricts the private bank's ability to bid competitively for certificates of deposit (C.D.'s) and one of the reasons for which it was introduced initially was to prevent 'round-tripping' within the banking system.

In general terms, the 'corset' has two major effects. First it leads to a distortion of money market interest rates, lowering those in the private sector relative to the public sector, and so making public sector debt more attractive to hold. In this sense it is an alternative to raising interest rates through open market operations and tantamount to a subsidy to public sector capital raising. Second, it leads to increased disintermediation primarily through the use of acceptance credit. If customers are unable to obtain bank loans, their bills can be accepted by the bank and then sold to the non-bank investing public. In this case credit flows are distorted and money supply (M_3) growth artificially held down. Evidence of the effects of the 'corset' can be seen in Charts 4 - 6. A similar pattern emerges on all three occasions, though the effect during the second is less strong, which accords with a view expressed by the banking system and the Bank of England, namely that during this period the banks were not under great pressure to lend because of the effects of high interest rates as well as the fiscal and monetary deflation announced as part of the terms of borrowing from the IMF. The trends which emerge are nevertheless

clear:-

- (a) in anticipation of the imposition of the 'corset' banks increase their IBELS by issuing C.D.'s - hence the ratio of IBELS/Sterling M_3 rises;
- (b) the discount houses increase their holdings of C.D.'s and finance them by borrowing call money from the banks;
- (c) hence both the balance sheets of the banks and discount houses grow rapidly as they hold each others newly issued liabilities;
- (d) after the imposition of the 'corset', the rate of growth of IBELS and C.D.'s falls and the ratio of IBELS/Sterling M_3 falls, as the decline in the growth of IBELS is more rapid than the decline in the growth of M_3 ;
- (e) the restriction on bank lending encourages disintermediation - hence bank acceptances rise as do the discount holdings of bank bills.

It is especially important to notice the way in which the 'corset' distorts the official money supply statistics and hence gives the appearance of the money stock being under control, even though in reality it is simply distorting monetary statistics. To the extent that the 'corset' is effective it is a way of reducing the cost of public sector debt relative to private sector debt.

A third defect of the present system is the increasing reliance which is being placed by the authorities on the use of non-market techniques, notably Special Deposits and the 'corset', in the one case as a substitute to and the other as a complement for sales and purchases of public sector debt in the market. Over the past few years the authorities have made increasing use of Special Deposits as an alternative to open-market operations. As can be seen from Chart 5, the authorities have called for and released Special Deposits as a way of offsetting sales of gilts to the non-bank private sector. From the evidence of the past four years the trigger for a release of Special Deposits is a rise in debt sales to the non-bank public in excess of £700 million averaged over a three month period; while a call for Special Deposits seems to be prompted by sales of less than £250M, again averaged over a period of three months.

A fourth problem with the present system is the distortions created by the peculiar definition of reserve assets. Reserve assets were defined with the introduction of Competition and Credit Control in 1971 to include balances at the Bank of England, Treasury bills, money at call to the discount market, British government stocks with less than one year to maturity, eligible local authority bills and eligible commercial bills up to a maximum of 2% of total eligible liabilities. It is difficult to understand the criteria which the authorities may have used in deciding which were eligible for reserve asset status. Those chosen do not correspond to the traditional banking definition of reserve assets neither are they under the control of the monetary authorities while, if they were intended as a form of prudential control, they were clearly an arbitrary choice.

Defining reserve assets in this way has had two major effects. First, the effect of granting certain assets the stature of reserve assets is to raise the demand for them and so reduce their yield compared to other comparable non-reserve assets. Hence the result has been to reduce the cost of certain categories of public sector debt, such as Treasury bills, local authority bills and gilts of less than one year to maturity, as well as the cost of call money to the discount houses. The second consequence is more serious. Because the definition of reserve assets includes gilt-edged stock of up to one year to maturity, the Bank of England is forced to conduct its active debt management operations in gilt-edged stock greater than one year to maturity. This is because under the changes which formed part of COC in May 1971 the Bank stated that in its operations in the gilt-edged market it would;

- (i) "no longer be prepared to respond to requests to buy stock outright, except in the case of stocks with one year or less to run to maturity", and
- (ii) that it reserved "the right to make outright purchases of stock with more than a year to run solely at (its) discretion and initiative".

The only reason the Bank restricted its ability to conduct effective open market operations in gilt-edged stock of one year or less was because those assets formed part of eligible reserve assets. Defining reserve assets in this way has meant, therefore, that the authorities do not have any debt instruments of less than one year to maturity in which they are able to conduct open market operations. As a

result this has imposed a needlessly heavy burden on the
gilt-edged market. It has also led the authorities to restrict
the private sectors' ability to compete against the public sector
by limiting the interest which can be paid on, for example,
certificates of deposits, which results from the imposition of the
'corset'. In other words the corset is necessary as an instrument
of policy largely because of the curious way in which the authorities
have defined reserve assets.

Options for Reform

Before discussing specific reforms it is important that reforms in general should be placed in perspective. A reform of the monetary system is not a way of reducing high interest rates. If the government pursues an inflationary monetary policy and if the PSBR is large, interest rates will remain high and no amount of monetary reform can ever be a substitute for a reduction in either of these. Similarly, if day to day and week to week there are large and unexpected movements into and out of the Exchequer's account at the Bank of England, there will be large and unexpected movements in either monetary growth or the level of short term interest rates. Once again monetary reform can never be a way of removing the basic uncertainty from the monetary system. In addition, if a future government is determined to achieve a given monetary target but at the same time also attempts to control interest rates and/or exchange rates, such a policy will of necessity create instability and no reform can possibly enable the basic contradictions of its policy to be reconciled.

The fact that monetary reforms cannot reduce interest rates or remove uncertainty from the monetary system or enable governments to control both money supply growth and the level of interest rates or exchange rate does not mean however such reforms are of no consequence. Monetary reforms can achieve both a more stable money supply growth and greater interest rate stability. Large cyclical swings in interest rates created by the day to day and week to week interest rate inflexibility of the authorities is something which could be avoided by monetary reform. Similarly "buyers strikes" and periods of heavy selling in gilt-edged stock, resulting in unstable money supply growth could also be avoided by greater short term interest rate flexibility achieved through various reforms.

A. Reforms within the Present System of Control

(a) Removing Interest Rate Rigidities

This is a change which could be carried out within the present system. For it to be implemented it means that the Bank must accept the logic of pursuing a policy of monetary targets, namely that interest rates are market determined.

In terms of the gilt-edged market it would require a number of changes. First it is necessary to shorten the period of time between the announcement of a new tap stock and the day on which the Bank is prepared to start dealing in the stock. At present new stock issues and tap prices are announced on Fridays (exceptions are variable rate bonds issued to a government department) for which applications are invited by Thursdays for dealing the following day. But during a period of market volatility which results from the market receiving information, this is an unnecessary restriction. Part of the reason for the delay is a Stock Exchange rule which insists on a minimum of two days separation between the announcement of a new issue and the date for application, so that all investors have the opportunity to buy. In the local authority markets the delay is slightly shorter, with new stock issues being announced on Mondays for applications on Thursdays and trading on Fridays. At the very least there is a strong case for devising a system in which the period of time between the announcement of a new stock and the day in which it is dealt in on the market is reduced substantially. Second tap prices should be far more closely related to market prices. At present a tap price is announced at the time of the issue of a new stock and not changed sometimes for many months even though the market

rate of interest may have moved considerably. This would be very much easier to achieve if the Bank were to issue stock in much smaller amounts than they do at present. Third, there is a strong case for the Bank and the UK Treasury following the example of the US Treasury by forming a committee of senior gilt-edged brokers and jobbers to discuss market conditions possible tactics over the setting of tap prices and the choice of new issues.

In terms of the Treasury bill market greater interest rate flexibility would mean that the Bank of England allow the weekly tender rate to be truly market determined, to the extent that at present the Bank persuades the discount market to set a tender price different from that which commercial judgement would dictate, the Bank is merely influencing the short term profits of the market and in the medium term achieving nothing more than changing the time path of interest rates. Allied to this is the Bank's use of Minimum Lending Rate. When MLR was introduced in 1972 the intention was that it should be set at a fixed percentage above market interest rates such that its level reflected current market rates rather than as a device to force the private sector to set certain rates. It was introduced specifically to create greater interest rate flexibility. When interest rates started to rise this proved inconvenient and on certain occasions the formula linking MLR to Treasury bill rate was suspended. Finally in May 1978 the formula was abandoned, the argument being that it "could on occasion lead to undesirable erratic movements in interest rates". (Q&A P.166. June 1978). Hence the present system is almost exactly the same as that which held up until 1972 and which once again gives the Bank greater control over short term rates.

If the Bank is serious in implementing a policy of monetary targets then by far the simplest arrangement would be to set MLR at a fixed absolute per cent above sterling inter-bank rate which is the key short term interest rate in the banking system. This would be far superior to the old formula because through its intimate relationship with the discount houses it was able to bring pressure to bear on the determination of the Treasury bill tender rate, so ensuring that MLR did not adequately reflect the level of market rates.

(b) Auctions for New Issues of Gilt-edged Stock

A major problem under the present system is that a new issue of gilt-edged stock will be completely sold only if the Bank happens to choose a tap price which is precisely the same as that which would have obtained in a free market. If the price is lower the issue will be oversubscribed and those who happen to have bought enabled to earn a capital gain (such as happened in the New Charge riots of March 1979), while if the price is too high, the Bank is left holding a large amount of the stock (which is usually the case) which is then sold on demand either at the current or at revised tap prices. From the point of view of monetary control the system is extremely inefficient since after the Bank has chosen the tap price, the outcome in terms of money supply growth is entirely at the prerogative of investors and especially the large institutions. However good the judgement of the Chief Cashier and however sophisticated the Bank's estimate of the demand function of the non-banking private sector to hold gilt-edged stock, an even money supply growth will emerge from such a system only as a matter of accident.

The case for an auction is that by allowing the market to determine the appropriate price for new stock, the Bank is in a position to determine how much stock it wishes to sell. By varying the amount of stock on offer, at, for example regular monthly or bi-monthly auctions, the Bank is then in a much better position to achieve a more even money supply growth. One could envisage various kinds of auctions. For example, the Bank could sell all gilt-edged stock through a weekly auction, in which the amount of stock on offer per week was related to funds needed by the Exchequer for that week. Or one could envisage a system under which a substantial proportion of the debt was sold at monthly auctions with the rest being placed between auctions under a tap system. Although the UK authorities recently introduced a tender for the issue of a new stock, because they also fixed minimum price it was more a method of ensuring that investors could not make substantial short term capital gains rather than a move towards a regular auction system of issuing debt. Three major objections are frequently raised against moving to an auction system. First, there is the view that one would not know to whom one was selling the stock (banks, non-banks or overseas investors) and that this is important as it has implications for money supply growth. This is correct but would simply mean that the system would be no different from the present. It is a fairly trivial objection. (Incidentally the objection would be redundant within a cash base system of control). Second, and more important is the view of the authorities that it is necessary for the auction to be covered, and that most likely institutions to cover would be the banking system. The objection in this event is that the institutions concerned could form a cartel to secure a lower price and that if the new issue was bought by the banking system acting as a kind of warehouse, to be sold on to the pension funds and insurance companies later, this would have a perverse effect on the money supply. Not only this but if the banking

system found it difficult to pass on the stock it would undermine the major advantage of an auction system, because the authorities would lose control over the timing of bond sales.

It is difficult to understand why a competitive auction needs to be covered. To suggest that the stock on offer would not be bought is to suggest that a slightly higher rate of return in gilts would not induce investors to purchase more. It is very difficult to find evidence (such as the lack of cash flow of the investing institutions or a non-interest rate determined ceiling on their holdings of gilts) which would substantiate this concern. A competitive tender will result in a competitive price. It may not be the price that the government would choose but to suggest either that there will be no price at which all stock will be bought or that such a price could well be quite out of line with the general economic outlook is perverse. The argument that the banking system could form a cartel to exploit the auction is also difficult to accept. In view of the fact that an auction would attract the discount house, the banks, the pension funds insurance companies and jobbers, it is difficult to believe that such a large group could even form a cartel, let alone begin to police it. In any case, any hint that there is collusion among the investing institutions can be dealt with very early by reference to the Office of Fair Trading or the Monopolies Commission. Similarly, the argument that an auction might so disrupt the market that future auctions are difficult to hold is another piece of special pleading. Presumably the only way in which the system could be disrupted would be if it were required to absorb more stock than was prudent given the capitalization of the institutions concerned. It is false to think however that the only institutions who might participate in an auction

would be banks. One would also expect the pension funds and insurance companies to enter, taking on more stock than they might initially require. In this case if the banks were to find that their capacity was being stretched then rates would rise so as to make it attractive for others to take part. In addition the only way in which this system could be stretched would be if fiscal policy were to be very expansionary relative to monetary policy. To the extent that the PSBR were curtailed the problem would not arise.

