PREM 19/177

PART 3 ends:-

SS End to PM
~~Note for the record Chan Ex/PM~~ 2.5.80

PART 4 begins:-

Chan Ex HMT to TPL 6.5.80.

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
CC(80) 9th Conclusions, Item 6 (Extract)	06/03/80
C(80) 17	11/03/80
CC(80) 10th Conclusions, Item 5	13/03/80
E(80) 27	13/03/80

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed *P Wayland* Date *18 March 2010*

PREM Records Team

JU 010

PRIME MINISTER

cc Lord Trenchard

Ever since we came to office Lord Trenchard has foreseen a very severe cash squeeze on manufacturing industry. He has pressed his fears upon me many times. He argues that we need to guard the bulk of our manufacturing industry from the full impact of the present hostile climate.

He has pressed me for

(a) fiercer use of import controls, above all on textiles;

(b) the creation of some UK non-tariff barriers;

(c) more positive use of public purchasing;

(d) a reduction of national insurance contributions, or - and this would be more cost-effective and much cheaper - increased help for research and development;

(e) a stronger trade union package to ease management's huge and distracting problems on the shop floor.

He is anxious that you should see the attached paper. He himself is constantly discussing (a) with Department of Trade: on (b), we are trying, very gingerly: on (c), we have made a start on the initiative agreed at E Committee; (d) we are considering in case liquidity deteriorates much further: and (e) there is a Green Paper pending.

Therefore, at his request, I forward his paper.

KJ

K J

2 May 1980

Department of Industry
Ashdown House
123 Victoria Street

SECRET

Original filed on:- Iran Situation Pt 6. Econ Pol

12

NOTE FOR THE RECORD

The Chancellor called on the Prime Minister at 0900 hours this morning. The following points came up in discussion:

(i) Select Committee on the Treasury and Civil Service

The Chancellor said that the Committee were causing him considerable difficulty in their demands for information and the general tone of their approach to the Government's economic policies. Their first report was likely to be fairly critical, and this was bad for the Government's credibility. Unfortunately, the Chairman and some of his Tory colleagues were being almost as unhelpful as the Opposition members. He was trying to get the more sympathetic members of the Committee, such as Mr. Beaumont-Dark, to play a bigger role in the Committee's deliberations.

(ii) The Exchange Rate

The Prime Minister said that the high exchange rate was beginning to have a serious effect on manufacturing industry. She agreed with the Chancellor that there was no easy way of getting the exchange rate down, and in any case there would be disadvantages in terms of the RPI even if it were possible. Nonetheless, she hoped that the Chancellor was considering what might be done. The Chancellor said that the effect of the exchange rate was to move resources out of the manufacturing sector to consumers, and this was reflected in the recent big increase in real disposable income. But he did not think there was any mileage in trying to reduce the exchange rate: if anything was to be done for manufacturing, it would be better to look at fiscal reliefs. He had this whole question under review.

(iii) Interest Rates

The Chancellor said that the money supply figures for banking April now seemed likely to be worse than earlier expected: instead of a negative figure, sterling M3 was likely to show an increase of $\frac{1}{4}$ per cent. This in itself was not too bad, but it concealed a continued high level

/lending to

SECRET

lending to the private sector. Interest rates had fallen a little partly in sympathy with American interest rates, but it was too early to contemplate a reduction in MLR. The Bank would need to put out a new tap, probably this week, in order to maintain the funding programme.

(iv) Iran

The Chancellor referred to his minute of 28 April and said that he fully agreed with Mr. Nott that it would be very difficult to get legislation through Parliament if sanctions were to apply to existing contracts. The Prime Minister said she agreed. The Chancellor then turned to the question of Iranian assets, and reported that the Governor had recently met Mr. Nobari of the Iranian Central Bank - who had asked for an assurance that we had no intention of freezing. The Governor had given him this assurance, and in answer to further questioning, had made clear that he was not under any pressure from HMG to freeze the Iranian assets. He had explained to Mr. Nobari that the situation would have been different if the UN Resolution had included freezing of assets; but since it had not there was no question of HMG going down this route. Mr. Nobari had told the Governor that he had been given a similar assurance by the Germans and the Austrians. The Prime Minister said she was glad that Mr. Richardson had made our position clear.

T.L.

1 May 1980

cc: Mr. Michael Alexander

cc IG

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PRIME MINISTER

To see

MS

1. PL to see

2. PA

MS

Treasury Chambers, Parliament Street, SW1P 3AG

N J Sanders Esq
Private Secretary to the
Prime Minister
10 Downing Street
London SW1

30 April 1980

Dear Nick,

The Chief Secretary has asked me to send you the attached copies of letters from Professor MacKay of Heriot-Watt University about the Sunday Times report of his speech in Edinburgh on 19 April. The letter to the editor was published in the Sunday Times on 27 April.

The Chief Secretary had not met Professor MacKay before the Edinburgh conference, and his remarks about the speech and action in writing to the Sunday Times to protest about their treatment of it were entirely unsolicited.

Yours ever

Alistair Pirie

A C PIRIE
Private Secretary

Heriot-Watt University

Department of Economics

31-35 Grassmarket, Edinburgh EH1 2HT
Telephone 031-225 8432 Ext.101

Professor D I MacKay

your ref

our ref DIM/jr

date 22nd April, 1980

Rt. Hon. John Biffen M.P.
House of Commons,
LONDON.

Dear Mr Biffen,

I very much enjoyed the opportunity of meeting you last Saturday and I particularly appreciated the frank way in which you presented and discussed present economic policies. Given your exposition I was quite taken aback to see the headline in the Sunday Times next day and I felt strongly enough to write a letter to the Editor in protest, a copy of which I enclose. I hope that you feel that it is a fair expression of your remarks and of the manner in which they were treated by the Sunday Times.

Yours sincerely,

Donald MacKay

D.I. MacKay

Encl.

Department of Economics

Heriot-Watt University

31-35 Grassmarket, Edinburgh EH1 2HT
Telephone 031-225 8432 Ext. 101

Professor D I MacKay

your ref

our ref DIM/jr

date 22nd April, 1980

The Editor,
The Times Newspaper Limited,
New Printing House Square,
Grays Inn Road,
LONDON WC1X

Dear Sir,

On Saturday 19th April I shared a public platform with John Biffen, Secretary to the Treasury, speaking to the theme of "Productive Manpower". Mr. Biffen gave a most able exposition and defence of current government economic policies.

On Sunday 20th April, the Sunday Times reported Mr Biffen's remarks under the headline "Shock for Thatcher from key Minister". The report claimed that Mr Biffen had "challenged the whole foundation of right-wing Conservative theory, shared by the prime minister, that money supply and inflation are directly linked".

The article appeared to contain only one alleged source of difference between Mrs Thatcher and Mr Biffen. It suggested that Mrs Thatcher believes there is a mechanistic link between money supply and inflation while Mr Biffen thinks that while a link exists, its exact form is not easily predictable.

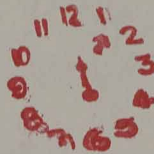
It seems doubtful to me that this does reflect Mrs Thatcher's view and even more doubtful that such differences as may exist are the stuff of sensational headlines. What I am certain of is that Mr Biffen's remarks were in no way intended as an attack on present policies. His speech deserved serious analysis and honest reporting. As a reader of the Sunday Times I am disappointed to report that neither was forthcoming.

Yours faithfully,

D I MacKay

Professor D.I. MacKay

30 APR 1980



Econ Pol 2

LIVERPOOL OCCASIONAL PAPERS — 1980 Number Two

Mr Mettin

Prime Minister

Here are Patrick Minford's forecasts. The one at Flag A incorporates PSBR assumptions fairly close to those in our medium term strategy. The forecast is very helpful to our general case that monetary deceleration is essential for getting down inflation and if we are to have sustained economic growth. Even though his track record is unproven, a useful antidote to Cambridge gloom.

T.. 25/4

THE ECONOMIC OUTLOOK

by Patrick Minford and Kent Matthews

(University of Liverpool)

Liverpool Occasional Papers will address issues of interest to those concerned with policy; they are circulated privately and may be quoted freely.

Department of Economics,
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INTRODUCTION

In his evidence to the Royal Commission on the Value of Gold and Silver (1887) Alfred Marshall argued that an increase in the supply of money would effect economic activity by lowering interest rates, increasing loans, expenditure and finally prices. However he also added that if the increase in the supply of money was well known, then individuals would anticipate the consequent expansion in demand and the effect on prices would be much faster.[1] Is there a lesson to be learned from this?

First of all it is now widely accepted that expectations are the key to understanding inflation and that the economy tends to some 'natural' state when expectations are fulfilled. Secondly the Rational expectations controversy has focussed attention on the process by which economic agents adjust their expectations in the light of recent information. Whatever view one takes as to the realism of 'fully rational' expectations this line of thought must lead to severe modification of the basic textbook transmission process. Private sector behaviour is influenced in many ways by expectations of future variables. If changes in government behaviour change these expectations, econometric models that ignore these links from Goverment to private sector behaviour via private sector expectations, would be likely to forecast poorly and produce misleading policy simulations.

RATIONAL EXPECTATIONS

The overall effect of these two developments is to minimise the scope for 'fine tuning' and introduce a real need

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(1) We are grateful to R. Harrington (1979) for bringing this to our attention at the Oxford Annual Money Study Group Conference 1979.

for government 'announcements' regarding future policy. Simulations with the Liverpool Model have shown that current inflation is a function of expected future inflation which is itself a function of expected future monetary policy. Consequently changes in expected future policy have fast acting immediate effects. However it goes without saying that these targets for government policy have to be believed to be translated into expectations. In other words they have to pass through some 'credibility threshold'. Announcement effects only occur if the announcement is credible. That is, if a particular regime announces a certain policy and all the indicators show that this policy is not being adhered to then economic agents would make up their own minds as to what the underlying policy truly is. Despite the considerable uncertainty a policy of 'announcement and U-turn' produces, the theory of Rational Expectations asserts that economic agents refuse to allow themselves to be systematically fooled. The events leading up to the 67 devaluation and our recent history of incomes policy is ample confirmation of this assertion.

To summarise, what then does the theory of rational expectations tell us? It tells us that current macro variables are based on expected future macro variables and these expected future macro variables are themselves based on expected government policy. Furthermore it says that the smaller the error in predicting future government policy the smaller will be the error in predicting current or immediate future macro economic variables. It does not in any way say that expectations will always be fulfilled or that government policy for the future

is known with certainty. As long as the future is uncertain expectations or predictions of future macro economic variables will have errors. What the theory does say, however, is that the world is uncertain enough as it is without the government unnecessarily adding to this uncertainty.

INFLATION MECHANISM

Keeping this view in mind, let us briefly examine the underlying inflation transmission mechanism before proceeding to the forecast. Inflation occurs when the government by running up a deficit,issues Financial assets in excess of what the private sector will absorb. The amount of Financial assets the private sector will initially hold will depend on a variety of factors but the two major factors will be the state of long term inflation expectations and the structure of interest rates. The excess of Financial assets will be absorbed by the private sector in so far as inflation cuts the real value of its existing assets and so forces it to acquire new assets in order to maintain its real stock of them. The stock of real Financial assets create an imbalance with the existing stock held in the private sectors portfolio. In principle this imbalance is removed by the private sector getting rid of this excess of Financial assets over their desired level, by spending. It is this expenditure that produces the necessary inflation at which they will absorb the assets created by the deficit. In many respects the story is not dissimilar to the way Marshall described it in the Nineteenth Century.

In practice this mechanism is 'short-circuited' by expectations; since there is a general expectation that inflation <u>will</u> occur, there is an <u>immediate</u> impact on all those areas of contracting which must take notice

of future inflation, ie. across all financial markets, labour markets and goods markets. Interest rates rise, the exchange rate drops, wage increases accelerate, and prices are marked up more rapidly - at once.

If the government persists with its deficit, the economy gradually settles down at a higher rate of inflation and interest rates, the real economy returns to the natural state with contracts in effect being indexed at the higher inflation rate.

It is essential that the processes described above be put into reverse. The long-run targets of a zero PSBR and output - matching growth in money supply are the essential ingredients of an inflation-free economy.

THE ECONOMIC OUTLOOK

Despite the gloomy forecasts for output by many macro economic commentators, the predicted recession supposedly on cue since early 1979 still refuses to appear. The same problem is apparent in the US where industrial production just will not decline. As for Japan and the rest of Europe, the story is similar; an interpretive analysis of the monthly series, indicates a flattening-off, but no decline. For the world at large, inflation has been running at 8% pa or so; prices are expected to rise faster than this in 1980 as oil and commodity price increases are 'passed through', and then to revert to a similar inflation rate in 1981 onwards in the face of expected money supply growth of 11% or so (it has been around this since 1976).

For the UK, inflation (ex-VAT and-oil) has been running at 12% pa. In 1980 the RPI is expected to average 16% because of

oil and despite the commitment to monetary targets the market is projecting 12½% inflation into the indefinite future. Such a view is clearly reflected in the gilt-edged market where the Consols 4% yield is nearly 14%.

Why has not the market responded to Ministerial pronouncements? Partly because without any clear signs of action, pronouncements fail to pass the credibility threshold.

In 1979/80 the PSBR will have been 5½% of GDP at factor cost, against 6.5% in 1978/79. £M3 in January this year was 11.2% up on a year ago (M1 7.3%), as compared with April 1979 when £M3 was 10.9%, and M1 14.6%, up on a year before.

The well-known distortions of £M3 mean that the M1 figures and the PSBR/GDP percentage are the best guides to the evolution of financial control. But these are small reductions at best. The previous budget showed not a 'cut' in government expenditure but a cut in the projected rate of growth of government expenditure for 1979/80; the residual being financed by the sales of special assets to the tune of £1 billion. The projected growth of government expenditure for 1980/81 shows only a fall of -½% excluding sales of special assets of £500 million. In some respects it is not surprising that the market has not allowed itself to be fooled by this budget. It has allowed the money supply growth to get out of hand. Last October the money supply according to most valid indicators was running at 16% above its previous year figure, and accelerating, and the PSBR was reaching 6% of GDP at factor cost (about £10 billion). Subsequent measures have probably managed to hold monetary

growth to just above the 11% target ceiling and the PSBR to just under £9 billion (or 5½% of GDP). Furthermore, this was in a year when the economy was hitting hard against supply ceilings and in a classic boom.