(c)

Issue of New Forms of Government Debt

One of the authorities responses to criticism of its methods of monetary control over the past few years has been to introduce new forms of debt. In April 1977 they introduced partly paid stocks and in July 1977 variable rate stocks. The two major innovations which have been suggested is that they should introduce (i) some short dated instrument such as a six or nine month or even one year Treasury bill, or a bill which is excluded from the definition of reserve assets, and (ii) indexed debt. The advantage of a short term instrument which was not classed as a reserve asset is that it would carry a higher rate of interest as it would be in direct competition with private sector short term debt and that it could be used by the authorities to conduct an instrument such as this is that it eases the restrictions imposed on the authorities by their definition of reserve assets.

The concept of indexed debt is a more far reaching idea.

There is nothing new in the idea as it was proposed by Keynes in to the Royal Commission on taxation.

Similarly government bonds have been indexed in a number of countries: Argentina (1972), Austria (1953), Brazil (1964), Finland (1945 - 67), France (1952-8, 1973), Iceland (1955), Israel (1948), Sweden (1952), United States (1742). In the context of monetary control the case for indexing is that at a time of inflation and interest rate uncertainty it would enable government to sell debt more easily than at present as it would provide investors with a ledge against long term interest rate increases resulting from a higher expected rate

While each of these reforms would be of some benefit) none of them really attack the root cause of the present problems which is the deficient framework underlying the money supply process. Other reforms have been suggested, however, which do attack the problems and they usually concern the introduction of a monetary base or some similar method of control, which involves the authorities in controlling the cash reserves of the banking system directly.

B. A Monetary Base Method of Control

Much as under the gold standard, a country's gold reserves imposed a constraint on money supply creation by the banking system, so in the present world of floating but managed exchange rates control of the monetary base by central banks could also be used to limit the banking system's ability to create money and credit.

The monetary base consists of those assets which are used by the banking system to settle inter-bank debts and by the public as non-deposit money; put differently they are those liabilities of the monetary authorities which are used as money. The base is derived from the consolidated balance sheets of the monetary authorities which in the case of the UK would involve the balance sheet consolidation of the Bank of England, Treasury (including The Exchange Equalization Account) and the Royal Mint. It can be defined in terms of either the liabilities (or 'uses' of the base) or the assets (or 'sources' of the base) of the consolidated balance sheets. The 'uses' of the base are notes and coin held by the public and the banking system (excluding the Bank of England) plus bankers deposits at the Bank of England. Such a definition specifically excludes special deposits and public sector deposits at the Bank. The 'sources' of the base show the three main ways in which the monetary authorities create or destroy base money: namely lending to the private sector, (mainly discounts and advances to the money market), lending to the public sector (largely government securities) and lending to the foreign sector (foreign exchange reserves).

To be rather more precise, in the UK the sources of the base are Bank of England's holdings of government securities, advances and other accounts, the holding of other securities plus Treasury currency outstanding minus public deposits at the Bank, Special Deposits at the Bank and reserves and other accounts. The gold and foreign exchange reserves are not included explicitly as they are in other countries, because the reserves are officially recorded in the Exchange Equalization Account, which is a Treasury account managed by the Bank. Any inflow or outflow of foreign currency, however, will, because of the mechanics of the EEA be reflected in the Bank's holdings of government securities. For example, a foreign currency inflow to a UK resident will lead to an increase in bank deposits and the money supply, an increase in bankers deposits at the Bank of England and an increase in the Bank's holdings of government debt as it sells the newly acquired foreign exchange to the EEA in return for government securities.

The major significance of the monetary base is that it forms the foundation for money supply creation. Currency is an important part of the public's money which is necessary for day-to-day transactions: similarly banks need currency in order to exchange currency for deposits and deposits at the Bank of England to settle inter-bank debts. If cash within the banking system is limited, then regardless of the private sectors demand for advances, its ability to expand its lending and in turn the volume of deposits is limited. It could either bid currency away from the public (which is extremely difficult) or it could reduce the proportion of its assets which it chooses to hold in the form of cash. Because both of these courses of action are limited, the money stock will be constrained by the size of the monetary base. It is worth emphasising that although the monetary base

approach is sometimes put forward in rather mechanistic terms the outcome in terms of money supply growth depends on the behaviour of both the banking system and the non-bank and in this sense a rather simplified presentation is very much a first approximation.

The base is also important because it is money which is 'produced' by the monetary authorities and by no one else. In fact the authorities have a total monopoly over its supply, i.e. the amount of notes and coin plus bankers deposit at the Bank of England which are created is at the sole discretion of the monetary authorities. In this sense, the monetary base is very different from the current collection of reserve assets, in that a number of these can be created by the private banking system independently of the actions of the monetary authorities*.

Because the money supply is the result of the interaction between the public and the banking systems demand for base money, and the amount of such money which the authorities are prepared to supply, control of money supply is a much easier business for the authorities than at present. Unlike the present system in which the Bank has to predict the demand for money and the size of the various counterparts of the money supply (PSBR, gilt-edged sales, growth in bank lending, external flows) under a cash base system it would have to predict just two magnitudes - the public's demand for currency (which although seasonal is very stable) and the banks excess cash reserves, (assuming that is that the banks were required to hold a certain proportion of their assets in the form of cash).

* It was in recognition of this that commercial bills are included in reserve assets only up to 25% of bank deposits and that the regulation of the discount houses was changed in July 1973 in order for the Bank to reassert control over reserve asset creation.

The monetary base is also important in that it records more accurately than any other variable the monetary implications of the combined actions of the government and central bank. If the government sells gilt-edged stock to either the banks or the public the base will fall; if the Bank discounts bills for the discount market the base will rise; if the Bank pegs the exchange rate and is a net buyer of foreign currency, the reserves will rise and so will the base; if the Bank takes up stock from the government to finance its excess spending the base will rise. Any action of the authorities which is expansionary will be reflected by an increase in the base, while any action which is contractionary will result in a fall in the base. In this sense, the size of the base depends on the actions of the authorities and not the private sector. For this reason the base is superior to minimum lending rate, Treasury bill rate, the growth of bank advances or the money supply and the size of the PSBR as an indicator of the monetary actions of the monetary authorities. Not only is the base unaffected by the behaviour of the private sector but in addition all of the monetary actions of the authorities in the domestic money and capital markets and in the foreign exchange markets must be reflected in the base.

Base Control and Institutional Changes.

A change to a monetary base system in the UK would require certain institutional changes. These would consist of:-

1. Eligible reserve assets for the banking system would have to be re-defined to include only:
 - (a) notes and coin in bank tills plus;
 - (b) bankers deposits at the Bank of England
(excluding Special Deposits)
2. The existing 12½% reserve asset ratio would be abolished.

3. The Bank would announce an explicit target for the rate of growth of the money stock and then control the monetary base, by co-ordinating the activities of the Discount office, Government, Broker and foreign exchange operations to achieve target growth.

It is important to notice that the imposition of a uniform cash ratio in place of the present reserve asset ratio is not necessary to a monetary base method of control. A banks' demand for base money (ie., their cash ratio) depends on the maturity structure of deposits, the frequency of cash withdrawal, the opportunity cost of holding cash - day to day interest rates, and the banks' aversion to risk. As these will differ from bank to bank, so will each banks desired cash ratio. However a uniform cash ratio is not necessary for monetary control; all that is required is that banks' demands for cash are reasonably stable, because as in this case the central banks would know that by changing the base it would have a predictable effect on money supply growth. If the Bank were to impose a cash ratio the major argument would most probably be on grounds of prudential control, which one suspects is the major case for the present 12½% reserve asset ratio; as this is in no way important for the present method of control.

Another point about the monetary base is that it can just as well be expressed in terms of fiscal, debt management and exchange rate policy as can M_3 . Derived from the consolidated balance sheets of the banking system the following identity holds:-

$$\text{Change in Monetary Base} = \text{PSBR} - \text{Sales of Government debt to private sector} + \text{Change in Gold and Foreign Exchange Reserves}$$

Within this framework an increase in the size of the PE and the

gold and foreign exchange reserves will ceteris paribus increase the monetary base while a sale of public sector debt, either to the banks or non-bank private sector will reduce the base. The important point about equation (3) however is that it enables policy making to relate monetary policy to exchange rate fiscal and interest rate policy just as easily as under the present system.

Technical Aspects of Base Control

Under a cash base method of control the money supply can be described as follows:

$$M = m B$$

in which M is the money stock, B the monetary base and m the money supply multiplier. Within this framework the growth of M is the result of two factors: the growth of the monetary base B which depends on the fiscal and exchange rate policy of the government and which depends on the behaviour of the public's demand for currency and the banking systems demand for cash reserves. Using symbols this can be written approximately as:

$$\frac{\dot{M}}{M} = \frac{\dot{m}}{m} + \frac{\dot{B}}{B}$$

where

$\frac{\dot{M}}{M}$ = growth rate of the money stock

$\frac{\dot{m}}{m}$ = growth rate of the multiplier

$$\frac{\dot{B}}{B} = \text{growth rate of the money base}$$

From the authorities point of view forecasting the growth of the money supply involves forecasting the money supply multiplier, m and then using either sales and purchases of government debt or foreign currency to offset variations in the monetary base to achieve the desired target.

Various methods can be used to predict the money multiplier. One is to develop an elaborate structural model of the financial sector of this economy examining in detail the portfolio adjustment of the banking system and the public and then to derive the multiplier from the estimated values of the structural coefficients. Another is that used by the Federal Reserve Bank of St. Louis and until 1976 by the Swiss National Bank namely a single equation estimate of the money supply multiplier. Various estimation techniques, ranging from simple regression to Box - Jenkins analogy have been used to estimate the multiplier in this kind of approach. Yet another approach is that which has been used by the Swiss National Bank since 1976. Because in Switzerland the monetary base has behaved in a volative way, largely the result of short term capital movements, the National Bank has found that the banks do not adjust immediately their earning assets to changes in the base. Instead they decide whether the change in the base is likely to be temporary or permanent and adjust their behaviour only if they consider the change permanent. Within this approach both the growth of the base and the money stock can be divided into permanent and transitory components. Hence:-

$$\frac{\dot{B}}{B} = \frac{\dot{B}_D}{B_P} + \frac{\dot{B}_T}{B_T}$$

$$\frac{\dot{M}}{M} = \frac{\dot{M}^P}{M^P} + \mu$$

and

$$\frac{\dot{M}^P}{m^P} = \frac{\dot{m}^P}{m^P} + \frac{\dot{B}^P}{B^P}$$

where

$\frac{\dot{B}^P}{B^P}$ = permanent component of the monetary base

$\frac{\dot{B}^T}{B^T}$ = transitory component of the monetary base.

As a result of substituting in these equations the growth of the money multiplier can be written as:

$$\frac{\dot{m}}{m} = \frac{\dot{m}^P}{m^P} + \frac{\dot{B}^P}{B^P} - \frac{\dot{B}}{B} + \mu$$

which states that the growth in the money multiplier is equal to the growth in the permanent component of the money multiplier plus the permanent component of the growth rate of the base minus the actual growth rate of the base plus a stochastic element. In the Swiss National Bank model the banks are assumed to form their expectations about the extent to which a change in the base is permanent or transitory on the basis of past information. Hence the forecasting equation for changes in the money multiplier relates to past changes in the money multiplier and past changes in the base.

Using this approach the Swiss National Bank have found that the adjustment of the money stock to the monetary base is sluggish. In the very short term a change in the monetary base has no effect on the money stock. If the intention is to influence money supply growth then this implication of the Swiss approach is that the monetary base should be changed in very small steps.

Objections to the Monetary Base

- (1) "It would lead to unacceptable fluctuations in short term interest rates"

The introduction of a monetary base method of control would almost certainly result in greater short term fluctuations in interest rates than at present, as the Bank would no longer intervene in markets to prevent rate changes. However, the benefit of this would be to avoid the large swings in rates which we observe at present, because the Bank would no longer allow monetary growth to diverge so far from target and hence for expectations to form which ultimately require an even greater adjustment of rates than in the very short run. The choice, therefore, is not between interest rate stability within the present system and interest rate instability under a cash base approach but between frequent and relatively small interest rate adjustments in a cash base system and less frequent but much larger interest rate movements in the present system.

- (ii) "It would undermine the Banks' role as lender of last resort"

As lender of last resort the Bank provides cash to the banking system on a temporary basis and at a penal rate of interest. It is fallacious to argue that because the Bank extends advances or re-discounts bills to the banking system it is therefore unable to control the monetary base. In the short term the monetary base will deviate from the target to the extent that credit granted by the Bank as lender of last resort is not offset by sales of gilt-edged stock. However if the

Bank were to target a three month moving average there is no reason why acting as lender of last resort to relieve the market of a temporary shortage of cash would undermine base control carried out within such a fine dimension. For the system to operate efficiently, however, it would mean that the Bank would need to use the rediscount facilities for the purpose for which they were intended and not as alternative to open market operations.

- (iii) "Most other central banks control the money stock through interest rates"

Of the world's major central banks only the Swiss National Bank has targeted the monetary base explicitly. Nevertheless, there is a very important difference between the use of interest rates as a means of money supply control in countries such as the US and Germany on the one hand and the UK on the other. In the US, for example, bank reserves are defined as cash reserves and the growth of cash reserves or the monetary base are seen by the authorities as having a critical influence on the growth of the money supply. Interest rate policy is used, therefore, by the Federal Reserve as a means of controlling the growth of the cash reserves of the banking system. This is in sharp contrast to the UK, where interest rates are seen as affecting the demand for money and as changing the growth rate of various components of the money stock.

- (iv) "It would involve institutional change"

From a practical point of view this is likely to be the most powerful argument against change. At the time Competition and Credit Control was introduced, the Chief Cashier stated quite categorically that

"In framing the proposals in Competition and Credit Control it seemed to us that our objectives could be met without structural change because despite what the critics may say, that structure serves the interested parties very satisfactorily". If the 'interested parties' is intended to include the public interest as well it is doubtful if such a statement could be made at present. Yet if a cash base system of control were to be introduced this would necessitate a change in the definition of reserve assets, which would remove the interest rate advantage obtained by call money because of its reserve asset status, and in all probability lead to a loss of business for discount houses. This in turn could produce mergers and a desire to diversify the business conducted by discount houses. Similarly a change in the method of issuing gilt-edged stock which would also be a desirable concern and to moving to a monetary base would almost certainly lead to a decline in the income of jobbing firms. As the number of firms has fallen significantly over the past two decades, a substantial drop in income could threaten the viability of jobbing and it might conceivably undermine ultimately the system of single capacity throughout the Stock Exchange.

While one has to accept that the authorities might face some difficult problems if changes such as those mentioned above were introduced, they nevertheless also have to accept that it is difficult to justify the present structure if it involves imposing artificial requirements which are effectively a form of subsidy. In our view, it would be far preferable for all concerned if the discount houses and jobbers' role in the present system of monetary control arose not from certain arbitrary requirements (such that call money defined as a reserve asset or that all deals in gilt-edged stock have to pass through the hands of jobbers) but from a straightforward commercial viability based on comparative advantage.

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Chart 0 Derivation of the Monetary Base

Definition Monetary base = currency held by public and banks plus
bankers deposits at the Bank of England

The UK Monetary Base, June 1976

Sources of base

Bank of England credit
Government securities
Advances and other accounts
Other Securities
Treasury currency outstanding
Public deposits at Bank of England
Special deposits at Bank of England
Reserves, other accounts
Error term

Uses of base

Currency held by public and banks
Bankers' deposits at the Bank of England

12 JUL 1979





Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

THE INTERNATIONAL CURRENCY SITUATION

It may be useful as background to the weekly meetings which we are to have if I send you a short note about the international currency outlook and the implications which it might have for us.

2. The key issue is the position of the dollar, which is still overwhelmingly the main reserve currency. It is also the main currency of international trade, including the oil trade: and of international borrowing. In the early part of this year the dollar was firm. Countries which took large quantities of dollars into their reserves in 1977/78 were selling them again on a massive scale - the main countries sold over \$16 billion in April and May alone. However, in the second half of June the dollar weakened and the seven important countries operating in the exchange markets bought \$6 billion net. This month purchases of dollars have continued, though at a somewhat slower pace.

3. We cannot be sure how the dollar will perform during the second half of this year. The question is whether the factors making for a stronger dollar (like a decline in the US growth rate or evidence of determination to tackle oil imports) prove stronger or weaker than adverse factors (like US inflation,



doubts about the firmness of policy of the US Administration, the course of oil prices, delay in reducing the US current account deficit because of the high cost of oil imports; or a further narrowing of the important interest rate differential between the United States and Germany). There are signs that the Germans fear a further weakening of the dollar later in the year.

4. If the dollar does weaken, the question how far Germany will be ready to help, either through market intervention or interest rate policy, could be critical. The decision could well be a more difficult one for the Germans than it was in 1977 and 1978 when they took large quantities of dollars into their reserves. This time inflation is rising, not declining, in Germany. They will be reluctant for counter-inflationary reasons both to hold down the value of the mark and to risk inflating their money supply ("importing US inflation" as they would put it) either by large scale intervention or by lowering, or even holding down, their own interest rates. The line which the Bundesbank has been taking on all three points in the first half of this year in the interests of fighting inflation has been causing difficulty to Germany's partners in the EMS.

5. The international scene may not develop like this. For example, the risks to the dollar could be a good deal less if pressure on the oil price eased. But, if pressure on the dollar did continue, that could have implications for us. It might make it more likely that sterling would remain strong (which could lead to inflows which would tend to increase the money supply).

6. It would certainly affect the operation of the EMS and might well strengthen pressures for realignment. It could in these circumstances have a bearing both on our own decision about entry to it and on the attitude of our European partners to early UK entry. It would probably tend to lead to a higher average international level of interest rates, and that could react on

S E C R E T



the UK. It could encourage discussion of (partial) alternatives to the dollar as reserve and trading currency, and we would be involved in this. But there would also be important political implications from signs of US economic weakness, which I do not think we would welcome. We must hope that the course of the dollar will in fact be more favourable, but there is a strong link here to oil and all the matters we were discussing in Tokyo.

A handwritten signature in black ink, appearing to be "G.H." with a stylized flourish.

(G.H.)

11 July, 1979

S E C R E T



11 JUL 1979

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SECRET



file 16
Evan Pol

10 DOWNING STREET

From the Private Secretary

6 July 1979

The Prime Minister has read your letter of 3 July in which you set out the Chancellor's suggestions on the agenda for the Monetary Seminar. She is content with the Chancellor's suggestions.

I am sending a copy of this letter to John Beverly (Governor's Office) and to Martin Vile (Cabinet Office).

T. P. LANKESTER

M. A. Hall, Esq.,
H.M. Treasury.

SJP

Extract from P.M.'s Meeting with Gordon Pepper 4.7.79.

Eun Pei

II. Gilt-edge Funding

Mr. Pepper said that the Bank should have been concentrating to a greater extent on shorter dated stock. Their failure to announce a new short tap immediately after the Budget had been a great mistake. Following the announcement of the MLR increase, they had dropped the price of the long tap by 5½ points. This had caused a shambles amongst the Jobbers and Brokers, and with the shortage of short dated stock it had resulted in a very unsatisfactory yield curve - with yields at the shorter end far below yields at the long end. Both the existing tap stocks were now exhausted and the question arose as to what new stocks should be announced. Mr. Pepper's own view was that it would be right to issue both a new long and a new short stock - perhaps £1 billion of each. But the Bank should try to sell the short stock more vigorously than the long stock and establish a smoother yield curve. The institutions were currently rather short of liquidity, while the corporate sector was reasonably liquid: so this concentration of the shorter end should be feasible. It might also be a good idea for the Governor to indicate in a forthcoming speech that the Bank were going to concentrate more on the shorter end.

III. Money Supply

Mr. Pepper said that it was very difficult to estimate at this stage what the June banking figures would look like. There was a good deal of anecdotal evidence that bank lending to the private sector was continuing at a high level but this was not necessarily conclusive because of the window dressing by the banks for their half-yearly make-up. Nonetheless, he continued to be very worried about the money supply figures. The recent heavy sales of gilts were likely to have been offset by continued private sector lending at a high rate. The latter was suggested by high retail sales, for example, of cars. The main element in this was likely to be personal lending; corporate loan demand by contrast, which always lagged at this stage of the cycle, was likely to be running at a reasonable level.

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V. Sterling

Mr. Pepper said the continued upward pressure on sterling was a real worry: the sterling dollar rate above \$2.20 would make it impossible for many industries to stay competitive. However, because of money supply worries, it would not be possible to hold sterling back by reducing interest rates in the near future. This must be achieved by a further early relaxation of exchange controls. The latter might have a perverse effect in the short run, but in due course it would take some of the pressure off sterling.

72..

c.c. Mr. Wolfson

Subject file
Econ 107- May 79
Mtg with Gordon Pepper

5 July 1979

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cc JOHN HOSKYNs
Wolfson
Mr James

Econ. Pal.



Copies can be found in
1) Muster Set Records.
2) Housing: Organising
+ structure of Building Societies.

10 DOWNING STREET

From the Private Secretary

4 July 1979

Dear Tony,

The Prime Minister held a meeting this afternoon to discuss building society mortgage rates. The Home Secretary, Chancellor of the Exchequer, the Secretary of State for the Environment, the Financial Secretary, the Governor, Sir Douglas Wass and Sir John Hunt were present. The following are the main points which came up in discussion.

The Governor first described the monetary and interest rate background to the reports that mortgage rates are likely to rise. Banking figures for June were not yet available, but it seemed likely that lending to the private sector had continued at a very high level - between £700 and £900 million. The Government's funding programme, particularly over the past few days was going well; but the continued high level of private sector lending meant that the money supply was continuing to grow at about 13% at an annual rate - significantly higher than the 7-11% monetary target. The increase in MLR in the budget had been primarily designed to arrest the recent increase in bank lending, but this was unlikely to have a quick impact. It was essential for the time being to maintain MLR at its present level until the reduction in bank lending began to come through. To make any reduction now would suggest that the Government were no longer determined to maintain its policy of monetary discipline, and would make it impossible to achieve the monetary target. On the other hand, there was a good case for a release of special deposits which would help to keep short term rates down: because of the recent gilt sales, the banks were facing a liquidity squeeze and this was forcing up short term rates. With a special deposit release, short term rates would be prevented from rising any further, and this would be helpful to the building societies. He hoped that it would be possible to make an announcement either tomorrow or next Wednesday.

The Prime Minister said that she accepted that, in view of the worries about the money supply, it would not be possible to reduce MLR immediately. However, she was determined to avoid any increase in the mortgage rate. Any increase would mean a further rise in the RPI, which would be seen as Government induced; and this would be politically very damaging. If the mortgage rate rose at all, it was likely to go above 12½%, which would be

/ higher

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higher than it had been in 1976. Home owners would not understand why the rate had to be higher than it had been then, when the economic situation was now so much better. The reduction in the composite rate should give the societies some extra liquidity; and if they had to cut back their lending, this would be no bad thing in view of the recent escalation of house prices. Some means had to be found to prevent the societies from increasing their rates.

The Chancellor said that the Government's commitment to monetary policy would be fatally impaired if there was any attempt to hold down interest rates by artificial means. He agreed with the Governor that it would be quite wrong to reduce MLR: if building society rates went up, the Government could argue that this was still part of its inheritance from Labour. However, a increase in their rates was still not inevitable. The release of special deposits would tend to hold short term rates back; the societies could be told that there was the prospect of MLR and interest rates generally falling; they could be told that a short term mortgage famine would not be altogether unacceptable; there was the possibility that they could draw on their substantial liquidity; and the reduction in the composite rate should assist them.

The Prime Minister then reiterated her view that any rise in the mortgage rate would be politically disastrous. She disagreed that it would be possible to argue that this was part of the inheritance. The pre-budget spending spree, which appeared to have continued, was all too likely to be attributed to the new administration; and this had clearly influenced the level of private sector borrowing. She was opposed to any subsidisation of the societies' interest rates. But the Government should be prepared, if necessary, to lend them money on the condition that it had to be repaid during this financial year. This would be on the lines of the scheme put together by Mr. Harold Lever in 1974.