The damage can now be evaluated. The labour market has been tight. Prices, excluding VAT and oil, have accelerated. Wage rates this year have increased by 14-16%; and earnings, reflecting consolidation of previous rate increases and back-pay, have risen by 18-20%. Much of this it appears has been a catch-up of public sector pay after the previous governments incomes policies. Private sector wage rates and earnings appear to be in the region of 14-16%. Finally, long term interest rates, the best available indicator of long term inflation expectations, have risen from about 11½% at election time to about 14%; deduct 1½% for a 'real' rate of interest and one can see that the underlying inflation rate has risen from 10% to 12½%.

THE FORECAST

The indicators for output suggest zero or little growth for 1979/80, but hardly a severe recession. To begin with real disposable income continues to grow moderately; it rose 5.4% in 1979. Non-durable consumers expenditure is unlikely to decline; it rose 4% in 1979. The most likely path for consumers expenditure will be, after currently levelling off, some modest growth in 1980.

Business spending on investment and inventories is likely to be reduced from already low 1979 levels by poor profitability and cash flow. Exports will slow down, but so will imports (sharply) after a bumper year in 1979 (already imports have

clearly flattened off).

This picture of little growth but not severe recession suggests the demand for money will be more buoyant than generally painted. Short term interest rates are therefore unlikely to come down until later in the year and they will probably have to rise further in the first half as rising commodity and oil prices increase working capital demands. Long term interest rates are likely to drift sideways for some time before edging downwards towards the end of the year.

In producing our forecast we use the Liverpool Model.[2] The model is a highly aggregate one which balances trade and capital flows with private sector asset acquisition. Besides incorporating stock and flow equilibrium, the model includes an explicit government budget constraint and introduces Rational expectations of inflation as a parameter of portfolio balance. In its favour the model accommodates 'announcement effects', but its forecasts are necessarily of an aggregate nature.

We conduct 3 kinds of forecasts. The first assumes a no change in government strategy regarding the PSBR-GDP ratio. It is assumed that the government continues with an announced medium term target of PSBR as 5.5% of GDP. See Table 1. The second forecast assumes that the PSBR is cut in 1980/81 to 4.5% of GDP (about £8.5 billion) and then is announced to be maintiined at this % of GDP for subsequent years, see Table 2. Thirdly we assume an announced target of gradual reductions in the PSBR-GDP ratio at the rate of 1% per annum, see Table 3. This is the set of policies we believe will be followed; and so it is our main forecast.

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(2) See Minford, Brech and Matthews (1978) and Minford (1979).

The outstanding feature of all 3 forecasts is the near identical picture each one portrays for the movement of real variables, such as growth and consumption. They differ markedly in movements of nominal variables such as inflation and interest rates according to assumptions. Each forecast assumes an announcement of government policy for the medium term. Provided that each announcement passes the credibility threshold, the knowledge of the future path of government policy and its consequent effect on monetary growth reduces the amount of uncertainty in the system allowing the real sector to get on with its business.

As suggested earlier output is not expected to grow in 1980, but picks up sluggishly in 1981, and in 1982 is expected to grow a little faster than normal. During 1980/81 Non durable consumers expenditure grows at the expense of stockbuilding, fixed investment and durable expenditure. Despite the expected slow growth of 1981, consumers expenditure is expected to remain buoyant throughout the forecast period. The reduction of the level of uncertainty in the system and its consequent reduction in the variance of inflation plus the anticipation of higher growth in the future serves to reduce the Savings ratio for 1980/81.

The high level of interest rates, in conjunction with poor profitability and the consequent pressure on cash flow is expected to continue its depressing effect on Physical capital accumulation by the Private sector. The contraction in Business Investment is expected to continue into 1981, but by then it is expected that Stockbuilding and Durable expenditure would rise as expectations filter into capital expenditure. As the

amount of uncertainty is reduced and long run expectations of inflation stabilise, this, plus the expectation of sustained higher growth after 1982, stimulates Private Physical asset accumulation in 1982 onwards. Fixed Investment is expected to rise dramatically reflecting a more buoyant state of confidence.

The Trade balance is expected to be in deficit of approximately 1% of GDP (about £1.6 billion). The outlook for World Trade in the short term is dominated by the doubling of oil prices over the last few months. We expect a moderate growth in world trade, in the order of 1.7% in 1980, but rising to 4% in 1981 and continuing at 6% from 1982 onwards. The prospect for exports in 1980 is one of slow growth with only a marginal increase in import penetration caused primarily by the expectation of zero growth in expenditure and the continuing strength of Sterling.

The real exchange rate (defined as the fractional deviation from Purchasing Power Parity) is expected to remain high throughout the forecast period but it adjusts slowly back towards equilibrium as the initial shock of tighter financial policies wears off. On the assumptions relating to the forecast shown in Table 3 there is a faster adjustment of the real exchange rate and consequently a more rapid adjustment of the Trade balance as a percentage of GDP.

Our forecast of inflation for 1980 is not out of phase with alternative forecasts (NIESR 15.8%, LBS 17.7%, CBI 15.9%, OECD 16.5%) but shows a rapid adjustment in response to announced targets. From 1981 onwards one percentage point of PSBR to GDP roughly represents 2 percentage points in inflation. The Consol yield also reflects this rapid adjustment but at least for 1980 we do not expect a marked change.

TABLE 1

	1980	1981	1982	1983	1984
PSBR/GDP%‡	5.5	5.5	5.5	5.5	5.5
GDP growth%‡	0.0	1.5	2.8	2.7	2.5
Inflation%	17.0	11.3	11.1	11.1	11.1
Trade Balance as % of GDP‡	-1.0	-1.5	-1.5	-1.4	-1.3
Non durable consumption real growth%	2.6	2.4	2.4	2.4	2.4
Real Exchange Rate	.058	.067	.059	.054	.04
Business Fixed Investment (inc. Housing) + stock-building and Durable consumption growth %	-3.4	-2.1	3.8	3.6	3.5
Consols 4%	12.9	13.0	13.0	12.9	12.9
3 month Treasury Bill rate	14.8	14.6	14.6	14.4	14.3

TABLE 2

	1980	1981	1982	1983	1984
PSBR/GDP%‡	4.5	4.5	4.5	4.5	4.5
GDP growth%‡	0.0	1.2	2.9	2.6	2.5
Inflation%	16.5	9.0	9.1	9.3	9.2
Balance of Trade as % of GDP‡	- 1.0	-1.0	-1.0	-.9	-.8
Non Durable consumption growth %	2.9	2.6	2.4	2.3	2.3
Real exchange Rate	.058	.054	.044	.041	.038
Business Fixed Investment (inc. Housing) + stock-building and Durable consumption growth %	-3.4	-2.4	3.5	4.5	4.1
Consols 4%	12.0	11.2	11.2	11.2	11.2
3 month Treasury Bill rate	12.9	12.7	12.7	12.7	12.7

A.

TABLE 3

	1980	1981	1982	1983	1984
PSBR/GDP% ‡	4.5	3.5	2.5	1.5	0.5
GDP growth% ‡	0.0	1.6	2.9	2.7	2.5
Inflation%	16.5	9.0	8.1	4.3	1.4
Trade Balance as % of GDP ‡	-1.0	-.8	-.5	-.3	-.2
Non Durable consumption real growth%	2.9	2.8	2.4	2.3	2.4
Real exchange rate	.058	.043	.038	.035	.026
Business Fixed Investment (inc. Housing) + stock-building and Durable consumption growth%	-3.4	-2.2	3.8	4.8	4.4
Consols 4%	12.0	9.6	7.8	6.0	4.2
3 month Treasury Bill rate	12.9	11.1	9.3	7.5	5.7

‡ GDP at factor cost

(in other words, in relation to GDP at market prices – which is the basis in the Red Book – the PSBR would be higher than shown in line 1 above).

R.

CONCLUSIONS

The implication of these forecasts for policy is fairly clear. Government should cut the PSBR (as % of GDP) and money supply growth as rapidly as is feasible since this will improve the inflation prospect without material effects on the output prospect. Inflation is a monetary and financial disease; it must be cured by financial and monetary remedies. It will assist the cure if targets for reduced PSBR and money growth are announced well in advance, since this will cause expectations to adjust earlier to the new environment. Inflation will respond correspondingly earlier. If policies are expected to be followed by a 'U-turn', then there will be a deflationary effect on output and no effect on inflation. The maintenance of credibility is therefore of extreme importance in the programme to reduce inflation by monetary and financial means. Therefore policies in the Budget in addition to the 1980/81 measures should announce a 'financial plan' for the subsequent 3 years, showing a PSBR dropping by 1983/84 to a negligible proportion of GDP, and money supply growth falling in parallel to a level that would finance only the normal growth in output.

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PRIME MINISTER

Mr. Biffen's speech to the National Conference of the Junior Chamber of Commerce in Scotland

Apparently, there is no final text of this speech. Mr. Biffen spoke from the attached summary.

Janice

20 April 1980

There are tentative and modest signs that the money supply - as measured by sterling M3 - is coming under control at last. The pattern of recent gilt edged sales will also serve to reinforce the hope that the Government's immediate monetary targets will be met.

How then should we greet this fledgling monetary swallow? In what sense does it presage a golden summer of falling inflation? The answer to that question contains and conceals the major economic fortunes of this Government.

There is no mechanistic and succinctly demonstrable link between a movement in money supply and a subsequent change in inflation. Enoch Powell and Lord Harris of High Cross (and the Institute of Economic Affairs) have recently suggested a rough time-lag of two years. That may be so, but I suspect the time lag-lag varies on account of the level of international trade, the rate of domestic business activity and the many social traditions that affect individual and corporate economic behaviour. Monetary policy is pursued in a social as well as an economic environment - as Treasury Ministers fully acknowledge.

Given these assumptions, I assert the following three points. First, time is the most precious asset for a politician. If a week is a long time for some people in politics, then two years is almost eternity. It is therefore essential that there is the political will and resolve to see through the transitional period ahead. A policy cannot be abandoned because there is a price that has to be paid in output and employment in the short term in order to secure the prize of reducing inflation.

Secondly, the transitional period of the time-lag has to be shortened and its severity tempered wherever possible. This is not entirely or even mainly the function of government. If wage bargaining acknowledges the implications of the Government's economic policy rather than seeking to frustrate

/it, then

it, then there will be beneficial consequences. Indeed, given the objectives of monetary control being exercised by the Government, the level of pay settlements will be the major influence on the outlook for employment and company solvency. That much can be stated and explained by the Government, but in a free society the decisive judgement of the determinations remain with the people and not with the politicians.

There are, nonetheless, areas where the Government can assist - and one is the creation of a more favourable tax climate for smaller businesses. This is being proposed in the Budget, and in due course could make a valuable, albeit modest, contribution to the very significant employment provided by smaller enterprises in the private sector.

The third assertion, however, is the one which I believe is most central. However infant is this swallow - it is at least launched into flight. It will become clear - as the month proceeds - that the Government are succeeding in their initial objectives and they are conscious of and accept the time scales implicit in the policy.

That realisation will engender credibility in the policy with all its subsequent impact upon the financial, commercial and industrial communities. All this will help create a climate within which interest rates can fall. Furthermore, the transitional period between a fall in the expansion of money supply and the subsequent fall in inflation can be made more manageable in economic and social terms. In the best traditions of Lord Butler, the Treasury team will have been practising "the art of the possible".

✓ Mu faxed to Chequers 19/4

PRIME MINISTER

Mr. Biffen made a speech today on the Government's economic policy to the Edinburgh Junior Chamber of Commerce.

The Sunday Times tomorrow has a front-page lead on the speech which suggests that Mr. Biffen cast doubt on the basic monetary approach of the Government. The sentence they have latched on to and apparently are misinterpreting is: "There is no mechanistic and succinctly demonstrable link between a movement in money supply and a subsequent change in inflation. Enoch Powell and Lord Harris of High Cross (and the Institute of Economic Affairs) have recently suggested a rough time-lag of two years. That may be so. But I suspect the time-lag varies on account of the level of international trade, rate of domestic business activity and the many social traditions that affect individual and corporate economic behaviour. Monetary policy is pursued in a social as well as an economic environment - as Treasury Ministers fully acknowledge". The rest of the speech affirms the Government's approach. The Treasury have said that Mr. Biffen in the above sentences is saying that he believes absolutely in the need for money supply control, but there is no precisely predetermined time-scale between the control of money supply and a subsequent drop in inflation.

Mr. Biffen has agreed to give an interview to BBC Radio 4 "The World This Weekend" tomorrow where he can make the position clear.

(SIGNED) JAN LUKE
PRESS OFFICE

19 April 1980

S E C R E T

Prime Minister.

TGR.
Duty Clerk
9.4.80.

Econ Pol

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

9th April 1980

T.P. Lankester Esq.

Dear Tim,

The March banking figures are due to be published tomorrow, Thursday 10 April. They suggest that the recent improvement in monetary trends is being sustained. The figures will show a slight fall (0.2 per cent) in banks' eligible liabilities during the banking month. This figure is, however, affected by seasonal movements, and we expect that £M3 will have increased by about 0.4 per cent. As usual, the Bank will informally indicate this £M3 figure to the markets when the banking figures are published.

As a result of this modest increase in £M3, the cumulative growth of sterling M3 in the 9 months since last June has come down to about 11½ per cent (at an annual rate), very close to the top of the 7-11 per cent target range. Over the last 5 months, the cumulative growth has been 9 per cent at an annual rate. Preliminary estimates of the components are shown in the attached annex.

The public sector contribution to money supply growth in banking March was larger than in recent months. Gilt receipts were very modest - there were substantial receipts of part payments on a previously sold stock, but one stock fell to be redeemed in the month - and only partially offset public sector borrowing. The increase in bank lending to the private sector, however, was much lower than in recent months, just £170 million. But this figure, although encouraging, does not imply a slackening in the underlying demand for credit. There was a substantial further increase in banking March in holdings of acceptances by the private sector outside the banking system and not recorded in £M3. If these and other factors (for example the effect of the steel strike in reducing companies' steel stocks and so their need for finance) are taken into account, the increase

/ in bank lending

S E C R E T

in bank lending is still of a similar order of magnitude to the average level over the previous 8 months.

<u>External and foreign currency</u> factors were again contractionary in banking March.

The press release published by the clearing banks at the same time as the eligible liabilities figures will only give partial information on bank lending, although it will imply that the underlying increase last month was no lower than in previous months. Nevertheless it seems probable that the markets will react favourably to the figures.