The Financial Secretary pointed out that a lending scheme could be very costly in terms of public expenditure if interest rates failed to fall and the societies were unable to repay. The cost might be as high as £750 million. The Secretary of State for the Environment commented that home owners were already subsidised, and that on existing mortgage rates there was already a substantial queue of potential borrowers. The recent spending spree suggested that people had money in their pockets, and that an increase in the mortgage rate would not be as politically damaging as the Prime Minister had implied. He was opposed to a loan scheme for the same reasons as the Financial Secretary; and he would prefer to see the mortgage rate rise so as to maintain the current level of lending for the sake of the construction industry.

After further discussion, it was agreed that there was a reasonable prospect of persuading the societies to hold their interest rates at present levels at least until September. But they would need to be pressed hard; and the arguments mentioned by the Chancellor would have to be put to them persuasively. It would be important to get an undertaking from them that they

/ would give

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would give the Government advance warning before deciding to raise their rates. The Government should have ready, on a contingency basis, a loan scheme which would be implemented if the societies did decide to increase their rates.

Summing up the discussion, the Prime Minister said that there should be no early reduction in MLR, but action should be taken to release special deposits; the amount and timing of the latter should be left to the Governor and the Chancellor to decide. The Secretary of State for the Environment, accompanied by the Financial Secretary, should see representatives of the building societies urgently and should seek to persuade them not to increase their rates. They should in any case obtain from the societies an undertaking that Ministers would be given due warning of an increase. At the same time, a contingency plan should be drawn up to provide loans to the societies in case they insisted on putting up their rates; but a decision to implement this plan would need to be considered in the light of further developments. The societies should not be told that this contingency plan was being prepared.

I am sending copies of this letter to John Chilcot (Home Office), David Edmonds (Department of the Environment), Paula Diggle (Financial Secretary's Office), John Beverly (Governor's Office), Nick Sallnow-Smith (Sir Douglas Wass's Office) and Martin Vile (Cabinet Office).

Yours ever,

Tim Laker.

Tony Battishill, Esq.,
H.M. Treasury.

SECRET



Prime Minister
This seems a
good agenda for
the monetary seminar.

Treasury Chambers, Parliament Street, SW1P 3AG Are you content?
01-233 3000

Yes

TL

3rd July 1979

Tim

5/7

Dear Tim,

MONETARY SEMINAR

You said that the Prime Minister would welcome the Chancellor's suggestions on the agenda for the meeting, and on the papers which might be tabled.

The two main items which we understand the Prime Minister wants to discuss are the suggestions for a "monetary base" control and the methods of funding the borrowing requirement, particularly in the gilts market.

to follow

The paper by Bank of England economists on monetary base, of which the Prime Minister is aware, has now been published in the Bank of England Quarterly Bulletin. The Treasury economists are completing their paper on this subject, which the Prime Minister commissioned. This was prepared after various discussions with Brian Griffiths, Geoffrey Ward and Gordon Pepper. Brian Griffiths has also let the Treasury have an advance copy of a paper which he has written on this subject. The Chancellor would suggest that the papers for the monetary base item on the agenda should therefore be the Bank of England paper, the parallel paper by Treasury economists, Brian Griffiths' paper and, of course, Gordon Pepper's contribution in Greenwell's Bulletin.*

Similarly the Bank have just published a survey article on methods of operation in the gilts market, which comments on the various proposals which are being made for changes in that market. The Chancellor has asked the Treasury to prepare a complementary paper covering the funding of the PSBR as a whole. He would suggest those two papers, plus the relevant parts of Brian Griffiths' paper for that item on the agenda.

/The Chancellor

T.P. Lankester, Esq.,
No.10, Downing Street

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The Chancellor also thinks that it would be useful to have a paper setting out the Government's monetary objectives and what may be involved in achieving them, in order to put the discussion on the two particular aspects of monetary policy into context; such a paper is therefore also being prepared here.

If the Prime Minister is content with these proposals, the Chancellor would hope to send her the papers on Friday, 13th July so that they are available for weekend reading.

I am copying this letter to John Beverly and Martin Vile.

Yours ever,

Martin

(M.A. HALL)

* I now enclose Greenwell's latest Bulletin dated 2 July - very opportune, and suitable as one of the papers for consideration.

SECRET

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Telephone: 212 832 7428 Telex: 710 5815122



A MONETARY BASE FOR THE U.K.

A PRACTICAL PROPOSAL

*A supplement to our Special Bulletin of 2nd March
proposing changes to the present monetary system*

We welcome the publication of the special article on "Monetary base control" in the latest Bank of England Quarterly Bulletin.

The authors of the article, M.D.K.W. Foot, C.A.E. Goodhart and A.C. Hotson, start by explaining that the various proponents of monetary base control often have widely differing proposals in mind. Most of their subsequent criticisms are about the more extreme and impractical proposals. What follows is, we believe, a middle-of-road and workable proposal.

The broad features of our proposed scheme are that the present control system of reserve asset ratio supported by the corset should be abolished and, in its place, banks should be required to hold deposits with the Bank of England. A clearing bank should be allowed to hold the deposit on behalf of a non-clearing bank if the latter so wishes.

The monetary base is the name given to the total of these bankers' deposits with the Bank of England. Foot, Goodhart and Hotson appear to argue that an undesirable feature of monetary base control would be that only the authorities could determine the size of the monetary base. For example, banks would not be able to increase their reserves by selling Treasury bills unless the Bank agreed to buy them. It is not clear to us why this might be thought undesirable; it seems a positive advantage for a control mechanism.

P. G. E. Greenwell
R. H. Lawson
C. E. Frappell
G. T. Pepper
The Lord Annaly
The Lord Renwick
J. A. Rickards

L. Gooderham
T. Quinn
A. T. Boanas
M. T. Higgins
D. G. Thomson
H. N. Seely
T. G. Wakeley

J. F. R. Hammond
J. Wigglesworth
E. J. Fenton
A. J. Bonner
N. S. King
G. P. P. Stewart
K. P. Joseph

A. G. P. Davidson
P. D. Jones
R. L. Thomas
K. C. Brown
J. C. Finch
S. J. D. Posford
K. G. Sykes

R. W. Walker
W. E. A. Bain
R. M. Harvey
R. B. Pomphrett
M. R. F. Wonfor

Associated Members
O. J. Olcay (U.S.A.)
Graham H. Greenwell

Monetary control

There is general agreement that the money supply should be controlled. If the authorities succeed in doing this, they cannot simultaneously control either interest rates or the level of sterling by direct intervention in the markets. Fluctuations of these in the short term (but not in the longer term) will inevitably be larger than under a regime where the money supply is not controlled. Foot, Goodhart and Hotson point out this disadvantage, but it applies to all methods of controlling the money supply, i.e. whether monetary base control is used or not. In our opinion, however, the short term fluctuations in interest rates will probably be smaller under our proposed system than is the case under the present system, because of the artificialities of the latter.

Firm foundation

Our objective in advocating a monetary base method of control for the U.K. is not to replace the published target for sterling M3 by one for the monetary base (M0). Instead, it is to replace the present quagmire with a firm foundation on which to build monetary policy. With M0 controlled, relative interest rates should be altered and other weapons used (e.g. fiscal policy, bank lending policy, gilt-edged policy) so that retail M1, sterling M3 and the broader definitions of the money supply all grow at rates which are consistent with the desired behaviour of national income in nominal terms. For example, if sterling M3 is behaving appropriately but the non-bank private sector's holdings of Treasury bills are growing rapidly to produce an excessive M4, then relative interest rates should be adjusted to persuade holders of Treasury bills to switch into gilt-edged stock. Both liquidity, in the Radcliffe Committee's sense, and the narrower definitions of the money supply ought to be controlled.

Our aim is to improve the authorities' control over the whole financial system. This is in contrast to the intention of those commentators who are in favour of publishing monetary targets only because it helps to reduce inflationary expectations. Whilst it is certainly desirable to reduce inflationary expectations, it is also essential to secure financial discipline. Further, if a central bank tries to control just one monetary aggregate, that aggregate very often becomes distorted; as Goodhart's Law states, the previous relationships between the aggregate and other variables break down. Paradoxically, the behaviour of the monetary aggregates which the central bank is not trying to control is often a better measure of the underlying stance of monetary policy than the behaviour of the aggregate which it is trying to control. Our focus, therefore, is the control of the whole system and not something which may become cosmetic. We repeat that retail M1, sterling M3 and the broader aggregates should all grow at rates which are consistent with the desired behaviour of national income.

The details of a monetary base system should be chosen so as not to penalise the domestic banking system relative to near-banks and off-shore banks. A horrible example of what can happen is currently occurring in the U.S., where no interest is paid on the reserves which banks who are Members of the System must deposit with Federal Reserve Banks. This prevents Member Banks from competing with near banks, non-Member Banks and off-shore banks when interest rates are very high. Member Banks have started to defend themselves aggressively. The result is a proliferation of money substitutes. The growth of these substitutes is swamping the growth of the money supply as officially defined. Currently, the official monetary indicators in the U.S. are not merely distorted; the monetary barometer is broken.

To stop a similar occurrence in the U.K. the level of reserves which banks should be obliged to place on deposit with the Bank of England ought to be close to the appropriate prudential level, and the Bank ought to pay a commercial rate of interest on most of them. If this were done, the market clearing rate of interest would affect the profit margins of banks, near-banks and off-shore banks equally.

The level of reserves

To prevent banks managing their liabilities to circumvent the control mechanism, there is a strong case for a common reserve ratio for all deposits, whether they are sight or time, large or small. The exclusion of vault cash (till-money) from the official definition of reserves means that sight deposits would in practice need larger reserves (reserves with the Bank plus vault cash) than time deposits. To secure equity between different types of banks, it would be inappropriate to pay the full commercial rate of interest on reserves backing non-interest bearing deposits. Although the amount of reserves ought to be the same irrespective of the type of deposit, the rate of interest could be different.

Information only

A central bank has up-to-the-minute and accurate information about the behaviour of the monetary base, it does not have to rely on reports from banks. But the central bank should not only use this information when deciding on the appropriate level of interest rates. In certain circumstances it should control the size of the monetary base and allow interest rates to clear at whatever level is necessary. This is one of the main objectives of introducing a monetary base method of control.

U.S. experience

In a speech on 10th May at a seminar organised by the City University, Lawrence K. Roos, President of the Federal Reserve Bank of St. Louis, described the way in which interest rates in the U.S. have not been allowed to alter sufficiently rapidly to control the money supply:

"Let's examine the published history of the behaviour of interest rates and the monetary aggregates in the period since long-term monetary aggregate growth ranges were first announced in 1975. In the 47 months in which short-term policy ranges have been set, the Federal funds interest rate has fallen outside of its target ranges only 5 times; in the same 47 periods, M1 growth has fallen outside of its ranges 23 times essentially 50% of the time.

The monetary aggregates (M1) have tended to exceed their targets during periods of rising Federal funds rates, to fall short of their targets during periods of falling Federal funds rates, while usually remaining within their targets during periods of stable Federal funds rates. For example, from June 1976 to December 1976 Federal funds rate fell from 5.6 percent to 4.5 percent and monetary aggregates fell short of their target ranges 3 out of 7 months. From April 1977 to October 1977, when the Federal funds rate rose from 4.7 percent to 6.5 percent, the monetary aggregates exceeded their targets 5 out of 7 months."

When the money supply is exceeding its target range, a central bank can blame politicians for being reluctant to allow rates of interest to rise sufficiently quickly; neo-Keynesians also frequently argue against such a rise. These excuses cannot be used when the money supply is falling short of its target range, because politicians and neo-Keynesians do not object to interest rates falling. The central bank is then to blame for not altering interest rates sufficiently quickly. The explanation is central bankers' innate caution and hankering after orderly markets. A most important objective in introducing a monetary base method of control is to ensure that the central bank alters interest rates sufficiently quickly to control the money supply.

Practical operation

Short term fluctuations in the money supply have no significance for the real economy. There is no need for day-to-day control of the monetary base.

Suppose for simplicity that the desired growth of M_0 is 10% p.a. The banking system would then know that the total of banks' assets could not grow for long faster than 10% p.a. If their assets persisted in growing too quickly, banks would have to act to constrain the excessive growth. There are various possible courses of action. For example, banks might sell assets, e.g. Treasury bills, gilt-edged stock or local authority debt. Alternatively, banks could start to curtail the growth of their lending to the private sector, e.g. overdrafts. A bank knows better than anyone else the behaviour of its own assets. It is also best able to make forecasts about them. Aggregate data are already published monthly and could be published weekly. If bankers understand the monetary base method of control they should not have difficulty in adjusting reasonably smoothly to undesirable trends in the growth of their assets.

As far as discount houses are concerned, they too should be able to react reasonably smoothly if the new system is fully understood. The total of banks' reserves with the Bank of England could be published daily, if necessary. At times when the total is showing a persistent tendency to grow too fast, discount houses would have advance warning that the Bank might give them less "assistance" than they want sometime in the near future. In normal circumstances the Bank would continue to give whatever quantity of assistance the discount market wants, choosing only the method and the price, as it does at present. But if banks' reserves are growing too quickly, the Bank, and not the discount market, would decide on the quantity of assistance. After due warning, the Bank might give slightly less assistance than discount houses want. The houses would have to raise the missing funds by selling assets. They have a proven record of being able to do so. For example, between mid-July and mid-October 1975 the Treasury bill holdings of the non-bank private sector rose by more than £500m., most of which were sold by discount houses to financial institutions and industrial companies. Under the proposed system, the published data for bank reserves would give discount houses plenty of advanced warning of the need to run down their books.

(Under the proposed system, call money which banks place with discount houses would no longer qualify as a reserve asset and, therefore, discount houses would lose their present privileged position. However, the discount market would retain its historic role of buffer between the banks and the Bank of England, with the ebb and flow of funds into and out of the Exchequer passing through it. Further, discount houses would have the job of widening the market in those assets which at present qualify as reserves for banks.)

Penalties

As with the corset at present, penalties could be set out in advance for any bank whose reserve ratio fell below the minimum. The penalties should be trivial for an occasional offence but should be severe for persistent offenders.

Free reserves and precision of control

To protect itself from an unexpected fall in its reserves, each bank would want to keep a cushion of reserves slightly in excess of the minimum. A modest level of free reserves in the banking system would be desirable because it would help banks to react smoothly to day-to-day events which are unexpected. However, fluctuations in the aggregate level of these free reserves would upset the precision of the relationship between M0 and sterling M3. If the money supply were tending to grow excessively, control of M0 would not provide complete control of sterling M3 in the short run whilst free reserves were falling; afterwards the control mechanism would become tight. In the opposite case of monetary growth tending to be too sluggish, sterling M3 would respond slowly* to control of M0 if banks continued to build up free reserves. A measure which would help to stabilise free reserves would be for the Bank not to pay any interest on free reserves, i.e. on any reserves which exceed the mandatory minimum.

* Interest rates would fall more quickly than under the present system and this would help to avoid substantial downward momentum. A clear signal of monetary policy needing help from easier fiscal policy, e.g. tax cuts, would be sterling M3 continuing to grow too sluggishly in spite of adequate growth of M0.

Lifeboats

It is important to distinguish between the Bank's two roles of lender-of-last-resort. The first, giving "assistance" to the discount market, has already been mentioned. The second is lifeboat operations. There is no question of monetary base control preventing the Bank from organising a lifeboat when an individual bank has an asset deficiency or runs out of liquidity because other banks are reluctant to grant it credit. Any lifeboat would certainly have priority in the short run. Whilst one was being launched, the monetary base might exceed its target range. After the banking failure had been contained, the Bank would act to bring the monetary base back under control. (Another circumstance in which the Bank would modify its target for the monetary base would be a substantial exogenous shock to the system.)

The authors of the article in the Bank's Bulletin warn about one feature of monetary base control which could cause difficulties for banks, but only if it were allowed to occur. In the event of a sudden and unexpected reduction in the monetary base, banks would be able to restore their reserve ratios only by reducing their assets and liabilities by a multiple of the initial shortage of reserves. But such sharp reductions in the monetary base would not occur because the Bank would be controlling it.

Conclusion

Our proposed method of monetary base control has been discussed with various bankers and officials of discount houses; many of them appear to be attracted by the clear cut environment which it would provide. There appears to be a general desire to move away from the present system of doubt about whether the Bank will act or not - with bankers being kept on tenterhooks wondering if the Bank will supply a deficiency in the quantity of reserve assets before a banking make-up, discount houses being forced night after night to go to the Bank for huge quantities of assistance, and both having to indulge in transactions which manufacture reserve assets or destroy IBELs. Many people in the banking sector express a strong desire to be rid of the present highly artificial system and to be left to get on with practical banking.

2nd July, 1979

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Jumping the gun in gilt-edged

The gilt-edged market followed up its recent strength most convincingly yesterday and has now done a thorough job of anticipating a lower interest rate structure. The remains of the long tap vanished at the opening, and fund managers were falling over themselves to get into the market ahead of any overseas buyers. Profit-taking was easily absorbed and the day closed with gains of up to £2½, while the highest yield available has now come down to 12.8 per cent from 13.1 per cent.

This is not the first time that the market has pre-empted official interest rate policy. It is unusual, though, for it to go so far, particularly at the short end, where stocks are now yielding 2½ points or so less than Treasury bills. If the rally is not to run out of steam gilt-edged buyers will have to have their own way quite soon and see a fall in Minimum Lending Rate.

The trend of money market rates is obscured at the moment by the liquidity shortages created by purchases of the tap stocks, and will be for some time, as heavy calls are due this week and next. It is probably wrong to draw any conclusions from the Bank of England's relatively accommodating behaviour in the discount market yesterday. But the authorities have sold enough stock now to make the money supply figures look satisfactory for a few months to come, and may be able to sell some more if they pitch a new partly-paid stock alluringly.

Now that the market has taken its jump of faith, the forthcoming economic statistics hold few terrors for it; the June banking figures, for example, will seem prehistoric. But if the authorities were primarily concerned with controlling bank lending, rather than the money supply as a whole, when they raised MLR to 14 per cent, they will be unwilling to lower the rate until they see evidence accumulating that the credit squeeze is working, which will take several weeks. The market's bet is that sterling, which rose to 70.1 on the trade-weighted index yesterday and has come up 4.2 per cent since the Budget, will force the Bank's hand. After all few things heighten the attraction of sterling so much as a strong gilt-edged market to which the official brakes are being ineffectively applied.

Mercury Securities

Mercury Securities has increased its dividend by nearly

Index rose 1.7 to 475.1



three-fifths—and still has one of the best covered pay-outs in the merchant banking sector. Attributable profits for the year to March are up from £8.1m to £10.7m, and the main features are a very sharp recovery in metal trading and refining, and a strong performance at S. G. Warburg. The joint ventures with Paribas seem to have shown a dullish performance again, but the minority charge—which mainly reflects Paribas' 25 per cent holding in Warburg—is up by more than a quarter. It is clear that the bank was one of the better performing accepting houses last year, and the volume of its merger activity is one of the main explanations.

Meanwhile the balance sheet total has expanded by roughly a fifth to a little over £900m, and the disclosed capital base has shown a similar increase thanks in part to a write back of deferred tax amounting to £4.2m. Mercury's metal trading activities mean that it has been able to take advantage of stock relief, unlike most banking businesses, and there are likely to be more of these clawbacks in future years.

The upshot is that the bank retains a noticeably solid balance sheet, and the prospects for fee income, which is Warburg's strong card, look reasonable for 1979-80. The U.S. associate is apparently doing better, while there is always the chance that the UK Government could put a little business Warburg's way given its plans for asset disposals. The shares have performed much better than the market as a whole for most of this year: they rose 11p to 172p yesterday, and the yield of over 5 per cent is covered more than four times.

Gilt-edged indices

Headaches for the Actuaries. The New FT Actuaries gilt-edged indices were introduced in May, 1977, just when the Government in its inconvenient way started to issue partly paid stocks. To date, these stocks have only been included in the indices from the date that they became fully paid—but a "correct" series has also been calculated incorporating them from their issue dates. The published indices have been brought into line with this correct series whenever the absence of any partly paid stock in the market has made this possible.

There are now two problems. Early this year, several partly paid stocks were issued at a time when the market was swinging violently, and this meant that the necessary adjustment from the published to the correct series—last made on June 20—has been much greater than in the past. The trouble is that the change cannot always be made in the same period of time as the market movement that created it.

Moreover the calculation of even the correct series is itself a matter for debate. At the moment, it only includes the partly paid element of these troublesome stocks, which necessarily makes the corrected indices more volatile during the partly paid period. Some users argue that this element of gearing should be removed by incorporating from the date of issue an allowance for future calls. Still with us? Anyone with strong views should contact the chairman of the Index Committee, Mr. R. H. Pain of stockbrokers Capel-Cure Myers.

Beecham

Beecham's report and accounts offer plenty of evidence of the group's financial strength. After last year's £83m rights issue it has £135m of net cash outweighing long-term debt of £132m, and shareholders' funds on an SSAP 15 basis total £490m. Leaving aside the rights issue, Beecham financed the £14m acquisition of Scott and Bowne and showed only a negligible cash deficit, even though profits only marked time.

There is nothing in the report to suggest, however, that Beecham is excited about the current year. The figures for the first half of 1979-80 are not generally expected to be up to much, and the shares are still languishing around 550p, nearly 20 per cent below the levels of mid-May.



10 DOWNING STREET

24. 6. 79

THE PRIME MINISTER

The Chancellor.

These points transmitted to Sunday.
to Treasury (points 2) and (3) already in hand).

① I am very worried about the reports in today's press that mortgage rates may have to go up within a few days. This must not happen. If necessary, there must be a temporary subsidy (as in 1977) for the continuing need to keep the rate where it is. ($11\frac{3}{4}\%$). That rate is already too high. Can you consult with Richard Butler of the Building Societies forthwith. This must be dealt with before we go to Tokyo.

② Related to the 16% MLR in the problem of state relief. One of the reasons why there is so much private sector borrowing is because the present state relief system encourages excess borrowing into state at below market

Exon B1
Original filed
Housing (Bldg. Sec.) May 79

time. We must change the state's
relief system before next year.

③ I hear increasing criticism about the
way the job market is being handled.

M.T.

NOTE FOR THE RECORD

Top Copy: Econ. Pol,
Sparrow Mtg.

cc Martin Sel
Econ Pol - Domestic
Monetary
Pol,

Mr. John Sparrow called on the Prime Minister at 1600 on Tuesday 19 June. The following are the main points which came up in discussion.

Mr. Sparrow said that the City was basically pleased with the Budget. The immediate marking down of gilts prices was inevitable, given the increase in MLR - which in itself had been somewhat unexpected. But the MLR increase clearly indicated that the Government was intent on keeping the money supply under control, and this ought to provide a good basis for the sale of gilts over the next few months. The take-up of the new tap stocks on Thursday would be watched very carefully. Another more promising aspect was the fact that corporate loan demand was likely to be rather lower over the next few months because of the recent accrual of cash from the pre-Budget spending spree and because of the short-term cash flow effect of the VAT increase.

Mr. Sparrow went on to say that he did not think the current level of sterling could be sustained - given the recent trade figures. The rate was being pushed up by the combination of high interest rates and the fact that many regarded sterling as a "petro-currency".

The Prime Minister said that she was concerned about the current provisions for corporate stock relief. Her impression - and this was confirmed by Mr. Sparrow - was that it had a distorting influence on company behaviour: companies tended to increase their stocks unnecessarily at the end of the financial year, which was a waste of resources and which meant a loss to the Exchequer. Mr. Sparrow added that corporation tax generally had become an "optional tax". It should either be abolished or made operative: he would prefer the latter. Mr. Sparrow then referred to PRT, and said that he was worried that the Exchequer was losing unnecessary funds because of the "uplift" provision. This meant, for example, that BP would be exempted from substantial amounts of tax when they took over part of the Beatrice Field, as they were reported to be proposing to do.

/The Prime Minister

The Prime Minister asked Mr. Sparrow for his views on the present methods of funding the borrowing requirement. Mr. Sparrow replied that he would let the Prime Minister have his views in writing, but did not not accept the Bank's argument that the institutions necessarily required long-dated stock. This was an excessively expensive method of funding. On the other hand, he thought that there must be a revival of interest in equities at the expense of gilts before too long. The Prime Minister commented that she could not see how businesses would be willing to borrow for investment purposes at current rates of interest. Finally, Mr. Sparrow said that in his experience industry was already becoming more aware of the need to negotiate responsibly on the pay front: they were beginning to realise that from now on they, rather than the Government, were responsible for their actions. But it would be helpful if the Government could produce a new "standard of living" index - this would involve regarding tax as part of the cost of living. The Prime Minister said that the Treasury were working on such an index.