I am copying this letter to John Beverly, Bank of England.

Yours

John

A.J. WIGGINS
Private Secretary

SECRET

ANNEX

STERLING M3 AND ITS COUNTERPARTS

£ billion seasonally adjusted

	Monthly average banking July-October (4 months)	Monthly average banking November -February (4 months)	Banking March
CGBR	+0.91	+0.59	+0.73
Less sales of central government debt to non-bank private sector	-0.51	-0.79	-0.21
(of which gilts:)	(-0.58)	(-0.98)	(-0.20)
Net other public sector	-0.04	+0.07	-0.14
Sterling bank lending to:			
private sector	+0.61	+0.70	+0.17
overseas	+0.01	+0.09	+0.10
DCE	0.99	+0.66	+0.65
External and foreign current finance	-0.32	-0.19	-0.30
Net non-deposit liabilities etc	-0.07	-0.03	-0.14
Change in £M3	+0.60	+0.44	+0.21
	(1.1%)	(0.8%)	(+0.4%)

SECRET

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

PRIME MINISTER

MONETARY DEVELOPMENTS

I thought that you might like to know the outcome of the discussions which I have just had with the Governor, to take stock of the monetary position following the Budget.

The Market Reaction to the Budget

2. The gilt-edged market reacted to the Budget very quietly. There was some selling on Thursday by loose holders, but the institutional investors appear to have adopted an attitude of wait and see. The market had begun to come back today, before the announcement of the findings of the Committee of Inquiry into the steel dispute. Since then it has strengthened slightly further. This recovery in the gilt-edged market has taken place, notwithstanding the rise in American interest rates, and some slight upward movement in our own domestic money market rates.

3. This means that there is a tolerable prospect that we may be able to resume gilt sales fairly soon. However, the present inflow into the Exchequer, partly because of the forward oil sales, means that we have a reasonable chance of achieving an acceptable April money supply figure, even if we do not achieve any gilt sales. We can afford to wait until some piece of good news cheers the market.

4. It is possible that this may happen on Thursday week, 10 April, when the eligible liability figures are published, along with the

/clearing bank

SECRET

clearing bank figures. We have only a very preliminary estimate of the money supply in banking March: on the basis of this, it is fairly certain that the growth of the money supply was less than 1 per cent in the month, and that bank lending was below the recent trend level, possibly significantly so. If the later figures confirm these first impressions, then that should help to reassure the market.

Money Markets

5. The Exchequer surplus to which I have just referred has also had the effect of causing very tight conditions in the money markets, and upward pressure on short term interest rates. The Governor and I have agreed that in these circumstances we must postpone the recall of special deposits which was due to be made on 8 April: this will be announced in a low key manner when the markets open on Tuesday 1 April. We may also need to renew the purchase and resale of gilts, which would otherwise expire on 14 April, especially if we make significant gilt sales before then. But we can delay a decision on that until after the eligible liability figures have been published, and we know whether we have achieved gilt sales or not.

(G.H.)

31st (?) March 1980

rd. 1.4.80

1 - APR 1960

cc: PS/Chancellor of the Exchequer

MR. LANKESTER

CF. pls put on file TL.

Note on Professor Minford's Forecast

You asked about Professor Minford's analysis that the inflation rate would fall to $1\frac{1}{2}\%$ a year by 1984-5 and output be growing by 3% a year if the PSBR was reduced to $\frac{1}{2}\%$ of GDP and money supply growth fell in parallel. (Financial Times, Tuesday, 25 March).

Professor Minford's analysis refers to the year beyond the end of the Medium-term Financial Strategy published in the FSBR. His remarks are clearly in general helpful to the Government's case that a steady deceleration in monetary growth is essential if inflation is to be reduced and conditions created for sustainable economic recovery. It would, however, probably not be advisable to refer directly to Professor Minford since his economic model is, to a large extent, unproved, and he is regarded by many as being at the extreme end of the "monetarist" spectrum.

The Prime Minister should also be aware that The Times this morning has interpreted the MTFS as implying a 5% inflation target by 1983-4. The FSBR itself gives no inflation assumption, and the Prime Minister is advised to do likewise. Any figure would risk becoming a hostage. The Prime Minister is also advised not to become involved in discussion of the output path for particular years.

I attach a form of words for use if required.

A. Bottrill
EB Division
HM Treasury

27 March 1980

"What is the inflation forecast underlying the Medium-term Financial Strategy?"

"The strategy is designed to achieve a substantial reduction in inflation over a period. Within the monetary targets, the greater the slow-down in inflation, the greater will be the scope for real output growth."

Published Papers

The following published paper(s) enclosed on this file have been removed and destroyed. Copies may be found elsewhere in The National Archives.

Cmnd. 7858	Monetary Control
HMSO	March 1980

Signed CAWayland Date 9 March 2010

PREM Records Team

PI

Econ Pol.

DEPARTMENT OF HEALTH & SOCIAL SECURITY
Alexander Fleming House, Elephant & Castle, London SE1 6BY
Telephone 01-407 5522
From the Secretary of State for Social Services

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
Treasury Chambers
Great George Street
LONDON SW1

20 March 1980

Pross

Dear Geoffrey,

I have read your paper on Monetary Control with great interest. I am happy to support the immediate proposals that you intend to make.

The issues discussed in the paper on alternative forms of monetary base control and on the possibility of some form of automatic adjustment to interest rates seem formidable. It appears unlikely that the debate, which will surely follow publication of the consultative document, will in fact produce useable schemes for implementation, although no doubt the financial commentators will make much of the issues raised. They will have much to live up to. The paper is a most thorough and comprehensive document.

I am sending copies of this letter to the members of E Committee and to Sir Robert Armstrong and Sir Kenneth Berrill.

Yours ever
Patrick

20 MAR 1980

CONFIDENTIAL until 11.30 a.m. on 20.3.80, then unclassified

FINANCIAL SECRETARY

cc Chancellor
Chief Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Mr Burns
Mr Ryrie
Mr Middleton
Mr Bridgeman
Mr Britton
Mr Unwin
Mr Riley
Mrs Gilmore
Mr P Davies
Mr Bottrill
Mrs Lomax
Mr Peretz
Mr Browning
Mr Grice o.r.
Mr Shields (+ 1 for UKTSD)
Mr Ingham
Mr Folger
Mr Bell
Mr Page
Mr Ridley
Mr Cropper
Mr Cardona

Mr Quinn, Bank
Mr Lankester, No 10
PS/PMG

cc Mr Ingham

MONETARY CONTROL

I attach the background brief for the publication of the Green Paper tomorrow. Please could I ask Mr Quinn to distribute copies in the Bank as necessary.

M L Williams

M L WILLIAMS
19 March 1980

MONETARY CONTROL TECHNIQUES

BACKGROUND BRIEF FOR CONSULTATION PAPER TO BE PUBLISHED ON 20.3.80
(References throughout are to Green Paper, Cmnd 7858).

Main Points

1. Monetary policy objective: to control monetary growth over the medium term, in order to bring down trend. Progressive reduction in rate of growth essential to achieving reduction in inflation.

2. Main instruments of monetary control are fiscal policy and interest rates.

3. Paper considers ways of moderating short term fluctuations in monetary growth. Specifically, it:

(i) examines scope for improvement in existing instruments (and proposes some changes, e.g. to reserve assets ratio);

(ii) considers role of direct controls, and alternatives to SSD scheme, including monetary base control.

Positive

1. Fiscal policy and interest rates must continue to be main instruments. Sufficient to control money supply growth in medium term, say over a year or more. Government intends to bring down over time PSBR as a proportion of national output.

2. Fluctuations in monthly figures do not destroy monetary control. Relation between monetary growth and prices and nominal incomes is medium term. But some advantages from smoother path, including reduced uncertainty and less volatile expectations.

3. Monetary target gives guidance to markets and industry on which to assess direction of policy and to formulate expectations. £M3 most suitable as target, but account taken of other aggregates, and policy directed to a reduction in growth rate of all.

4. Direct controls not an alternative to fiscal policy and interest rates. To the extent that they leave interest rates unchanged they simply divert and change forms of liquidity and credit, rather than affect underlying conditions.

5. Recommendations on existing control arrangements summarised in para 6.3. (Phase out SSD scheme, end 12½% reserve assets ratio, extend cash requirement to all banks, retain special deposits scheme. Bank issuing a separate consultative document on future prudential requirements, and will issue paper on cash requirement).

6. Monetary base system presents difficulties; there are practical problems and it might not produce desired results. Paper discusses possibility of more automatic system of adjusting Bank's lending rate in response to divergence of money supply from target. Bank and Treasury would welcome comments on whether the difficulties with monetary base control could be overcome and whether there is on balance anything to be gained from more automatic interest rate adjustments.

7. Consultation period. The consultations will take place over the next six months, but written comments should be made preferably within the next two months. Throughout consultation period Bank and Treasury will be inviting individuals and organisations to discuss further.

8. Recent monetary growth. Clear that measures already taken bringing monetary growth under control. Some deceleration in £M3 growth, and other measures growing more slowly. M1 falling.

Elaboration

1. Present instruments. Main instruments can achieve control over medium term. But time lags mean it can take up to a year or so to correct a divergence from target with present techniques. Smoother control would require substantial interest rate fluctuations. But some advantage from smoother path, hence consultation paper.

2. Fiscal policy. No simple relationship between fiscal policy

and monetary growth; affected by economic cycle, inflation and structure of tax and expenditure flows. In long run, unless there are to be steadily increasing interest rates, monetary restraint requires firm fiscal control.

3. Gilt sales. Substantial sales of gilts have helped to finance PSBR outside banking system. But sales irregular. Bank article (BEQB June 1979) discussed proposals for securing flow of sales more closely related to requirements of shorter term monetary control. Comments on paper welcome.

4. Interest rates. Interest rate changes affect bank lending, sales of public sector debt, exchange rate and/or external flows, although bank lending responds slowly. Can have immediate impact on expectations in financial markets and hence gilt sales. But not an exact control in short run.

5. Ratio controls (Chapter 3). Reserve assets ratio not designed as monetary base, but as element in control of short term interest rates. Separate consultative document on prudential liquidity requirements. Special Deposits scheme to be retained to guard against adverse effects of excess liquidity. Cash requirement is effective fulcrum for Bank's money market operations; propose to apply it to all banks, not only clearers (Bank to issue detailed paper).

6. Monetary base control (Chapter 4). See Annex B for full description of alternative systems and possible problems. In summary:

(i) Non-mandatory system: to secure sufficiently stable base assets/deposits ratio would require significant institutional changes, resulting in less flexible money markets (since only banks' balances at Bank would count as primary liquidity, there would be less role for money brokers and other intermediaries who help to transmit interest rate changes through markets).

(ii) Mandatory systems: with lead accounting, banks' could meet requirements only by disintermediation, i.e. with no effect on underlying liquidity. Under lagged accounting, severe practical difficulties, including insulating base from fluctuations in Exchequer's daily cash flow. No reason to suppose right interest rates would be generated, and could still have disintermediation problems if penalties imposed on banks.

7. Indicator Systems (Chapter 5). Uses changes in base from desired path to trigger interest rate changes. Alternatively, and more direct, use divergences in £M3 from desired path to trigger changes (e.g. using weekly figures). Greater automaticity may be advantageous. But although system could reduce policy delays, it could also mean more variability of interest rates and possibly even the money stock. Welcome views.

8. Bibliography and Glossary. See press release.

9. Impact on "Ordinary" Man. Fundamental reliance on fiscal policy and interest rates mean that proposal for smoother monetary growth will have little impact on general level of interest rates. But could mean greater interest rate fluctuation; individuals and institutions have to accommodate to this.

Defensive

1. Direct controls (Paras 1.12 - 1.17). Tend to reduce competition, involve loss of efficiency, and give rise to prudential risks. If permanent, funds move out of controlled sector; monetary statistics distorted (as is £M3 by SSD scheme), and impact on underlying growth weakened. If short term, problems of anticipation by controlled institutions, and removal of control can mean problems. New techniques must not provide significant incentive to development of financial channels outside controlled sector (disintermediation).

2. PSBR/£M3 Relationship. [e.g. Lord Kaldor in New Stateman of 14.3.80 argued that PSBR and £M3 growth are unrelated.] Many

factors affect relationship between PSBR and monetary growth. Close relationship not observable from published figures partly because of Government action to offset monetary impact of PSBR. Precise relationship will depend on structure of tax and expenditure flows, as well as interest rates. In long run, tight target will require ever higher interest rates unless fiscal policy is under control.

3. <u>SSD Scheme (Chapter 2)</u>. Government aware of limitations and scheme should be phased out as soon as convenient (further announcement in Budget on future of scheme beyond mid-June when present guideline ends).

4. <u>Adequacy of control techniques if SSD scheme not replaced.</u> Fiscal and interest rate policies adequate for control over medium term. Advantage in shorter term control; hence paper. Consultation process will explore alternatives.

5. <u>Phasing out SSD scheme and £M3 growth</u>. Development of credit channels outside the banking system (e.g. bill leak) means £M3 under-recording. Ending SSD scheme would mean process would in part be reversed, thereby increasing £M3. Would need to take account of this is interpreting figures.

6. <u>Exchange control abolition undermined SSD scheme</u>. Decision to phase out scheme would have been made even without abolition. Disadvantages of SSD independent of exchange controls and apparent well before abolition. Switching transactions offshore only one form of disintermediation.

7. <u>Exchange control abolition disruptive</u>: Abolition justified on its own merits. Strength of sterling and markets' confidence in Government's policies means abolition well timed, not disruptive. Monetary impact hard to assess, but probably small.

8. <u>Other aggregates</u>. £M3 adopted as target aggregate as well understood, and indicates links with other policies (especially fiscal policy). But substitutability between forms of liquidity

means authorities must have regard to other measures (both narrow, e.g. M1 and wide, such as measures of private sector liquidity; and also DCE). Fiscal and interest rate policies directed to any one aggregate will tend to control others over a period.

9. Current interest rates and monetary control. In recent months short term interest rates under upward pressure as a result of liquidity shortages in money markets. Not a reflection of fears about monetary control. Bank has taken technical measures to relieve pressure; do not reflect a weakening of monetary resolve. Relieving excessive money market pressure not inconsistent with more automatic interest rate adjustments for monetary control purposes.