R.

21 June 1979

B/F n/h/29.
for meeting.

Con Pol

19 June 1979

Further to our conversation on the telephone this afternoon I am writing to confirm that the Prime Minister is holding a meeting on Wednesday 18 July at 1500 at No. 10 to discuss gilts and monetary policy. She wishes all the Treasury Ministers to be invited and I have also asked the Governor of the Bank of England.

C.S.

A.J. Nelson, Esq.,
H.M. Treasury.

SECRET

Econ. Policy

8

DS



10 DOWNING STREET

From the Private Secretary

15 June 1979

Gilt Edged Market

The Prime Minister has considered the Financial Secretary's minute of 14 June in which he proposes that £800 million of short stock and £1,000 million of long stock should be announced today. The Prime Minister is content with the Financial Secretary's proposals, but she would like to have a discussion fairly soon with Treasury Ministers and with the Governor about gilt edged funding and monetary policy generally. I will be in touch with the Chancellor's Office in due course to arrange a meeting.

I am sending a copy of this letter to John Beverly in the Governor's Office.

T. P. LANKESTER

Mrs. P.C. Diggle,
HM Treasury.

SECRET

9B



Prime Minister

PRIME MINISTER

GILT EDGED MARKET

believe there for oversight.
but after we have
seen Gordon Pepper
- we will have
with, nearly 100
of the
making
of the

I know you are opposed to
20 year gilts. But I think
this makes a good case, especially
para 4, for issuing a long
stock as well as a short
one. (Sales of gilts to the banks
do not of course help with the
money supply).

Are you content with Mr
Lawson's proposals? 12

I am writing in Geoffrey Howe's absence today to let you know of the ^{14/6}
two stocks which it is proposed to announce tomorrow, especially
since I understand that you have expressed concern about the long
term costs of borrowing by gilt edged stocks which will not mature
until about the turn of the century.

As you will know, the Bank sold the complete long tap yesterday.
This will have significantly reduced the growth of the money supply
in banking June (which ends next Wednesday): although this falls
before the new 10 month target period, it will be useful in avoiding
uncomfortably high 3 month and 6 month moving average figures for
monetary growth being quoted in the markets in coming months.

We have now to deal with the problem of funding the borrowing
requirement in the first few months of the new target period.
We need to have a high level of gilt sales in this period, if
market conditions permit, while the borrowing requirement is still
high before the Budget takes effect, and before the changes in MLR
and clearing bank base rates have their effect on bank lending -
this tends to come through only after a few months.

④ The Chancellor, advised by the Governor, has decided that there
should be both a long dated stock and a short dated one. There are
two main reasons for including a long dated stock as well as a short.
The first is that the need is to secure sales outside the banking
system, who in normal circumstances can be substantial buyers of
short stocks. This requires a significant proportion of sales to

the long term investment institutions, the Life Offices and Pension Funds. In recent years the long term institutions have invested about twice the normal proportion of their new funds in gilts: this proportion will fall back as we reduce the PSBR but for some time to come we will need to sell to them substantially more than the normal proportion of their new funds, if we are both to control the money supply and leave room for an adequate level of bank lending to industry. The long term funds are primarily interested in securities which match their long term liabilities on life policies and pensions. We are therefore more likely to secure substantial sales of gilts to them without having to raise yields excessively if we provide gilts which are of a maturity which is attractive to them, namely in the 15-25 or 30 year band. Successive issues can be at different points in that band.


The other reason for bringing in a new stock ^{immediately} is that we do not want yields to fall back again in the coming weeks. If they did, they would almost certainly rise again later as the market became worried about the inflationary prospect during the critical months of this autumn, causing a hiatus in gilt sales while they did so.

X I am well aware that some commentators have argued that issuing stocks with this kind of maturity involves accepting very high borrowing costs in the years ahead if inflation does come down, and therefore either means that the Government expects inflation to continue in double figures, or that the Government is irresponsible in placing such a high interest burden on its successors. But this comment ignores the effect of the high inflation in the next two or three years on the real value of both the interest payments in subsequent years and the final repayment. The Treasury recently did some calculations of the real interest costs of long term borrowing, on alternative illustrative assumptions about the future rate of inflation. These showed that, on assumptions that involved inflation falling to 6% pa within 3 years, and remaining at that level thereafter, the real cost of borrowing now at a 13% yield for

10 years would be 3% and for 20 years would be 4%. Given that economists estimate that the real cost of long borrowing has averaged over the decades about 3%, neither is a very high figure historically. The Bank and Treasury consider that if the authorities were to shift the emphasis of their borrowing from stocks of about 20 years maturity to that of about 10 years, the relative prices and yields would shift to remove that advantage for 10 year stocks and we would at the same time have greater difficulty in securing the desired level of sales.

The intention is therefore to issue two stocks, a long and a short. Both would be part-paid, and with a tender provision on their price. Receipts from the short would come in banking July, and from the long in banking July and August. The short stock would be a new issue of £800 million (plus £250 million reserved for the National Debt Office) maturing in 1984, with an $11\frac{1}{2}\%$ coupon. The long stock would be a further tranche of £1,000 million $12\frac{1}{4}\%$ Exchequer 1999.

I hope that you will have been reassured by my explanation of the reasons for bringing in a long stock, and will be content that the Bank and Treasury should proceed this Friday on the basis proposed.



NIGEL LAWSON

14 June 1979



PRIME MINISTER

GILT EDGED MARKET

I am writing in Geoffrey Howe's absence today to let you know of the two stocks which it is proposed to announce tomorrow, especially since I understand that you have expressed concern about the long term costs of borrowing by gilt edged stocks which will not mature until about the turn of the century.

As you will know, the Bank sold the complete long tap yesterday. This will have significantly reduced the growth of the money supply in banking June (which ends next Wednesday): although this falls before the new 10 month target period, it will be useful in avoiding uncomfortably high 3 month and 6 month moving average figures for monetary growth being quoted in the markets in coming months.

We have now to deal with the problem of funding the borrowing requirement in the first few months of the new target period. We need to have a high level of gilt sales in this period, if market conditions permit, while the borrowing requirement is still high before the Budget takes effect, and before the changes in MLR and clearing bank base rates have their effect on bank lending - this tends to come through only after a few months.

The Chancellor, advised by the Governor, has decided that there should be both a long dated stock and a short dated one. There are two main reasons for including a long dated stock as well as a short. The first is that the need is to secure sales outside the banking system, who in normal circumstances can be substantial buyers of short stocks. This requires a significant proportion of sales to

the long term investment institutions, the Life Offices and Pension Funds. In recent years the long term institutions have invested about twice the normal proportion of their new funds in gilts: this proportion will fall back as we reduce the PSBR but for some time to come we will need to sell to them substantially more than the normal proportion of their new funds, if we are both to control the money supply and leave room for an adequate level of bank lending to industry. The long term funds are primarily interested in securities which match their long term liabilities on life policies and pensions. We are therefore more likely to secure substantial sales of gilts to them without having to raise yields excessively if we provide gilts which are of a maturity which is attractive to them, namely in the 15-25 or 30 year band. Successive issues can be at different points in that band.

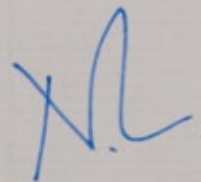
The other reason for bringing in a new stock is that we do not want yields to fall back again in the coming weeks. If they did, they would almost certainly rise again later as the market became worried about the inflationary prospect during the critical months of this autumn, causing a hiatus in gilt sales while they did so.

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The intention is therefore to issue two stocks, a long and a short. Both would be part-paid, and with a tender provision on their price. Receipts from the short would come in banking July, and from the long in banking July and August. The short stock would be a new issue of £800 million (plus £250 million reserved for the National Debt Office) maturing in 1984, with an $11\frac{1}{2}\%$ coupon. The long stock would be a further tranche of £1,000 million $12\frac{1}{4}\%$ Exchequer 1999.

I hope that you will have been reassured by my explanation of the reasons for bringing in a long stock, and will be content that the Bank and Treasury should proceed this Friday on the basis proposed.



NIGEL LAWSON

14 June 1979



11 8 JUN 1979

SECRET



Econ Pol. DS.
5

10 DOWNING STREET

From the Private Secretary

11 June 1979

The Prime Minister has considered the Chancellor of the Exchequer's minute of 11 June in which he restates the case for increasing MLR by 2 percentage points tomorrow. She has noted that the Chancellor appears to be placing rather more emphasis in his argument now on the need to sell gilts as opposed to holding back lending to the private sector. In her view, his proposal to increase MLR by 2% rather than by 1½% is mistaken. However, she is willing to abide by the Chancellor's and the Governor's judgement on this matter.

I am sending a copy of this letter to John Beverly in the Governor's office.

T. P. LANKESTER

Tony Battishill, Esq.,
HM Treasury.

SECRET

[Handwritten signature]



*PM seen and
willing to abide
by Chancellor's
judgment -
about my
reluctance.*

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

MLR

R

Gordon Richardson and I have considered again the size of the change in MLR to be announced tomorrow. We remain convinced that it should be 2 per cent.

11/6

2. An increase in MLR is, of course, as important as a signal as for its direct effect on other interest rates. A major purpose of this change would be to show our determination to take timely action to control the growth of the money supply, rather than just wait for the markets to carry up rates against us, as they almost certainly would in a few weeks time.

3. The practical purpose is even more important. We need to achieve the gilt sales necessary to fund the borrowing requirement that we have inherited. For that purpose, it is essential to avoid the danger of a subsequent feeling that the change is insufficient - as happened with Denis Healey last April. If that view gained ground in the markets, a self-fulfilling expectation of further increases would develop, and gilt sales would falter in the meantime.

4. For this primary purpose, Gordon and I both consider that a change of 2 per cent is essential. A change of 1½ per cent would be seen either as an attempt to "fine-tune" where it is not possible to do so, or as showing lack of resolve. One per cent would,



cent would, of course, be seen as repeating Denis Healey's mistake, and irrelevant.

5. The experience of the last few years has shown the importance of raising interest rates sufficiently and in time. The risk is largely one-sided since, if all goes well after a rise - with good gilt sales and maintenance of confidence - it is always possible to ease back and allow interest rates to fall somewhat. But if rates are not raised sufficiently in the first instance, it will probably be necessary later to go higher than would otherwise have been needed: in the meantime the monetary position would have deteriorated further.

6. On the other hand, the difference in the direct effects on the economy, (for example, on banks' lending levels and costs, between a move of $1\frac{1}{2}$ per cent and 2 per cent) is not great. Even building society leaders, I understand, will be influenced, when they take their decision on the changes in mortgage and share rates (probably early next month) not so much by MLR itself, as by the then level of money market interest rates and by their expectations about the future trend of such rates. It is indeed possible that a 2 per cent change in MLR would lead to a smaller increase in building society rates than a $1\frac{1}{2}$ per cent one, since the former stands a far greater chance of convincing the markets that sufficient action has been taken, and that any further shift in interest rates will be downward.

7. Finally I doubt whether the difference between 2 per cent and $1\frac{1}{2}$ per cent will make much difference to the Opposition's criticism - Denis Healey, for what that is worth, will realise that he would have had to make the change. On the other hand.

/I think that

S E C R E T



I think that, given our commitment to monetary targets, our first use of a monetary policy instrument should be effective and unequivocal.

I am sending a copy of this minute to Gordon Richardson.

A handwritten signature in dark ink, appearing to be "G.H.".

(G.H.)

1 (June, 1979)

S E C R E T

7/6

SIR DOUGLAS WASS

cc Sir L Airey
Mr Littler
Mr Middleton
Mr P Davies
Mrs Lomax
Mr Riley
Mr Taylor
Mr Ward
Mr Williams
Mr Bell

Chief Cashier

INFLATION AND THE COST OF BORROWING

You have, as Accounting Officer, expressed concern from time to time at the possible extent to which considerations of cost have been subordinated to considerations of monetary policy in management of the debt in recent years. This minute reflects a wet bank holiday weekend's work on the interplay between coupon, inflation and real rates of interest, which I hope that you will find somewhat reassuring.

2. A number of commentators and others (Mr Lever, Anthony Harris, Peter Oppenheimer) have questioned whether it has been right to borrow for 20 years or more at nominal redemption yields of 12%-14%, some saying that this only makes sense if the Government thought that inflation would continue in double figures. The suggested alternatives have varied - abandoning monetary targets, indexation, or shortening the period of borrowing.