10. Liability management (para 3.3). Likely to occur, particularly in short run, with most systems of control, including present one. Could be avoided only by some forms of direct control, but disadvantages of direct controls make such a solution unacceptable.

11. EMS (para 1.19). Some changes in control methods inconsistent with EMS; this is a consideration in assessing alternatives.

12. Cash requirement and monetary base control: Cash requirement to be extended to all banks for reasons of equity (all benefit from services of Bank). Monetary base system would possibly also require a uniform requirement, but that is not why change is now being proposed.

13. Liquidity requirements: Enquiries about Bank's consultative document to Bank: 601-4444 Ext 3275.

14. US System: Comparisons complicated by different institutional structure. October 1979 measures interesting experiment. Apparently only partial move to monetary base control as Fed has continued to supply reserves to the banks to prevent extreme short term movements in interest rates. Banks' reserves continued to grow rapidly in subsequent months; money supply growth slowed, but continued concern over total credit growth led to further restrictive measure on 14 March. (Direct control element of package largely "moral suasion",

Fed mainly relying on reserve ratios and interest rates.)

15. Timetable for consultation. Inevitably imprecise. Difficult subject. Implementation of RAR, etc. changes depends on reactions to Bank's papers. On monetary base hope to receive written comments within next two months. Any subsequent changes, and timing of implementation, will depend on how consultations develop.

Contact Point: M L Williams (HF3) 233 4533

20 MAR 1980

Econ Pol

Ref. A01674

PRIME MINISTER

Medium-term Financial Strategy

(C(80) 17)

BACKGROUND

You are familiar with the origins of this paper, and have discussed it in draft with the Chancellor of the Exchequer and with the Governor of the Bank of England. Sir Kenneth Berrill and I have both already given you our views on substance (in our minutes of 25th February and 26th February).

2. The intention now is to publish some illustrative figures and some text (yet to be finally drafted) in the Financial Statement and Budget Report (FSBR) on Budget Day. The Chancellor does not propose to circulate the text in advance to colleagues, though he will no doubt show it to you. He will need to send it to the printers early next week, so a decision at this meeting is highly desirable. If a decision has to be postponed, it should be possible to bring this back to Cabinet next Tuesday.

3. In addition the Chancellor has secured your agreement (Mr. Lankester's letter of 10th March) to the publication of a consultative document on monetary control, which implies the existence of such a medium-term financial plan: paragraph 1.1 says: "The Government considers that a progressive reduction in the rate of growth of the money stock is the only viable way of achieving a permanent reduction in inflation". Paragraph 1.3 begins "The Government believes that the money supply must be controlled consistently over a period of years". He proposes to publish that document on 20th March. There is not much overlap between the two papers, apart from this implied commitment.

4. The critics may argue that the Chancellor's memorandum is not only deceptively short but also deceptively bland. It does not disclose the path by which the money supply growth target is to come down from 7-11 per cent in 1980-81 to 4-8 per cent in 1983-84, though I believe that he intends to publish figures showing

the range as falling by 1 percentage point each year. It does not include any of the references to "transitional losses of output" which feature in the draft section for the FSBR. It states even more elliptically than that draft the absolute primacy to be given to the money supply target over all other policy objectives. There is no hint of the Governor's doubts about what is proposed. You may want to make sure that these points, and their implications, emerge in the discussion, because if they do not some of the colleagues, when they see the published text, may argue that it goes significantly beyond what they thought they were agreeing to in Cabinet.

HANDLING

5. The tactics will require some care. You may well want to introduce the discussion yourself. The danger is that discussion could go to the root of the Government's economic strategy and lead to a polarisation of views. You will have your own view on the best way to handle this. One tactic would be to imply at the outset that the strategy is common ground, that much of the information will all be a matter of public record in due course anyway, and that the sole question for Cabinet is not whether the strategy is right but whether it is right - or indeed avoidable, if the credibility of the strategy and the firmness of the Government's commitment to it is to be reaffirmed - to reassert the strategy in this quantified form.

6. You might then ask the Chancellor to introduce the paper, and call for quick comments from a few of his leading supporters, and from one or two potential critics. A possible sequence would the Secretary of State for Industry: the Secretary of State for Employment: the Secretary of State for Trade: the Minister of Agriculture (or the Lord Privy Seal). You might bring the Home Secretary in at the end, to round off the discussion and rally support for the Chancellor.

7. The Chancellor may well be asked his intentions about indicating a path of monetary targets, in the intervening years, leading to the target for 1983-84 referred to in paragraph 5 of his paper. It is in fact, we know, the Chancellor's intention to give indicative figures for the intervening years in the FSBR. The precise way in which these intervening year figures will be presented will reflect the Chancellor's need to accommodate the Governor's worries, and only the figure

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for the final year will be a firm "target". The Chancellor will no doubt be ready to explain all this if asked, and should perhaps be encouraged to do so, in order to reassure the doubters.

8. The Chancellor may face questions in Cabinet now, and later in public, about the implications of his forward plan for employment, inflation, GDP growth and so on. The Chancellor can be expected to resist such pressure - as involving spurious precision and offering all too many hostages to fortune. But again a discussion of this aspect of presentation might help the Chancellor and reassure those who are sceptical or unhappy.

9. If, despite your initial steer, discussion does centre on the underlying policy, questions which might be posed are:-

(a) Is there any viable alternative to making the money supply the centrepiece of the strategy despite its short-term implication? It is for those who are unhappy about the present course to offer an alternative. The Chancellor's figures (with PSBR still positive in 1983-84) suggest that in fact there is very little room for manoeuvre if inflation is to be overcome, taxes reduced and healthy growth resumed, within the timespan of the present Parliament.

(b) Is the speed of adjustment right or should it be "a policy for two Parliaments"? The job has to be done some time, and 1984 imposes its own imperative. If the blue skies do not arrive before then, the second Parliament may not be available to carry the policy through to a conclusion.

(c) Does the Government need to publish this "plan" at all, remembering the problems and fates of earlier "plans"? The arguments here are familiar - without a coherent indication that the Government's policies can work, the short-term misery will be that much harder to bear and to justify; but if the Government shows that it knows where it is going and that the end result is not only palatable but demonstrably credible, the decision-takers in the economy will be heartened and prophecy aided to self-fulfilment. /Note: If nevertheless the collective view of Cabinet is against publication some consequential amendments will be needed to the Green Paper on monetary control./

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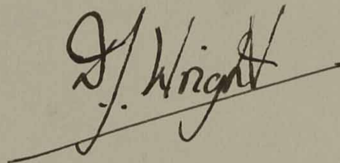
CONCLUSION

10. The conclusion to which you will hope to guide the Cabinet is authority for the Chancellor to publish a passage in the FSBR on the lines indicated in his paper.



ROBERT ARMSTRONG

(approved by Sir Robert Armstrong and signed in his absence)

12th March, 1980

9

Copy No 2 of 4 copies

CHANCELLOR OF THE EXCHEQUER

cc Prime Minister
Sir Douglas Wass

MEDIUM TERM FINANCIAL STRATEGY

It was kind of you to send your very full note of March 7 on Medium Term Financial Strategy.

I have noted your comments, although it would be true to say that my agnosticism, recorded in my minute of March 4, still persists.

I am copying this to the Prime Minister and Sir Douglas Wass.

W. J. B.

JOHN BIFFEN
10 March 1980

8

Prime Minister

For publication at 2.30 pm. (Roughly as the Governor indicated on Friday).

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

PRIME MINISTER

MONETARY SITUATION

The February banking figures are due to be published tomorrow, Tuesday 11th March. They will show that eligible liabilities fell slightly (0.1 per cent) during the month, but as usual this will give a misleading indication of monetary developments. In fact we expect sterling M3 to have grown by 1 per cent and briefing by the Bank will make this clear to the markets. The February figure means that growth in sterling M3 since the start of our current target in mid-June has remained at just over 12 per cent at an annual rate. Preliminary estimates of the components are shown in the Annex.

2. Central Government Borrowing in February was extremely small, but so also were sales of central government debt to the general public. Gilt sales were fairly substantial (nearly £500 million), but these were offset by net surrenders of certificates of tax deposit (CTDs) for payment of tax. The high net surrenders of CTDs are largely a seasonal phenomenon, however.

3. The growth of bank lending to the private sector was just over £500 million, well down on the January figure but still fairly high. Even this figure was achieved only with the aid of a sharp fall in the last week of the banking month which on

/the basis

the basis of past experience could well be followed by a sharp rebound this month. There is still no really clear sign of a turn-down.

4. I am copying this minute to the Governor.

(G.H.)

10 March 1980

ANNEX

STERLING M3 AND ITS COUNTERPARTS

£ billion
seasonally adjusted

	banking July-November (average of five banking months)	banking December	banking January	banking February
CGBR	+ 0.88	+ 1.47	+ 0.15	+ 0.02
Less sales of central government debt to non-bank private sector	- 0.47	- 1.25	- 1.62	- 0.16
of which gilts:	- 0.57	- 1.16	- 1.63	- 0.46
Net other public sector	- 0.03	- 0.14	+ 0.50	- 0.04
Sterling bank lending to:				
private sector	+ 0.64	+ 0.16	+ 1.30	+ 0.55
overseas	+ 0.03	- 0.02	+ 0.19	+ 0.09
DCE	+ 1.05	+ 0.22	+ 0.52	+ 0.47
External and foreign current finance	- 0.43	+ 0.18	+ 0.13	- 0.03
Net non-deposit liabilities etc.	- 0.06	- 0.14	- 0.02	+ 0.10
Change in £M3	+ 0.56	+ 0.26	+ 0.63	+ 0.54
	(+ 1.0%)	(+ 0.5%)	(+ 1.1%)	(+ 1.0%)

CONFIDENTIAL

cc CO
BofE

LPO

cc. Master set

Econ Pol

10 DOWNING STREET

From the Private Secretary

10 March 1980

Dear John,

As you know, the Prime Minister held a meeting on Friday evening to discuss the proposed medium-term financial strategy. The following were present: the Chancellor, the Governor, Sir Douglas Wass and Sir Robert Armstrong. They had before them a revised version of the draft which the Chancellor had sent under cover of his minute of 20 February.

The Governor said that he and his staff had had valuable discussions with the Treasury over the past 10 days, and as a result the draft had been softened and the targets made less rigid. But he still had serious misgivings about the whole exercise. He appreciated the object of the strategy - namely, the desire to show a path through the difficulties ahead and to demonstrate that the Government is committed to the policies necessary to overcome them. Yet the case presented in the latest draft was still less than persuasive. The assumption of 1 per cent per annum of growth would disappoint those who were hoping for a more dynamic economy from the Government's policies; and although the assumption might be no more than realistic, by publishing it in this way the Government would be seen as taking responsibility for continued slow growth. This was, admittedly, to a large extent, a political point. On the other hand, the Chancellor's proposals did affect his own task. Monetary policy had to be defensible. It was hard enough to set a monetary target for one year ahead: it was much harder for a four year period. Even with a target range, there was still in his view too much rigidity in the figures. He was concerned at the prospect that wages might not accommodate to the declining monetary path; and that if they did not, the pressure on interest rates and activity might well be intolerable. The Government was finding it hard enough to stay within the existing one year target. It would be better for Ministers not to commit themselves to targets for the later years until they had a clearer idea of how wages were going to respond. The Government had already made clear its strong commitment to getting the rate of monetary expansion down: to publish medium-term targets would add little to this commitment.

/In a brief

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In a brief discussion, the following points were made:

(i) whether or not the Treasury published medium-term monetary targets, it would almost certainly be obliged to reveal its assumptions about real growth in the context of the public expenditure White Paper. It was better to be cautious than repeat the unfounded optimism of the previous government;

(ii) there were risks in publishing a medium-term strategy. On the other hand, if it were not published, the Government would be seen as lacking confidence in its own basic approach. There was in any case no real alternative to pursuing the path of monetary deceleration shown in the draft. At the same time, the target figures would be reviewed annually;

(iii) the publication of medium-term targets and plans, including the figures for fiscal adjustment in later years, would greatly help the presentation of this year's Budget.

Summing up, the Prime Minister said that she understood the Governor's misgivings. But she and the Chancellor were convinced that it would be right to publish medium-term targets on the lines of the draft; she hoped that the Governor would be able to live with this. The draft itself ought to be looked at again - particularly paragraph 9 - before being finalised.

The Prime Minister confirmed that she would like the Chancellor's proposals to be endorsed by Cabinet, and asked him to circulate a paper in time for Cabinet this week. Contrary to my earlier advice, she does not want there to be an accompanying presentation by Sir Kenneth Berrill and Mr. Terry Burns.

I am sending a copy of this letter to David Wright (Cabinet Office), and to John Beverly (Bank of England).

Yours ever,

Tim Lankester

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

c: IND
TRADE
CO

5A

10 DOWNING STREET

From the Private Secretary 10 March 1980

The Prime Minister was grateful for the Chancellor's minute of 7 March with which he enclosed the draft of the Consultative Document on Monetary Control. She is content for the document to be published on 20 March, and she also has no objection to his circulating it to colleagues. (You told me that he had it in mind to circulate not to Cabinet, but to a smaller group of Ministers.)

I am sending a copy of this letter to Ian Ellison (Department of Industry) Stuart Hampson (Department of Trade) and David Wright (Cabinet Office).

T. P. LANKESTER

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HM Treasury.

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Prime Minister
The Chancellor wanted you to have this for the w/end (though I haven't had a chance to read it through). ~~I think we must leave it to the Treasury and the Bank~~
Would you like to discuss with the Chancellor?
Or are you content for publication to go ahead on 20 March?
[initials] 7/3

7 March 1980

Go ahead on 20 March.
[initials]

PRIME MINISTER

I attach a draft of the Consultative Document on Monetary Control which I promised to issue in my statement to the House on 15 November last year. It is in the form of a Green Paper which has two parts. The first is a statement by the Government which sets out the role of monetary policy and monetary targets. This makes it clear that we consider that we can meet our medium term objectives by the appropriate use of fiscal policy and interest rates.

2. The consultations will be conducted on the basis of the second part of the document which is an agreed paper by the Bank and the Treasury. A number of changes in the present arrangements are proposed. But the analysis suggests that the more ambitious changes in the system which have been put forward are unlikely to improve our short term monetary control. The discussions will however enable us to test the arguments and see whether there are any schemes - particularly those of the monetary base type - which would be an improvement on the present arrangements.

/3. I should perhaps

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3. I should perhaps add that I have included the two annexes to the document for the sake of completeness. They have not yet been fully reworked and it is very important that they should be kept secure until this has been done.

4. The techniques on which the paper invites discussion are those concerned with the generation of short term interest rates. Inevitably therefore it is not about the biggest issues in monetary policy. We shall need to make this clear in presenting the document. But though the issues it considers are not the biggest, they are certainly important. They give rise to sharply divided views in the City and elsewhere. So we shall have to be very careful with our presentation.

5. My plan is to publish the document no later than Tuesday 25 March and preferably on Thursday 20 March. This will enable me to get it out of the way before the Budget; it could be very damaging in the markets not to have done so. Publication on Budget Day itself would I think be a mistake. The Budget and the Public Expenditure White Paper are quite enough for one day. The press would resent any such move and we should lose the opportunity to present the document properly.

6. The key question on which we have to make up our minds eventually is whether we are willing to assign to the markets a greater role in the determination of short

/rates. The

rates. The authorities are of course always part of the market, whatever the technique used. Under a monetary base regime we would still be left to decide when and how the base should be changed if money supply deviated from the target. But would there be much point in going through all the upset which would be involved if we intend to exercise the same degree of discretion as we do at present? In circumstances such as those of the past few weeks, a regime under which the Government worked under predetermined rules, would have caused the market to carry interest rates up; that would have been the justification for the scheme in the eyes of its proponents.

Chancellor now tells me he would like to circulate to E colleagues only.
TL

7. If you are content, I will circulate the Consultative Document to the Cabinet for information. I am copying this minute and enclosure to the Secretaries of State for Industry and Trade and Sir Robert Armstrong.

G.H.

(G.H.)

7 March 1980

MONETARY CONTROL

Introduction

The Chancellor of the Exchequer announced in his statement to the House of Commons on 15 November 1979 that he had set in hand a review of methods of controlling the money supply, and that the Bank and Treasury would issue a discussion paper for consultation about possible changes in the methods of control.

The Role of Monetary Policy

1.1 The Government considers that a progressive reduction in the rate of growth of the money stock is the only viable way of achieving a permanent reduction in inflation. It is thus a necessary pre-requisite to a sustained revival of the British economy. Other Government policies, such as those to restore incentives, support this objective. But control of inflation, and thus control over monetary growth, is paramount.

1. 2 The relationship between the rate of growth of the money stock and the growth of prices and incomes is complex. They can diverge in the short run, but there are strong grounds for believing that they will not diverge significantly over a period of years. The high rates of growth of the money supply in 1972 and 1973 undoubtedly added to inflationary pressures, and so to the subsequent rise in the rate of price increase. Similarly, firm control of the monetary aggregates following the agreement with the IMF in 1976 helped to achieve the subsequent fall in the rate of inflation. But the growth of the money supply was allowed to accelerate again through 1978.

1.3 The Government believes that the money supply must be controlled

consistently over a period of years if inflation is to be brought down to a broadly corresponding level. Its policy is therefore to sustain downward

pressure on prices by a medium term strategy to reduce the rate of growth of the money supply.

1.4 The first requirement is that the authorities have the means to control the money supply over the medium term in order to bring down the trend. Second, it is desirable for the authorities to have at their disposal instruments to moderate short term fluctuations in monetary growth as the trend is being reduced. Excessive short term fluctuations in the rate of monetary growth may cause uncertainty about the Government's resolve and its ability to control monetary growth. This, through its effect on expectations in the financial markets and in the economy generally, can set up conditions which both make the medium term objective for the money supply harder to achieve, and delay its effectiveness in reducing the rate of inflation.

1.5 The main instruments must continue to be fiscal policy and interest rates. The Government is satisfied that these provide the means to achieve its medium term monetary objectives. In particular it intends to bring down the Public Sector Borrowing Requirement (PSBR) as a proportion of national output. But there may be room for improvement in monetary control over shorter periods.

Measuring Money

1.6 No single statistical measure of the money supply can be expected fully to encapsulate monetary conditions, and thus provide a uniquely correct basis for controlling the complex relationships between monetary growth and prices and nominal incomes. The degree of substitutability between forms of money or liquidity just inside or outside the respective measures of money and liquidity mean that it is insufficient to rely on one measure alone: in assessing monetary conditions the authorities have to

have regard to a range - including not only the narrow measure (M1) but to the wider measures of money (M3, £M3) and also to various still wider measures of private sector liquidity, which include, for example, non-bank holdings of Treasury bills, and short term investments in building societies and local authorities. It is also desirable to monitor measures of credit expansion, such as DCE.

1.7 The ways in which these monetary aggregates move over short periods can diverge significantly: £M3 is currently growing faster than the others. These divergences are partly caused by changes in relative interest rates, but they also reflect secular trends in banking and financial practices, such as changes in the relative attractiveness of different forms of money and liquidity on grounds other than interest rates as incomes and wealth grow and the financial system evolves. Policies directed to controlling any one of the aggregates by adjusting the PSBR and interest rates will tend to control the others over a period, although not necessarily to the same numerical rate of growth. The rates of growth of all the wider measures will be affected in broadly similar ways by changes in the growth of private sector incomes and financial wealth - of which the PSBR is a major counterpart.

Monetary Targets

1.8 The Government believes that its monetary policy can best be formulated if it sets targets for the growth of one of the aggregates, against which progress can be assessed. This gives the clearest guidance to those concerned in both financial markets and domestic industry, on which to assess the direction of Government policy and to formulate expectations. It is for this reason that in recent years the United Kingdon, along with most other industrialised countries, has published monetary targets.

1.9 As no one aggregate is by itself a sufficient measure of monetary conditions it could be argued that there should be targets for several or all. But this would make it much more difficult for the market and the public to appraise the determination of the authorities to meet their monetary objectives. In the short run, the various aggregates respond differently and with different speeds to changes in interest rates so that seemingly inconsistent measures might be needed to meet the various targets. The Government therefore believes that targets are best set in terms of a single aggregate.

1.10 If one aggregate is to be chosen for the target, there seems to be a considerable measure to agreement that the present measure £M3 best suits the present circumstances of the United Kingdom. It is well understood in the markets. It indicates links with the other policies - fiscal policy, debt marketing policies, policies to restrain bank credit and exchange market management - and gives a general assurance that the macro-economic policies available to the Government will be used in a way which mutually support each other in the reduction of inflation. It is also relatively easy to define in terms of the banking system. This is not to say that the definition may not need to be adjusted from time to time as circumstances change, or that it will remain the most appropriate aggregate in the face of long term changes in the institutional structure. But for the time being, the Government will continue to express its monetary targets in terms of this aggregate.

1.11 For the present therefore, the Government intends:-

a. to formulate the monetary target in relation to one aggregate;

b. to continue to use £M3 for this purpose;

c. to take account of growth of other aggregates, directing policy to progressive and sustained reduction in rate of growth of all, although not necessarily by the same amount.

1.12 The paper by the Bank and the Treasury which follows concentrates on the problems of short term monetary control referred to in paragraph 1.5. It examines the scope for an improvement in monetary instruments and proposes certain changes to existing instruments, in particular the Reserve Assets Ratio and the cash requirement which the clearing banks are required to hold with the Bank of England. It considers the role of direct controls and examines various alternatives to the present Supplementary Special Deposits scheme, including forms of monetary base control. It concludes by identifying the issues on which the Bank and the Treasury would welcome comments.

MONETARY CONTROL

A Consultation Document by the Bank of England and Her Majesty's Treasury

THE CONTROL OF THE MONEY SUPPLY

2.1 There are a number of policy instruments available to the authorities in influencing monetary conditions. Of these the main weapons are fiscal policy, debt management, administered changes in short run interest rates and direct controls on the financial system.

2.2 Apart from notes and coin, the £M3 money stock consists of liabilities of the banking system and in considering how these instruments affect monetary conditions, it is sometimes helpful to examine how a particular control will affect items on the asset side of the banking system balance sheet - the credit counterparts of the money stock. Indeed, by accounting identity, the change in £M3 equals the PSBR less sales of public sector debt outside the banking system plus the increase in bank lending to the private and overseas sectors plus the net external inflow to the private sector less the increase in banks' non-deposit liabilities. Useful though this widely known identity is, it must be emphasized that the counterparts are not independent. Policy action on one of them will typically induce changes in the others so that a change in any one rarely has an exactly equal effect on the money supply.

The Main Instruments

2.3 Fiscal policy has a major bearing on the growth of £M3. Tax and expenditure policies are the main means by which the Government affects the PSBR - though those policies also affect the other counterparts of the

money stock. For example a change in taxation of companies can affect their demand for bank loans. A particular change in fiscal policy may have a significantly different effect on £M3 than on the PSBR; the former is usually smaller. It is impossible, however, to forecast the PSBR with precision and therefore very difficult to control it closely. Its size in any period depends on the level of economic activity and the inflation rate as well as the fiscal stance. And over short periods - a year or less -it can fluctuate markedly, even after adjusting for seasonal factors, due to minor variations in the pattern from month to month of Government expenditure and receipts.

2.4 In recent years, the PSBR has been large, but substantial sales of gilts and other public sector debt have enabled a high proportion of it to be financed outside the banking system. But sales of gilt-edged stock have also been irregular, and there have been occasions on which the irregularities have accentuated fluctuations in the growth of the money supply. If the money supply starts to grow faster than the target range investors will expect interest rates to rise and so hold back from buying gilts: this further accelerates the growth of the money supply. On the other hand there have been other occasions when the authorities have been able to take advantage of the effect of expectations - for example about the PSBR - on the gilts market to bring about sales which have brought the money supply back under control far more quickly than would have been possible with other instruments.

2.5 In the Quarterly Bulletin last June, the Bank of England considered various suggestions for securing a flow of sales more closely related to the requirements of shorter term monetary control. The Bank has already invited reactions to that paper.

2.6 Bank lending to the private sector is determined by a number of factors including the financial position of the company sector, consumer confidence and inflationary expectations, as well as interest rates. It appears to respond only slowly to changes in interest rates. Moreover, the growth of lending exhibits sharp month to month fluctuations in response to normal commercial demand from industrial and other customers. Because of this and the delay before interest rates have their full effects, it is not feasible for the authorities to exercise an exact control over it through interest rates in the short run. However, there is no way in which the domestic money supply can be completely isolated from external flows because even if in total there is no net inflow or outflow, changes in the composition of flows between the various sectors of the economy will still affect the money supply.

2.7 External flows can exert a powerful influence on domestic monetary conditions, both directly through their impact on monetary growth and indirectly through changes in the exchange markets is small or self-balancing so that the exchange rate mainly reflects market forces, the direct effects of external flows on the money supply are likely to be small.

2.8 Another consideration is that some changes in methods of monetary control would be so inconsistent with subsequent membership of the exchange rate mechanism of the European Monetary System that they would have to be changed again if the Government decided that the conditions for joining were approprate.

2.9 Short term interest rates have a complex effect on the money supply; they affect all the counterparts but in differing directions, in differing degrees and with varying time profiles. A rise in rates will increase the PSBR through the cost of Government borrowing and tax relief on interest.

It will also affect both the amount and composition of external flows and so the exchange rate. A rise will tend to increase gilt sales both by raising yields and also by affecting expectations about future trends in interest rates. In the short run, however, the effect may be perverse if the rise is viewed as a harbinger of yet higher long term rates. It will also decrease the level of bank lending to the private sector but this is likely to take some months to occur.

The Efficacy of the Main Instruments

2.10 Using the basic weapons of fiscal policy, gilt edged funding and short term interest rates, the monetary authorities can achieve the first requisite of control of the money supply - control, say, over a year or more.

2.11 However, there have been substantial swings in the rate of monetary growth, not only from month to month, but also quarter to quarter. Given both the volatility and short term unpredictability of all the counterparts, it is almost certainly unrealistic to think in terms of a smooth path from month to month - it could only be achieved, if at all, by massive swings in interest rates, and then would probably involve significant switches back and forth between closely substitutable forms of liquidity just inside and just outside the definition of the target.

2.12 Such month to month control is not necessary to achieve the desired impact of monetary control on the g rowth of money national income, since that is essentially a medium term relationship. But there would be advantage in shortening the period within which it is possible to exercise control if it were practicable to find ways of doing this. If there were smoother growth of the money supply from quarter to quarter, there would be greater reassurance about the efficacy of the Government's instruments, and so expectations could be affected favourably to a greater extent - both

in the financial markets and elsewhere in the economy.

Quantitative Controls

2.13 Various forms of quantitative controls have been used, or suggested, to supplement the main instruments of monetary policy. Such controls can be applied either to the assets side of financial institutions concerned -as with the ceilings on bank lending in the 1960s - or to their liabilities, as in the Supplementary Special Deposit (SSD) scheme. The general pros and cons are, however, the same in either case. A more useful distinction can be drawn between permanent and temporary controls, a point returned to below.

2.14 The main purpose for introducing such controls in this country has been to reduce the need to raise interest rates, at least in the short-term, by causing banks to restrict their lending by rationing. It has generally been recognised that, in time, lending rates would still tend to rise. But controls have more recently been seen as a way of bridging the time-lag before other policies have their effect. They have also, on occasion, provided reassurance to financial markets that the Government is concerned to hold to its monetary policy, thereby helping to end a hiatus in gilt sales. A particular reason behind the form of the SSD scheme was the desire to affect relative interest rates - especially those on bank deposits vis-a-vis other short-term assets - to a greater extent than could be achieved through the more general instruments of MLR and open market operations.

2.15 If such a control is effective, it will almost certainly reduce competition within the controlled sector and between that sector and uncontrolled institutions doing similar business. It will involve some resource cost and loss of efficiency. There may also be prudential risks for - almost by definition -uncontrolled forms of business are less likely to be

within the ambit of regulation by the monetary authorities.

2.16 If the control becomes permanent, the resource costs and prudential risks may in time be considerable. There is also the danger that funds are disintermediated, that is, business increasingly moves out of the controlled sector. The aggregate most directly affected by the control (£M3 in the case of the SSD scheme) becomes an increasingly distorted measure of the monetary position. This distortion soon becomes obvious, and causes both the statistic and the policy to fall into disrepute.