3. The justifications of the existing policy have been:-

- i. the high priority given by Ministers to securing the monetary target and therefore the need to sell gilts on whatever terms we could;
- ii. the preference of "long term" institutions for longer dated securities;
- iii. even for long dated stocks the high nominal interest rates reflected a view about the rate of inflation

in the next 2 or 3 years, rather than in the medium term - compounding diminishes the long term effects, so that the expected real cost is significantly less than (nominal yield less expected long term rate of inflation) if higher rates of inflation are expected in the first years.

4. You may recall that the last point arose in a particular form last year, prior to the decision to launch a stock maturing in the 21st Century. At that time redemption yields for stocks in the next century were about $\frac{1}{2}$ % less than redemption yields of stock maturing in the 1990s: calculations separately done by the Government Broker and HF3 showed that unless nominal rates fell into the very low single figures in the 1990s it would be cheaper to borrow now into the next century than to borrow until the 1990s and then refinance for a decade or so.

5. However, I thought that it might be useful to quantify the point more generally given Mr Oppenheimer's recent assertion that:-

"It is arguable that the authorities should be issuing 20 year debt only if they believe that the UK inflation rate in the 1990s is at least as likely to be higher as it is to be lower than in the past few years."

(Vickers and Costa: April 1979)

The Inflation Assumptions

6. The calculations were based on three illustrative alternative assumptions for the inflation rate over the next 20 years. For obvious reasons, the illustrative assumptions are based on pre-Budget expectations in the market that inflation is accelerating again, that it will probably reach 15% pa or more and that it may then decline as the result of a monetary squeeze. All involved the assumption that in the next 4 half years inflation would build up to 8% a half year (an

annual rate of 16.64%) and then:

Case A assumed a decline to 3% a half year (6.09% a year) over the following 2 years, which rate was maintained steadily thereafter;

Case B assumed a decline to 5% a half year (10.25% a year) over the following 2 years, which rate was maintained steadily thereafter;

Case C assumed a decline to 7% a half year (14.5% a year) in the following year, which rate was maintained steadily thereafter.

Most people would probably regard Case A as being towards the optimistic end of the spectrum of possible outcomes, and Case C towards the pessimistic - although neither is at its respective extreme.

The Results

7. The results are summarised in the graphs annexed.

Annex A plots coupon against real rate of return for the different inflation assumptions and 10 year and 20 year maturities.

Annex B plots coupon against long term rate of inflation for different real rates of return and maturity periods.

The Cost of Borrowing

8. On the 3 respective assumptions, the real rate of return on 20 year stocks issued at par with yields of 12%, 13% or 14% are:-

CONFIDENTIAL

- 4 -

<u>Nominal Yield</u>	<u>Assumptions</u>		
	A	B	C
12%	3.2%	0.4%	-2%
13%	4%	1.3%	-1%
14%	4.8%	2.2%	-0.1%

Given that the real rate of return historically on long stocks is estimated to have been about 3% pa borrowing for 20 years on a 12% coupon is not expensive on any of the inflation assumptions. Even borrowing at 14% is only above average in cost if one thought Case A significantly more likely than the others - a far more optimistic criterion than suggested by Mr Oppenheimer.

Borrowing for 10 years or 20 years

9. The real rate of interest on borrowing for 10 years is somewhat lower than that for 20 years, if both have the same nominal yield (as they have in the last few months with a flat yield curve). The real rates for 10 year borrowing are:-

<u>Nominal Yield</u>	<u>Assumptions</u>		
	A	B	C
12%	2.2%	0%	-2%
13%	3.1%	0.9%	-1%
14%	4%	1.8%	-0.1%

The margin is somewhat under 1% in Case A, 1% in Case B, and nil in Case C. But if the Government were to issue no gilts longer than 10 years, we would find the yield curve changing against us. It is difficult to forecast by how much yields in the 10 year maturity band would increase. The differential which existed between stocks maturing in the 90s and those maturing in the next century a year ago suggests that it would almost certainly increase by $\frac{1}{2}$ %, and quite

probably by significantly more: moreover experience with recent medium taps suggests that there is normally a limited (but nonetheless useful) demand for such stocks. On this basis, the argument on cost for shorter borrowing is at best marginal on the most optimistic assumption for inflation, and against it on the others.

10. Looking at it from the point of view of the lender, the calculations quantify the point that the present flat yield curve gives an incentive to invest long rather than medium, provided that he expects inflation to decline.

Conclusion

11. I think that this arithmetic shows that borrowing long at historically high rates of interest is not necessarily as disadvantageous to the Exchequer as has sometimes been feared, and cannot only be justified on pessimistic assumptions about the future rate of interest.

12. On the other hand, there would clearly be advantage in being able to assess potential real borrowing costs against alternative assumptions about the future course of inflation. I will therefore explore with the Chief Cashier whether one of the Treasury, Bank or Government Broker might not have a computer programme to be able to do such calculations more readily for the future.

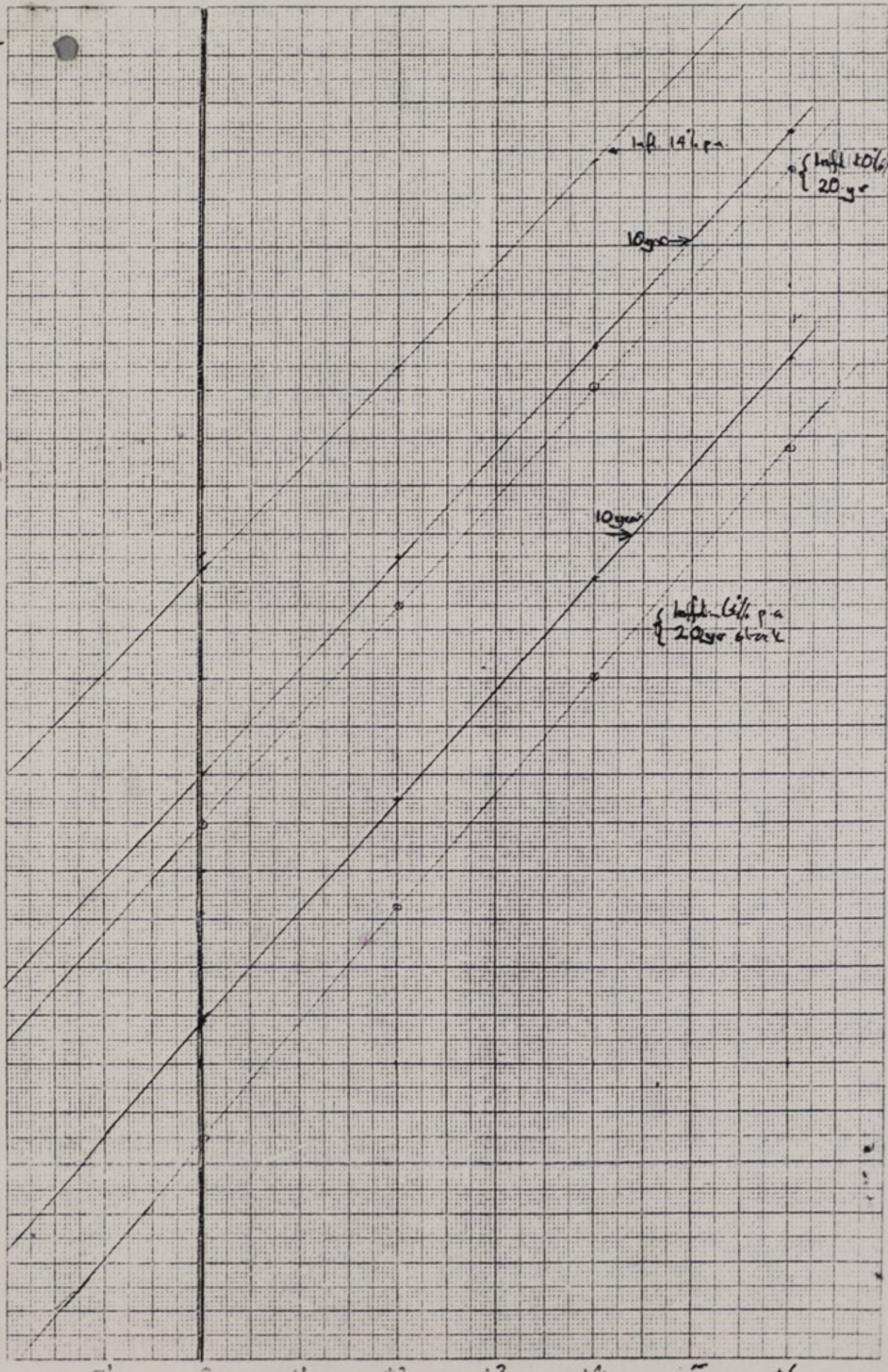
J. M. B.

J M BRIDGEMAN

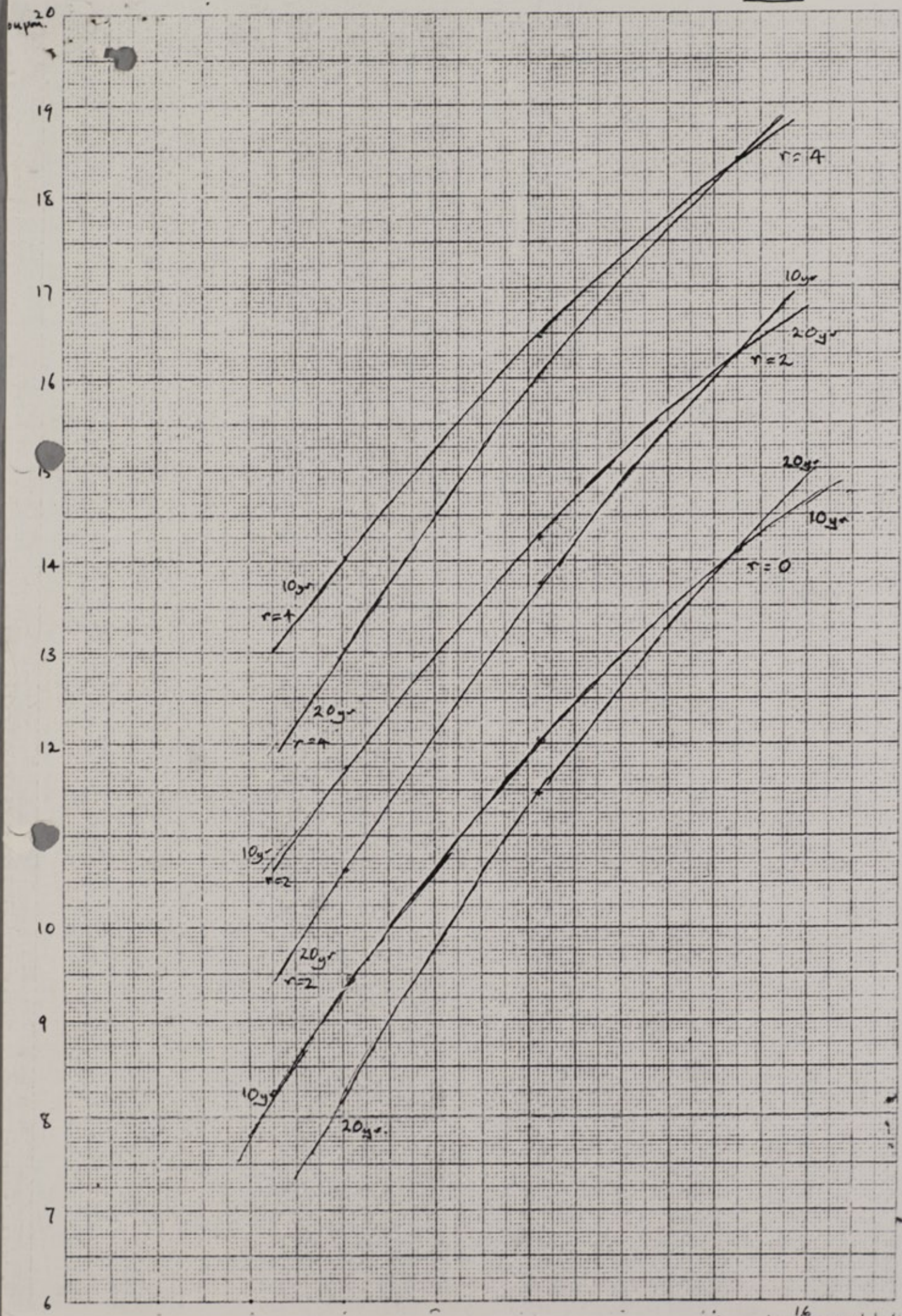
7 June 1979

Coupons

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+6





3
Economic

10 DOWNING STREET

From the Private Secretary

7 June 1979

~~Mr. Healey~~

This is, briefly, what
happened last night.