2.17 If the control was occasional and temporary, resource costs and prudential risks would be much less significant. Distortion of the target aggregate may occur as exemplified by the build-up of the so-called bill leak since 1978, when the SSD scheme was reintroduced. A different problem arises, however, because the controlled institutions may anticipate the reintroduction of the control and, at the worst, actually precipitate the action they have been expecting. Something of this sort occurred in the first few months of 1978. There is no obvious solution to the problem. A final difficulty with temporary controls is that, if conditions do not improve as quickly as was hoped when the controls were adopted, it becomes difficult to take the control off, because of the likelihood of reintermediation and appearing to ease the stance of policy.

2.18 The distortion of monetary indicators by a control is less misleading if it can be measured. For example, with the SSD scheme, it has at least been possible to monitor the main form of disintermediation hitherto: the bill leak. However, other forms are less easily measurable and now that UK residents are free to transact business abroad in sterling or in foreign currency, both the difficulties of measurement and the ease of avoidance have become the greater.

2.19 In the real world, there are no techniques of monetary control which involve no risk at all of disintermediation. But the authorities consider that any new technique must avoid providing a significant incentives to disintermediation.

2.20 Other forms of control - ratio controls of one sort or another -have a different purposes. They are designed to enable interest rates to be changed more quickly that at present or to generate the changes in market interst rates necessary to achieve the monetary target. This is seen as the chief merit in some versions of monetary base control and is considered further is sections 5 and 6.

THE SUPPLEMENTARY SPECIAL DEPOSIT SCHEME

3.1 Under this scheme, now widely known as the "Corset", the authorities set a guideline for the rate of growth of the banks'" interest bearing eligible liabilities", expressed as a percentage rate of growth over the average level in a specified base period. To the extent that the growth for a particular bank or other controlled institution, as measured by the moving average of the levels on 3 successive monthly make-up days exceeds the guideline, that bank has to place non-interest bearing SSDs with the Bank of England. The rate of call for SSDs rises progressively with the amount of the excess, and is 50% of any excess over 5%. In practice this means that the effective cost to a bank which is over the guideline of securing additional funds for on-lending is significantly above market interest rates - in the highest third penalty zone it is nearly two and a half times market rates.

3.3 The scheme succeeded, after it was introduced in December 1973, in its immediate objective of causing the change in relative interest rates, necessary to remove the incentive to round-tripping. It appears also to have had the effect of inhibiting the development by the banks of new types of business. But a major effect has been to divert flows into uncontrolled channels. On occasions, the banks have reduced their holdings of short term public sector debt which has been taken up by others outside the banking system. This reduced £M3, but had little effect on the underlying liquidity of the economy since there is virtually no difference for that liquidity in the economy between, say, an industrial company holding a Treasury Bill itself, or the company holding a bank's certificate of deposit and that bank holding the Treasury Bill. More recently, the most obvious form of avoidance has been the growth in holdings outside the banking system of bank-accepted commercial bills. To the holder such bills are no less liquid than a bank deposit or certificate of deposit of comparable term, and to the borrower they are a very close substitute for direct bank credit.

3.4 These are but two of many possible forms of such disintermediation. Any attempt to stop them by redefining the scheme would only lead to disintermediation into other forms, for example, into overseas sterling deposits, which would be more likely to carry the dangers referred to in the previous section. They are difficult to measure so their extent would be unknown. There could be prudential risks, either for those involved or for the financial system as a whole.

3.5 It was originally envisaged that the scheme should not be applied continuously. It would be operated for relatively short periods when there was particular upward pressure on the money supply. But it would he held in suspense for the rest of the time. However, as mentioned in Section 2, it has run into the inherent difficulties with temporary controls, namely anticipation of reimposition and the likely resurgence of the controlled statistic when the scheme ends.

3.6 The Chancellor of the Exchequer therefore announced on 17 November that this scheme should not have a permanent place in the techniques for controlling the money supply.

7 March 1980

SHORT TERM INTEREST RATES AND THE OTHER EXISTING CONTROLS

4.1 The level of short term interest rates at any time is determined by the interaction between the markets and the authorities. The short term interest rates generated by the markets are not necessarily those needed to achieve the monetary target. Markets respond to current supply and demand for particular types of funds and their expectations about future movements in interest rates. Market operators will take a view of future trends in the domestic and world economies - notably the domestic inflation rate, and interest rates elsewhere - but also any actions which they believe the authorities need to take to achieve the monetary targets.

4.2 The Bank's main instrument to vary short-term interest rates is discretionary alteration of Minimum Lending Rate (MLR) made effective through money market operations conducted through the discount market. It has available to help in this two requirements on the banks, namely the Reserve Assets Ratio (RAR), with the associated power to call for Special Deposits, and the requirement on the London Clearing Banks to hold cash balances with the Bank of England. (These are discussed in greater detail in Annex A).

4.3 The banks will normally respond to a rise in MLR, and hence in the cost of money to them, by raising their lending and deposit rates. The rise in lending rates will tend to reduce the demand for bank loans and thus the growth in £M3. This may be reinforced by an increase in the demand for gilt-edged securities by the private sector as yields rise. On the other hand the rise in deposit rates makes holdings of such interest-bearing deposits more attractive, and, when bank liquidity comes under pressure and the banks respond by bidding in money markets for funds, the yields offered for those deposits may rise relatively sharply. Such liability management -

which has been an increasingly frequent response in recent years - can produce large swings in short-term interest rates. It also reduces the ability of the authorities to "fine tune" the money supply.

The Reserve Assets Ratio and Special Deposits

4.4 The RAR had its origins in the banks' customary holdings of liquid assets for prudential reasons and was adapted to its present form, and applied uniformly to all listed banks, in 1971. Under it, banks are required to hold equivalent to at least 12½% of their eligible liabilities, on a daily basis, in reserve assets. Reserve assets consist essentially of balances at the Central Bank or Securities against which the Bank is prepared to lend without question.

4.5 Special Deposits, introduced in 1960, involve those banks subject to the requirement depositing funds with the Bank of England, on an interest-bearing basis, at some specified percentage of their eligible liabilities. While the funds are with the Bank, they are not available to the banks, and hence an increase in the rate of call for Special Deposits acts to reduce the liquidity of the banks as a whole. Until September 1971, only the clearing banks were subject to calls for Special Deposits. But since then, the requirement has applied to all banks on the statistical list.

4.6 The RAR was never designed to serve as an officially-controlled monetary base through which the pyramid of credit created by the banks might be directly limited. Instead, in conjunction with Special Deposits, the RAR was regarded as an element in the control of short-term interest rates. It enabled the authorities to vary bank liquidity and so influence the level of short-term interest rates in the required direction.

4.7 It has been argued that the RAR distorts the yield relationship between short-term assets qualifying as reserve assets and others; and that this distortion is a factor inhibiting the development of a broader market in short-term public sector debt which might otherwise be helpful to shorter-run control of some of the monetary aggregates, including £M3. In practice this differential is probably a reflection of the special liquidity of the assets in question.

4.8 Thus, although the RAR was introduced in 1971 as a monetary control, the assets which it includes also represent the banks' first line liquidity. This has undoubtedly caused confusion. The authorities have accordingly reviewed the operation of the RAR and, for the reasons set out in Annex A, consider that it is not necessary for the purposes of influencing short term interest rates.

4.9 It is therefore proposed to end the requirement to meet the RAR irrespective of whether it is decided, in due course, to introduce any of the changes discussed in sections 5 and 6. But it remains essential to ensure that adequate prudential standards of liquidity are maintained. The Bank of England are issuing a separate consultative document on prudential liquidity requirements in parallel with this paper: as soon as the consultation on it has been completed, and the proposed new prudential requirements are agreed and specified, the RAR would lapse. It is proposed that Special Deposits would be retained to provide the ability occasionally to reinforce control over interest rates by operating directly on the liquidity of the banking system, as a whole.

The Cash Requirement

4.10 The London Clearing Banks are currently required to hold balances with the Bank of England amounting to 1½% of their eligible liabilities. In

part, but only part, this reflects their need for balances with the Bank to cover clearing operations. This cash requirement, rather than the RAR, is effectively the fulcrum on which the Bank of England works when it seeks to affect short term interest rates through its money market operations. However, it may be more equitable to apply the requirement more generally. It is proposed to discuss replacing the existing requirement by one that all banks and licensed deposit-taking institutions above a minimum size should be required to hold cash balances with the Bank. The Bank will issue a more detailed paper for discussion with those concerned about the amount, form and calculation of the requirement.

7 March 1980

MONETARY BASE CONTROL

5.1 In concept a monetary base scheme is very simple. The banks keep at least a known proportion of their deposits (which, currency in the hands of the public apart, constitute the money supply) in base money, however specified, either because there is a mandatory requirement on them to do so or because they can be relied on to do so over a period for prudential reasons. The authorities then either: -

a. control the amount of base money in existence and so the total growth of the money supply, since the banks' balance sheets cannot exceed a specified multiple of the base;

or b. use divergences of the base money figure from the desired trend as a trigger for a change in interest rates intended to correct the divergence.

5.2 In the former case, if there is a tendency for the money supply to grow too fast, banks compete in an attempt to secure the base assets which they require to match the growth in deposits. This generates changes in relative and absolute levels of interest rates. The first case therefore is intended to provide a means for the markets to generate the interest rates necessary to bring the rate of the growth of the money supply back towards the desired path.

5.3 The latter case provides an arrangement for more rapid and automatic adjustments in interest rates than the present discretionary changes since the timing of changes is determined by movements in the base. But the amount of the change can either be discretionary or determined by a scale set in advance by the authorities, rather than by a market process balancing the supply and demand for such a base asset.

5.4 A monetary base system, in which the extent of interest rate changes is determined by the markets is directed to both the shortcomings referred to in paragraph 2.19 above - namely the timeliness of interest changes and the problem of fixing their amount. (Such systems are referred to below as monetary base control systems). But the variants where only the timing of interest rate changes is determined by changes in the base still face the authorities with the problem of setting the amount either each time or by a predetermined formula. (Such systems might more accurately be described as monetary base indicator systems and are so referred to below).

5.5 The translation of this apparently simple concept into practice raises a number of inter-related problems: as to how the scheme should be specified, as to how the authorities would control the base if the variant was of the first type, and as to how the banks and other financial institutions would behave in the changed environment. There are therefore a large number of potential schemes within the monetary base approach. These are discussed in more detail in Annex B.

Schemes Without a mandatory requirement

5.6 In one family of proposals for monetary base schemes the bankers' need for the base assets stems from their own requirements for operating their business, rather than from a mandatory requirement imposed by the authorities: it presumes that the former requirement should be fairly stable over time in relation to total liabilities, if the scheme is to achieve the aim that controlling the size of the base should control the growth of the money supply. With the present financial structure in the United Kingdom, this is most unlikely to be achieved since a bank's requirement for cash balances would depend far more on the total level of transactions and type of business than on the size of its balance sheet. For a tolerably stable relationship to

exist, it would probably be necessary for the banks' holdings of the base to stem from their need for liquidity rather than for transactions balances. This relationship has been achieved in Switzerland, because cash at the central bank is virtually the only form of domestic primary liquidity. It could only be achieved in this country if there were a major change in the structure of the money markets, including withdrawing the lender of last resort facility. It is this facility which makes a range of money market instruments primary liquidity in the hands of a financial institution. Cash with the central bank would then become the only effective form of liquidity.

5.7 Even if this were done, and it were practicable to control the base sufficiently closely, it is doubtful whether it would produce a more even growth of the money supply. The banks' liquidity requirements are not absolute and would, in the absence of a mandatory ratio, vary somewhat from time to time: for example, if the banks' liquidity ratio moved from 10% to 9% over a period, it would permit the percentage monetary growth to be some 10 percentage points more than the growth of the base over that period.

5.8 It is, of course, true that the authorities' actions to influence the rate of growth of the base would, normally, tend to produce effects which would help to control the rate of growth of the money supply itself, at least in the sense that the movement in interest rates would in general be in the right direction. But the interest rate changes so generated could not be relied upon to produce smooth short term monetary growth because of the differing potential short run response of the base and the money stock to changes in interest rates.

5.9 A change to a monetary base system of this type would therefore have significant institutional effects, resulting in a less flexible money market. There would be a period of years before it could be established that there was a predictable relationship between money and the base and there would be no assurance that monetary control would necessarily be better at the end. It is possible that it would be, but there can be no certainty, given the scale of changes in institutional structure required. We therefore conclude, given the known costs and uncertain benefits, that it would be ill-advised to adopt a scheme on this basis.

Schemes with a mandatory requirement

5.10 A mandatory relationship between the base and deposits could be expressed in three ways:

a. lagged accounting - as in the United States - where current base requirements are fixed by reference to deposits in a previous period;

b. current accounting - as with the RAR requirement - where required base assets relate to the same make-up date as the relevant deposits;

c. lead accounting where the holding of base assets would put a limit on deposits at some future date.

5.11 The attraction of lead accounting, if it worked, would be that it would give a warning about the immediate future development of the money supply as foreseen by banks. But this would depend on the ability of banks to predict their future balance sheets and then to control them to achieve that forecast. This is difficult for the banks, given:-

a. uncertainty about calls on facilities - whether overdrafts or term loans;

b. that the banking system provides residual finance for the Exchequer (including the Exchange Equalisation Account) whose position neither they nor the authorities can predict very accurately in the short term.

If, despite these difficulties, the forecasts were to have any value it would be necessary to have penalties for both under and over prediction. But if the penalties were of any significance the banks would protect themselves by artifical adjustment, disintermediation or reintermediation, to ensure that they kept to their forecast: the scale of such artifical adjustment might well be sufficient to cause serious distortions. We therefore consider that a scheme with lead accounting is not practicable..

5.12 Lagged or current accounting requirements run into a somewhat different problem. In the case of a lagged requirement, the total balance sheets of all the banks on one make-up day would determine the holding of monetary base assets they were required to hold on some later date. So, the amount of base assets required on a particular day would be pre-determined by what has already happened, and that amount might well not correspond to the level of the base desired by the authorities at that time. The situation with current accounting is similar, since by the time that the banks would know their requirement for base, it would be too late to change it, if the total differed from the level desired by the authorities.

5.13 Several alternative methods have been suggested for bridging the gap between the base desired by the authorities and that needed by the banks to meet their requirements. These are considered in more detail in Annex B. In broad terms the alternatives are either (i) to provide the banks with their

requirement but with increasing penalties on the individual banks.

5.14 Under (i), so long as the actual base was above that desired by the authorities, the rate at which the Bank lends would be entirely determined, not by the market, but by the scale which the authorities had laid down. This would be a major determinant of other short-term money market rates but the associated change in longer rates would, as now, reflect the markets' response. Under (ii), the market would have a larger role to play, but there would be a risk of significant disintermediation to avoid the penalties on individual banks. Furthermore the movement in short-term market rates would still be circumscribed by the scale of penalties. Monetary base control systems also encounter the general problem resulting from liability management identified in paragraph 4.3.

5.15 There would also be practical operational difficulties common to all these schemes. The authorities cannot estimate accurately on a day to day basis either the actual base that would be consistent with the (seasonally adjusted) target path for the money supply or the base that the banking system may obtain; or, with current accounting what the banks would need to match their requirements. This is, in part, because of the large, erratic and unpredictable swings in cash flow on some days.

5.16 These difficulties, which are set out more fully in Annex B are such that we doubt whether a monetary base control system with a mandatory requirement to hold base assets would produce the desired results. None of the schemes so far suggested appear to give a reasonable prospect of doing so. Moreover, there would be severe practical difficulties, in operating such schemes with any precision. However we would welcome views on whether the difficulties which are set out more fully in Annex B, can be surmounted, and, if so, by what form of scheme.

7 March 1980

AN INDICATOR SYSTEM

6.1 An alternative approach would be to develop an indicator system in which the monetary base was not directly controlled, but used as a trigger for changes in the Bank's lending rate and so other interest rates. The requirement to hold the base would be mandatory, for the reasons discussed already. Lender of last resort facilities would be available. Departures of the base once it had been observed, from the desired path, which would be calculated to correspond to a smooth path seasonally adjusted for the growth of the target variable, £M3, would trigger a predetermined adjustment by the Bank of its lending rate. The resultant change in other interest rates would depend on the markets' response. It might well lead to quicker adjustments in short term interest rates than at present.

6.2 However, if the divergence between the actual monetary base and the target monetary base could helpfully be used to determine short term interest rates, then the divergence between the actual growth of £M3 and its intended trend could be used directly and thus more appropriately for this purpose as well as being operationally simpler. Moreover, there would be relatively little time lag between the availability of figures for such a monetary base and for the money supply itself. Such a system could certainly be operated, and would not necessarily involve significant changes in the financial system.

6.3 If the scheme were to give a significant time advantage over the present system, in which discretionary decisions by the authorities are based on monthly data, it might be desirable to base the figures on the weekly series for the money supply, which are currently collected by the Bank on a sample basis - although they are still experimental - and further work would be required before they were ready to be used in this way. The system

would be as fallible as the data on which it was based. There are problems of accuracy of measurement and of seasonal adjustment, which would be serious with a newly introduced statistical series. This is further discussed in Annex B.

6.4 Such a scheme might broadly work in the following way. There would be a pre-set graduated scale of adjustments to the Bank's lending rate to deviations of £M3 from its target path. This scale would be varied as experience was gained. Initially at least, the scale would also have an upper limit in order to reduce uncertainty. Apart from this, the authorities could continue their operations in the money markets much as as present.

6.5 It is possible that the above policy changes could be introduced without necessitating any consequential changes in the structure and working of the financial system, at least at the initial stage. However it is not easy to foresee the full implications for the financial markets of arrangements on these lines.

6.6 These arrangements should provide added assurance that interest rates would be adjusted promptly in response to a divergence from the target rate of monetary growth, and that such adjustments would be continued until the money supply came back on course. This assurance should strengthen confidence in effective monetary control, and so could encourage greater long term stability in the gilt-edged markets. The financial markets would still need to assess whether the initial divergence which triggered a change in the Bank's lending rate was likely to persist, leading to further changes in that rate, or whether it was erratic and likely to be quickly reversed. The short term markets would, as now, seek to anticipate changes in the Bank's lending rate, and their expectations would determine the structure of short term rates which would in turn affect bank lending rates. With the

authorities' discretion constrained, it is uncertain whether or not short term markets would become any less volatile. In any case uncertainty about the future course of short term interest rates would be likely to continue to affect the gilt-edged market periodically in the short run, so that it is not clear that it would become easier to tailor the gilt-edged funding programme any more closely to the achievement of a smoother path for the growth of £M3 through the year than at present. Indeed it is arguable that the reverse would be the case. The arrangement would increase the attention given by operators in the gilt-edged market to short-term monetary developments, rather to underlying trends.

6.7 The main advantage claimed for such an automatic arrangement over the present one is that it could reduce what may be a bias towards delay. The causes of movements in the monthly money supply are frequently difficult to assess confidently on the basis of one month's figures, and short-term forecasts are hazardous. Given this, and the unwelcome consequences of higher interest rates for other areas of policy, there may be a built-in tendency to avoid increases in interest rates that could prove in the event to have been unnecessary, by delaying the decision until the new trend is clearly established. Moreover, such delay, in those cases where the adjustment does turn out to be needed, may lead to a need for a greater adjustment in interest rates when the time comes. On the other hand, there will also be cases under an automatic system when an adjustment is triggered by transient and erratic fluctuations in monetary growth: this might increase variability not only of short-term interest rates but arguably of the monetary aggregate itself. In assessing the underlying trend, and when taking discretionary decisions under the present system, the authorities can take account of what they know about future developments, for example, possible trends in the central government borrowing requirement.

6.8 The scale of response would inevitably be somewhat arbitrary. As at present with discretionary interest rate changes, the authorities would not know whether a particular excess of money of x% could be eliminated over some desired time period by a rise in rates of y%. All they could expect is that, by altering their lending rate, market rates would tend to move in the same direction, which would, over time. tend to influence the money supply in the desired direction. But there could be a risk that too vigorous a response of interest to the deviations could produce added instability, since the long run effect of interest rate adjustments on £M3 could well be much greater than those in the short run, as earlier indicated in section 2.

6.9 It would seem desirable that there should be a power for the authorities to override automatic interest rate changes, for example if the Government decided that the correct policy response to the growth in the money supply deviating from the target was a fiscal one, rather than an interest rate one, particularly in a pre-Budget period. Moreover, as at present, it might be right to take account of what is happening to aggregates other than £M3 and so of the general development in monetary conditions. If, however, the override had to be used frequently, the advantages of automaticity would be lost.

6.10 Any automatic system linking the Bank's lending rate to the money supply would of course preclude the use of the authorities' influence over interest rates for any other purpose. It would for example be impossible to use short-term interest rate changes, as a response to the strength or weakness of sterling.

6.11 The difference between the present discretionary system and an automatic system with override is that the authorities would have to justify delaying a change in either direction, rather than the present situation where the presumption is that the authorities must justify making the change, particularly in an upward direction. It is certainly arguable that such a shift in presumption would be appropriate, given that monetary policy is now directed to controlling the growth of the aggregates, and not to maintaining any particular structure of interest rates.

6.12 We would therefore welcome view on whether such an automatic system of adjusting the Bank's lending rate would, on balance, be advantageous.

Summary and Conclusions

7.1 This paper has discussed means of achieving the objective of controlling the growth of the money supply. The principal means must be fiscal policy - both public expenditure and tax policy - and through interest rates. These are sufficient to control the growth of the monetary stock in the medium term. But the time lags in the system are such that they can take up to a year or so to bring monetary growth back to the desired trend once a divergence has been identified. Direct quantitative controls are not an alternative, since they either act by changing interest rates or tend, over time, to divert and change the forms of liquidity and credit rather than to affect underlying monetary conditions.

7.2 We have reviewed a number of possible changes in monetary control techniques which it has been suggested might achieve a smoother path in the growth of the money supply from quarter to quarter.

7.3 With regard to the present arrangements:-

i) The Supplementary Special Deposit scheme has come virtually to the end of its useful life, and should be phased out as soon as it conveniently can be;

ii) the requirement to maintain the 12½% Reserve Assets Ratio is no longer necessary either as a means through which interest rates are influenced or as a means of affecting the rate of growth of banks' balance sheets. It is proposed that it should end;

iii) the Bank are issuing a separate Consultation Paper on the needs for holding liquid assets for prudential reasons;

iv) it is necessary to have some cash requirement, to act as a fulcrum for the Bank when it wishes to generate interest rate changes. It is proposed that the present requirement, which applies only to the London Clearing Banks, should be replaced by one which applies more generally. The Bank will issue a detailed discussion paper on this;

iv) Special Deposits should be retained to guard against the possible effects of excess liquidity in the banking system as a whole.

These changes would leave the way open for further developments after discussions on this consultation paper if it were decided to proceed with them.

7.4 We would welcome views on:

a. Whether the difficulties with monetary base control outlined in section 5 and developed more fully in Annex B could be surmounted, or whether it is right to conclude that there would be no advantage in such a system.

b. Whether an automatic system of adjusting the Bank's lending rate would on balance be advantageous.

29 February 1980

Annex A

RESERVE ASSETS, CASH REQUIREMENTS AND SHORT-TERM INTEREST RATES

The Official Influence over Short-Term Interest Rates

1. It was noted in para 4.2 of the main paper that the Bank's present influence over short-term interest rates is exerted through discretionary changes in MLR, made effective through money market operations conducted through the discount market.

2. In principle, the discount houses' long-standing agreement to underwrite the weekly Treasury Bill tender - whatever the size of the tender - enables the Bank (using forecasts of other cash flows between the banking system and the Bank) to engineer a shortage of cash, week by week, in the money market. Individually banks that are short of cash can either borrow or realise assets in the market, but the overall market shortage can only be relieved by the banking system borrowing from or selling assets to the Bank itself. One form in which the banking system can obtain such relief at their own initiative is by banks running down cash balances at the Bank: but the scope for this is very limited - only the London clearers, under present arrangements, maintain cash balances at the Bank of any significant size, and they have agreed to maintain a minimum cash ratio of 1½% of their eligible liabilities - on average over each banking month. Apart from this small element of flexibility, the net cash transfer to the Bank has to be financed through the Bank's money market operations which are mainly conducted through the Discount Market, through the purchase of Treasury, corporation or eligible bank bills or through secured lending, either overnight or for seven days. The form in which, and hence the cost at which, the Bank provides the necessary assistance can affect the cost of funds to the discount houses, which will in turn affect both the price that

they are prepared to pay for short-term assets (most obviously their bid at the subsequent Treasury Bill tender, but also their buying rates for commercial bills, CDs, etc.) and the interest rates they are willing to pay for funds borrowed in the market (mostly from commercial banks). Thus the terms on which the Bank is prepared to assist the Discount Market has a diffused influence on the level of short-term interest rates generally.

3. In practice the Bank's influence over short-term interest rates is much less mechanical than this would suggest.

4. In the first place, there may be large unanticipated movements of cash between the Bank and the banking system (eg. through unexpected savings in central government revenue or expenditure, or through official foreign exchange or gilt-edged market transactions) - on a week-by-week as well as a day-by-day basis - which mean that the Bank cannot in the short run be sure that the money market shortage intended will in fact materialise, or that it will not be much larger than anticipated. Very short-term rates can then become quite volatile.

5. But more fundamentally market interest rates beyond the very short term are often heavily influenced by expectations about the future movement of MLR, which may mean that greater importance is attached to the prospect of capital gains or losses, particularly on longer-term money market assets, then to the immediate interest cost to the discount houses of short-term funds. In this case, if there is a strong expectation of an early cut in MLR, it may take persistent penal lending to stem a fall in, say, 1-3 month market rates in relation to MLR; or, if an early rise in MLR is expected, even generous help by the Bank to relieve any shortage of funds, or the deliberate creation of easy conditions, may not be enough to induce the houses to hold on to longer-term, say, 1-3 month assets, or therefore to

prevent the comparable money market rates from rising. Thus in practice the Bank's money market operations are at times intended to influence expectations in a much broader way rather than simply to influence the immediate cost of money to the Discount Market. None of these operations depends directly upon the existence of the present minimum reserve assets ratio, which is required to be observed daily.

The Reserve Asset Ratio and Special Deposit Requirements

6. Special deposits, introduced in 1960, essentially involve those banks subject to the requirement depositing funds with the Bank of England, on an interest-bearing basis, at some specified percentage of their ELs. While the funds are with the Bank, they are not available to the depositor, and hence an increase in the rate of call for special deposits acts to reduce bank's liquidity. Until September 1971, only the clearing banks were subject to calls for special deposits. But since then, the requirement has applied to all banks.

7. Also since September 1971, all listed banks[1] have been requested to hold a minimum of 12½% - on a daily basis - of their eligible liabilities (ELs)[2] in specified reserve assets. Before then, the clearers had maintained voluntary liquidity and cash ratios and the replacement of these by a uniform reserve requirement was seen by the authorities as an integral part of the encouragement of fair competition and of equitable credit control as between banks.

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[1] Certain of the larger finance houses have maintained a similar 10% ratio and been subject to special deposits.

[2] These comprise, in broad terms, sterling deposit liabilities excluding deposits having an original maturity of over two years, plus any sterling reserves obtained by switching foreign currencies into sterling. Inter-bank transactions and transactions with the discount market (other than reserve assets) and sterling certificates of deposit (both held and issued) are taken into the calculation of individual banks' liabilities on a net basis, irrespective of term. Adjustments are also made in respect of transit items.

8. Reserve assets are defined broadly as being:-

a. balances with the Bank (other than special and supplementary deposits).

b. money-at-call with listed discount market institutions and brokers;

c. Treasury bills issued by the British and Northern Irish governments;

d. British Government marketable securities (gilts) with less than one year to maturity;

e. UK local authority bills eligible for rediscount at the Bank;

f. commercial bills eligible for rediscount at the Bank (to a maximum of 2% of eligible liabilities).

This definition of reserve assets adopted in 1971 reflected the Bank's view that no significant change in the structure of the short-term sterling markets or its operations therein was required. As a result of the definition chosen, the authorities recognised that they could not seek to control strictly the supply of reserve assets, for it included claims on the public sector which could be held by non-banks as well as by banks and also certain claims on the private sector. The lack of control over the supply of reserve assets is not a particular concern, because as described above the authorities regard the datum point of control over short-term interest rates as being the 1½% of their ELs kept by the clearing banks at the Bank of England.