Dear Tony,

TL
7/6

The Chancellor of the Exchequer sent the Prime Minister a minute yesterday evening proposing that MLR be raised by 2 per cent to 14 per cent today. The Chancellor and the Governor called on the Prime Minister later in the evening to discuss the proposal.

The Chancellor and the Governor explained the background. The latest banking figures indicated that money supply was growing at more than 13 per cent at an annual rate. This was due to exceptionally heavy lending to the private sector in recent months and a PSBR running at an annual rate of over £10 billion. The post-Budget projections were for a continuation of these trends at least until the autumn. The Bank's and the Treasury's judgement was that, without an early increase in MLR, bank lending would not be held back and gilt sales would not take place on a sufficient scale to bring M3 back within the 7-11 per cent target which it had been decided would be announced in the Budget. A 2 per cent increase was the minimum needed to create the right expectations so as to get gilt sales moving and to bring about a gradual reduction in interest rates in due course.

As regards timing, there were only two realistic options - to announce the move today or on Tuesday. The Chancellor said that he would far rather that the announcement should come today. It would thus be seen as an inevitable, and proper, response to the banking figures. It would also be out of the way and therefore another part of the 'inheritance', and this would make for a better Budget presentation. The Governor said that he felt less strongly about the choice of dates: his principal concern was that the 2 per cent increase should take place. None the less, after the experience of Mr. Healey's Budget in 1978, he tended to go along with the Chancellor.

/ In reply,

In reply, the Prime Minister said that she could not accept the Chancellor's argument on timing. It left out one very important factor - the fact that today is polling day for the European Election. A jump in MLR today could, in her view, have a significant impact on the Election result. But in addition, she did not find the presentational argument altogether convincing. If there had to be an MLR increase, it could just as well be presented as part of the overall strategy of putting the economy right, and also - although it was primarily intended to bring the monetary aggregates into line - as a partial response to the trade figures. In any case, even if the increase were announced today, the Chancellor would still be held accountable for it as part of his Budget package. The Prime Minister said the increase would have to be on Tuesday.

As for the amount, the Prime Minister said she was doubtful whether a full 2 per cent increase was needed. There seemed to be little expectation in the press that there would be any increase; lending to the private sector might possibly diminish in the next few months as recent special factors unwound; and the Budget itself ought to improve the prospect for gilt sales. Moreover, it was very desirable to avoid an unnecessary increase in view of the likely repercussions on mortgage rates. None the less, the Prime Minister said she was prepared to accept the Chancellor's and the Governor's judgement that a significant increase was required. Whether it should be 2 per cent or something less, she would like them to consider finally in the light of developments over the weekend. *

I am copying this letter to John Beverley in the Governor's Office.

*I would be grateful if you could let me know of their decision so that I can inform the Prime Minister on Monday evening.

Tim Lankester

T.P. LANKESTER

A.M.W. Battishill, Esq.,
HM Treasury.



2

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

I am afraid there is more bad news (to place alongside the trade figures) to show that our inheritance was much worse than we had appreciated.

2. The money supply figures for banking May show a growth of 1.2 per cent (an annual rate of 13.1 per cent since last October). For banking June the figures will be higher, possibly 2 per cent if we take no action. And the CGBR (£730 million in banking May) is expected to be £1,300 million in the next month, even after seasonal adjustment. The figure for bank lending to the private sector (banking May) is up to £870 million - nearly twice the average monthly rate forecast.

3. These figures were considered by Treasury and Bank officials. And I met Gordon Richardson this morning (together with John Biffen and Nigel Lawson) to discuss the position.

4. Gordon's view was clear - and he emphasised that he would have had to give the same advice to the last Government, Budget or no Budget - to the effect that MLR would have to go up tomorrow by 2 per cent to 14 per cent. This is, of course, bound to raise mortgage rates - not necessarily immediately, but probably to 13 per cent.

/5. None

8-12



5. None of us has any doubt that the rate would have to go up. And anything less than 2 per cent would simply arouse expectations of more. For it is the only possible response to money supply figures moving, as they are, right outside even Denis Healey's target range. That case is, of course, even stronger for us, since we are working to a target of 7-11 per cent at an annual rate from mid June 1979 to mid April 1980. And our commitment to monetary discipline is well known, although it has yet to be shown in practice.

6. The only question was over the timing of the necessary response. Nobody argued for it to be announced on Budget Day (Denis Healey made that mistake last year). After the Budget, at any time and in any stages, it would look like a vote of no confidence in the Budget. Yet all our advisers are agreed that the Budget should, in itself, be well received and have a good effect on confidence.

Friday
7. We are left then with tomorrow. Even then, there is some risk that the announcement could diminish the impact of the Budget. But this is not thought likely. For the decision to raise MLR would be seen as a more or less inevitable response to the deteriorating monetary situation. And that judgment would be seen as justified in retrospect by Friday's trade figures.

8. This was a most disagreeable problem to have to face. But given the choice between rising interest rates and declining confidence after the Budget, and a firm display of our determination to reassert monetary discipline, in face of an obvious need, before the Budget, I am as confident as anyone can be in such cases that we have made the right decision.

9. I am copying this minute to Gordon Richardson.

Am Baccini

Principal Private Secretary

Approved by the Chancellor of the Exchequer and signed in his absence 6th June, 1979 (G.H.)



IA 1 JS
cc DCB
Boyt
CO
BF18/6/79

10 DOWNING STREET

From the Private Secretary

18 May 1979

Top copy on: Econ Pol, May 79,
~~the~~ Talks with Gordon Pepper

In the course of a conversation which the Prime Minister had this morning with Mr. Gordon Pepper, two points came up which the Prime Minister has asked me to pass on to the Treasury for consideration.

First, Mr. Pepper suggested that one important source of revenue in the coming Budget might be the sale of commercial property currently owned by the New Town Development Corporations. In his view, the institutions would readily take up the purchase of such properties, and it would also help dampen the current property boom. He went on to suggest that a Government company might be formed to take over commercial property from the Development Corporations, and this company would then sell it off to the institutions. The Prime Minister is aware that legislation would almost certainly be required for this, but she would like this idea looked into.

Second, Mr. Pepper referred to the possibility of moving to a monetary base method of controlling the money supply. In his view, this would be an important improvement on the present system. He said that the Bank had been studying this approach for some time and were planning an article for a forthcoming Bank of England bulletin. The Prime Minister has asked me to say that she hopes the Treasury will consider the studies which the Bank has undertaken urgently; and while she is fully conscious of the need for the Chancellor to concentrate primarily on the Budget in the next few weeks, she would like to have the Chancellor's views in due course on the possibility of moving to a monetary base method.

I am sending a copy of this letter to David Edmonds (Department of the Environment), John Beverly (Bank of England) and Martin Vile (Cabinet Office).

A.M.W. Battishill, Esq.,
HM Treasury.

010

cc Mr Wilson
Mr Ryder

SECRET

Prime Minister
To note. 2



R
11/5

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

I have now had an opportunity to consider the immediate monetary prospect with the Governor and Treasury officials.

faster than the Treasury said earlier.

i.e. the 6 months to May

2. The money supply figures, to be published next Thursday, show that the growth of M_3 in the last six months was at an annual rate of 12.8 per cent - slightly over the top of the target range. The market is now anticipating such an outcome, after the publication of the eligible liability figures. There are some indications that the rate of growth may now be slightly lower, but the underlying rate must still be close to the top of the range. Moreover, we cannot yet be certain that the growth of bank lending to the private sector will continue to fall back from the exceptional levels it reached in the first few months of this year.

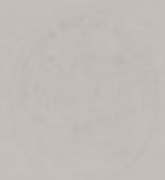
i.e. to keep lending to the private sector from growing too fast

3. I do not think that this calls for immediate action to tighten monetary policy ahead of the Budget. But it does mean that we must err on the side of caution. The Governor and I have agreed that we should keep MLR at 12 per cent, and that the Bank should resist any significant downward move in short term interest rates, should the market point that way. We also propose to bring in a new long tap stock, to continue the funding of the PSBR, as soon as market conditions permit, possibly this Friday.

4. I am sending a copy of this minute to the Governor.

(G.H.)

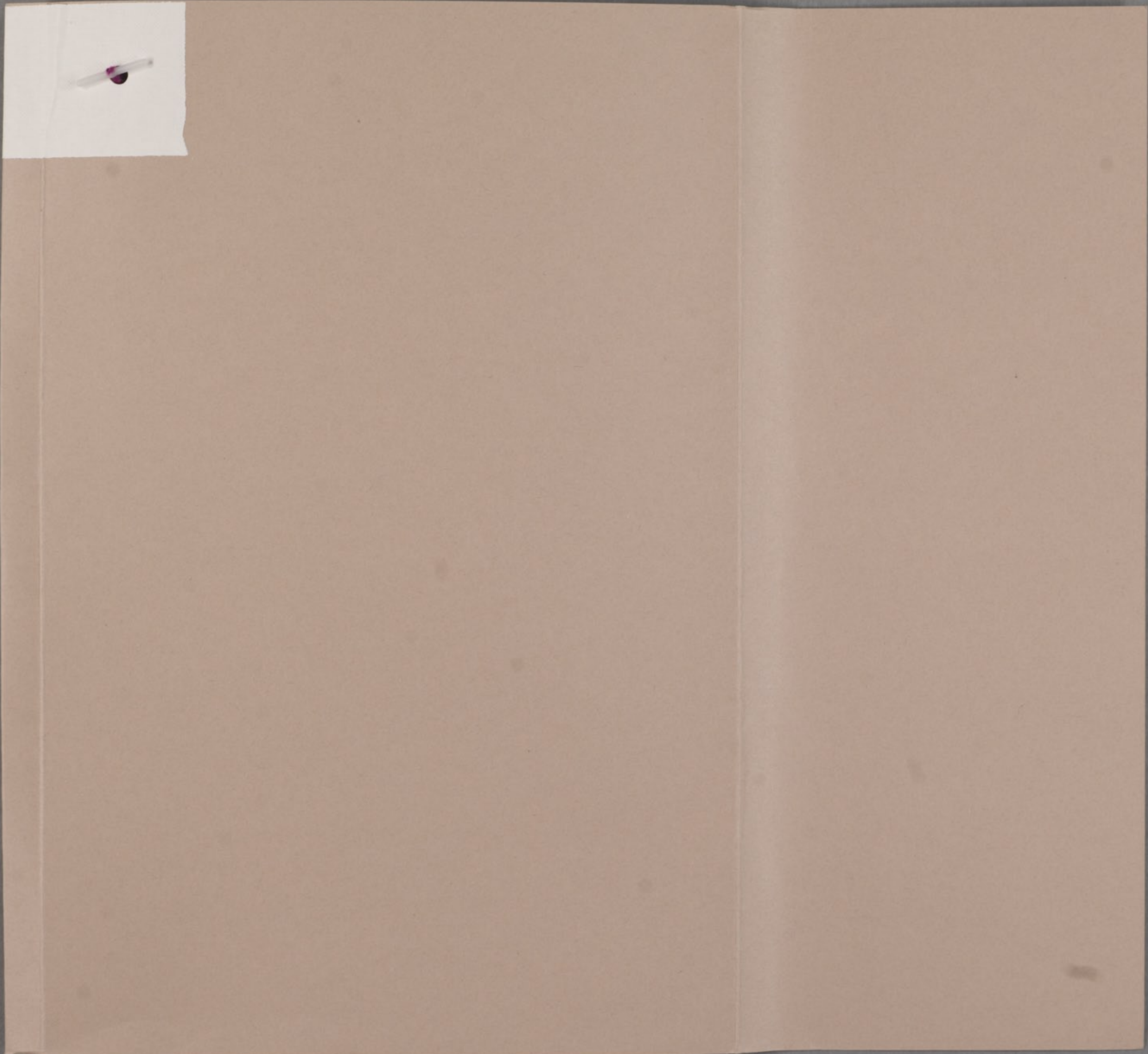
10 May, 1979



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10 MAY 1979







END

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February 2010