9. It was, however, intended that the reserve asset requirement should be used in conjunction with Special Deposits to mop up any abnormal excess liquid assets in the banking system and, on occasion, to go further than this and to require the banking system to seek to dispose of assets not eligible for the reserve asset ratio. It was recognised that this second use might

lead to a strong upward influence on, for example, short-term interest rates in the inter-bank market and that, under some circumstances, it would be necessary to accompany a call for Special Deposits with an increase in Bank Rate (Minimum Lending Rate from October 1972) so as to bring about the rise in short-term interest rates and the consequent fall in prices of marketable short-term assets that would be needed to shift debt out of the banking system.

10. In the event, it quickly became apparent that use of joint reserve asset and Special Deposits requirements presented particular short-term difficulties. In the new competitive environment, after September 1971, the inter-bank market became increasingly active, and, when Special Deposits were called late in 1972 and again in July and November 1973, the immediate response of the banking system as a whole was to practice liability management on a much greater scale than had been envisaged in 1971. (In other words, to meet a shortage of reserves engineered by calling Special Deposits, the banks bid for funds in the wholesale money market - increasing their liabilities - with which to obtain more reserve assets, rather than reduce their total assets.) Interest rates in such circumstances tended to shift in an unhelpful fashion, with the Treasury bill rate falling[3] (as the banks competed vigorously to buy additional reserve assets) often in absolute, and always in relative, terms compared to the inter-bank rate (pushed up as banks bid for funds). As the inter-bank rate rose relative to other rates, the non-bank private sector was perversely encouraged to switch funds into bank deposits and Certificates of Deposit; £M3 rose as a result, in the short-term at least. The problem was compounded when

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[3] The introduction of Minimum Lending Rate (MLR) in October 1972 made this a particularly difficult problem. MLR was formally linked to the Treasury bill rate and, although the authorities had the power to override the formula, they were reluctant to exercise this power except when absolutely necessary. Repeatedly during the first half of 1977, however, the formula had to be overridden as the authorities tried to restrain downward pressure on short-term interest rates when a massive volume of funds moved into sterling; while, subsequently, the restoration of short-term interest rates to a level appropriate to domestic monetary policy was achieved through the market related formula only with considerable difficulties. In May 1978, MLR became fully administered.

institutional rigidities in the system or inhibitions felt by the banks (partly, no doubt, the result of uncertainty as to the authorities' attitude to higher interest rates) made the banks unwilling to pass higher rates on immediately to their customers; this led to a slower rise in the rates on banks' lending than borrowing and consequently provided opportunities for "round-tripping", namely borrowing from banks to re-lend at a higher interest rate on the money markets. (In the summer of 1973, it is thought that such round-tripping inflated M3 by over 1% in one month). As a result, it became apparent to the authorities that it was better to put up interest rates directly rather than to use special deposits to achieve this effect less directly.

11. When the Supplementary Special Deposit(SSD) scheme was introduced in December 1973 and on the subsequent occasions when it has been in operation, the effect of the reserve asset requirement in combination with the SSD scheme has been to encourage banks to manage their assets rather than their liabilities. This followed from the fact that the SSD scheme put a limit on banks' liability management, by imposing an effective ceiling on the volume of interest-bearing deposits (IBELs) that a bank could take. Thus a bank close to its ceiling and also short of reserve assets tended to find it cheaper to manage its assets (for example, switching from non-reserve to reserve assets) rather than its liabilities (which might incur penalties under the SSD scheme through bidding for funds). The result was still to put upward pressure on at least some interest rates, as banks sought to sell non-reserve assets and thus pushed their prices down. However, the risk of a jump in inter-bank rates, and thus a perverse short-term effect on £M3 was greatly reduced by the operation of the SSD scheme.

12. There were still major limits on what the authorities could achieve, however, not least because of the difficulty of forecasting the likely reserve

asset position of the banking system even over short periods of time (which matters, of course, because, under the terms of the scheme, the banks can dispose of any excess reserve assets and reduce their IBELs). Further, asset management has frequently taken the form of disintermediation, notably through the bill-leak, by which bank lending (and thus £M3 and IBELs) has been kept below what it otherwise would have been, without any significant impact on activity in the economy[4].

13. The reserve asset ratio has also had the effect of ensuring that banks always hold a significant proportion of their assets in "near-cash"[5]. However, for prudential purposes, it would be much more appropriate to have a control designed specifically to meet prudential needs. The Bank's proposals for such a control are set out in the separate consultation paper being issued by them. The critical features of the liquidity proposals, for the purpose of the discussion in this document, are:-

a. that it is considered essential that the banking system should normally hold a significant amount of primary liquidity; and

b. that the range of assets which the authorities regard as primary liquidity includes certain claims on the private as well as the public sector;

c. that it is set in the form of a norm - departures from which are appropriate in clearly defined circumstances - rather than in terms of a daily minimum;

d. the present reserve ratio is calculated against a bank's ELs, a total which makes little sense in supervisory terms, notably because - among other offsets and exclusions - a bank can offset its claims on other banks against its total deposit liabilities in calculating ELs. Further, it relates only to sterling business.

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[4]For a discussion of the role of disintermediation, see paragraph in the main paper.

[5]The reserve ratio was never intended as a prudential control, but, of course, it grew out of the liquidity ratio maintained by the clearers until 1971, which did not have prudential origins.

14. As the companion document explains, primary liquidity would be provided by those assets that were cash or which the Bank of England would regard as acceptable collateral when making loans as lender of last resort or which represent claims on institutions in the money market having access to lender of last resort facilities. On strictly prudential grounds therefore, under the present arrangements for their open-market operations, the authorities have no hesitation in including call money with the discount houses and eligible commercial bills in their definition of primary liquid assets. The proposed list is:-

i. cash;

ii. balances with the Bank of England (including special deposits);

iii. call money with the London discount market;

iv. UK and Northern Ireland Treasury bills;

v. bills eligible for re-discount at the Bank of England;

vi. British government securities with less than one year to maturity.

15. The present reserve asset requirement has therefore little to contribute to the present system of monetary control[6]. Its limited prudential value will become redundant once specific prudential proposals are adopted.

16. There will, however, remain a need for special deposits. It would still be appropriate, as now, to call special deposits to absorb excessive liquidity in the banking system. Further, special deposits would retain their present role in which releases and recalls can help to smooth out conditions in the money markets and in which announcements of such moves can help to show the pattern of official policy towards conditions in these markets. Finally,

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[6] This would hold a fortiori as and when the SSD scheme is phased out.

the release of special deposits would be one option open to the authorities if the banks brought their liquidity position under pressure through, for example, official sales of gilt-edged securities and the authorities thought it appropriate to ease that constraint. Such a response would be an alternative to the Bank of England's buying-in short-term assets in periods, such as has occurred recently, in which the outstanding volume of Treasury bills has fallen to the minimum required for money markets to function properly.

The Effect on the Short-Term Markets

17. The effect of the prudential proposals, together with the abolition of the reserve asset requirement on the structure of the money markets will depend on whether they would have a significant effect on the relative yields of short-term assets. This woud be particularly true if there were a noticeable change in the present tendency of the Treasury bill rate to be well below other short-term interest rates and for it, on occasion to move in a divergent fashion.

18. It seems likely that the Treasury bill would remain particularly attractive to banks (and LDTs) as a readily available form of primary liquidity although no longer a reserve asset. As a result, the yield differential between Treasury bills and, say, Certificates of Deposit of comparable maturity may decline, but not disappear. Consequently, the banking system would probably remain the predominant holder of Treasury bills. Further, the likelihood of divergent movements between Treasury bill and other short-term interest rates will remain whenever there is significant pressure on the banking system's primary liquidity; however, the fact that the new requirements are cast in terms of a norm rather than a minimum might help to mitigate the effect of very short-term pressures on liquidity.

9. MONETARY BASE CONTROL

9.1 This section examines more fully than in section 5 the issues which arise when considering how a monetary base control system might operate.

The Possibility of not having a Mandatory Requirement

9.2 Several of the proposals for monetary base control take as their starting point that the base should be an asset, which the banks wish to hold for operational reasons, but that there is no mandatory requirement as to amount: the system then depends on there being a reasonably stable relationship over time between the banks' holdings of this asset and their total balance sheets. This is in fact the basis of the operational system which probably corresponds most closely to the essential monetary base system described at the beginning of section 5, namely the monitoring system undertaken by the Swiss central bank (SNB)[1]. In Switzerland, the banks voluntarily hold balances at the SNB for prudential purposes (largely because - at least until recently - there has been no adequate alternative source of primary liquidity[2]). The SNB found that the resulting monetary base (defined to include these balances) was a stable and leading indicator of movements in M1 (for which the SNB set targets until the end of 1978). From movements in the base, the SNB could therefore determine whether the growth in M1 was likely to remain on target and, if not, could conduct foreign exchange operations to influence the base.

9.3 In this country, a system along Swiss lines, without regular compulsory cash reserves, would be unlikely to work, in the sense that movements in the base would indicate anything about the money stock. Unless there were

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(1) Buttler, Gorgerate, H & K Schiltknecht, "A multiplier model for controlling the money stock Journal of Monetary Economies, July 1979.

(2) Swiss banks have to meet cash requirements on only four days each year and the SNB always ensures that adequate cash is readily available on these days.

some change in the structure of the financial system, most banks might well be prepared to hold no balances at the Bank of England, and even the clearing banks might be prepared not to do so if they could obtain overdrafts at the bank, for the operation of the clearing house system. But if, as at present, such overdrafts were not allowed, the clearing banks would need balances to settle inter-bank transactions at the end of each business day. However, the total of such balances need not, of itself, give a good indication about the immediate or future movements in any monetary aggregate in which the authorities were interested; it could be expected to be, instead, a function of the expected value of both the average volume, and the variability in that volume, of all transactions - including inter-bank payments - passing through the banking sector.

9.4 The system could be brought closer to the Swiss case by encouraging the banks to hold prudential as well as operational balances at the Bank, in the hope that these holdings would bear some stable relation to, say, £M3. Naturally, it would be several years before it could be said definitely whether or not such a relationship might emerge but, given the existence of the highly developed short-term money markets in London, the odds against a relationship emerging are high. Unless the authorities were prepared to suppress many of the existing short-term money markets, a bank would have a wide choice of forms of primary liquidity, of which the facility to hold prudential balances at the Bank was only one. Shifts in the attractiveness of various competing assets would almost certainly lead the banks to change their preferred liquid assets portfolio, but in no easily predictable fashion. The position would be similar to the present situation where the authorities have little idea, at any point in time, of the relative size of banks' preferred holdings of, say, call money in the Discount Market of Treasury bills and of local authority short-term deposits.

9.5 There would only seem to be a reasonable chance of such a scheme working, therefore, if the authorities induce the banks to hold the bulk of their prudential balances as bankers' balances at the Bank rather than in short-term primary liquid assets. This would require a strict limitation on the ability of the banking system to transform such short-term assets into cash, thereby making them cease to serve as primary liquidity for the banks. This would have far-reaching structural consequences for much of the present London money market. Moreover, the authorities would need to keep the discretionary right to intervene in a crisis to inject additional cash reserves by purchasing assets from the banking system. Whether the uncertainty about if, when and in what form the authorities should so intervene would serve either to improve official operations or the conduct of domestic banking is doubtful.

9.6 But, even if changes were made sufficient to make the banker's balances at the Bank the only acceptable form of primary liquidity, it is, to say the least, uncertain whether, at the end of this major readjustment, any stable relationship between that monetary base and present or future monetary growth would be established. Indeed, it is almost of the essence of a prudential requirement that the rates of liquid assets to the total balance sheet will vary somewhat over time. As explained above it will be a norm, rather than a minimum. There will be situations in which individual banks, or banks generally, may consider it prudent to hold more than the norm, and there will be clearly defined circumstances when banks will need to draw on their liquidity to an extent which brings it below that norm. The arithmetic is such that it would be possible to have sharp short-term swings in the growth of the money stock of the kind experienced at present, while the monetary base grew steadily and there were only relatively small variations in the primary liquidity ratio, on a scale which might be acceptable to the banks and the authorities on prudential grounds.

9.7 Therefore, it seems most unlikely that the relationship between the growth of the monetary base in this type of system and the growth of the money stock would of itself be sufficiently close to ensure that a steady growth path for the base would produce a steadier path than now for the path of the base.

9.8 This limitation would not be a conclusive argument against a system of this type if the actions which the authorities took to control the growth of the base generated changes in interest rates which could be expected to lead to a smoother path for the growth of the money stock. But for the reasons discussed in paragraph 9.23 et seq below on how the base might be controlled it is far from certain that they would have that effect: although there is some presumption that any interest rate changes generated in order to control the base would be in the sense necessary to correct growth, even that would not always be the case.

9.9 A scheme not based on a mandatory requirement therefore would first require substantial changes in the structure of the money markets and then a transitional period of several years before there would be any prospect of the relationship between holdings of the base and the money supply to have stabilised. Even then, it would be far from certain that it would generate a steadier path for the growth of the money stock than now.

<u>A Mandatory Requirement - Lead Accounting</u>

9.10 There are three ways in which a mandatory requirement could be expressed:

i. banks could be required to hold base assets at time t+1 related to the level of deposits in some previous period t (this is lagged accounting, the basis of the present system in the United States);

ii. the banks could be required to hold base assets at time t related to the level of deposits at the same time t (current accounting, as with the present reserve asset ratio requirement);

iii. the banks could be required to limit their deposits at time t to some multiple of the base assets held at a previous time t-1 (lead accounting, a basis recommended by some observers in the United States but never, to our knowledge, used in any major country).

9.11 Lead accounting would have the attraction - if it worked, or giving a warning about the immediate future trend in the money stock. The controlled institutions would have to forecast movements in their balance sheet over the lead period, provided they faced some penalty for inadequate base assets since, if there were no penalties, the banks would have little incentive to make realistic forecasts. A significant rise in the demand for base assets would suggest that the banks expected a similar rise in their deposits. Either the base would 'lead' the money figures, if the system were an indicator one, or the rise in demand would generate a rise in interest rates, if the total quantity of base was controlled by the authorities.

9.12 For such a system to work , it would be necessary for the banks to be able to make tolerably accurate forecasts of their balance sheet. One difficulty is that much of the volatility and vagary of monetary growth is in fact caused by fluctuations in the public sector's position, not only in revenue and expenditure accounts but also arising from a whole range of financial transactions. Another is that even if it were possible for the banks to prodict the public sector's position accurately, the present structure of the system of lending to the private sector would make it difficult, if not impossible, for the clearing banks to forecast their future position vis-a-vis

the private sector at all accurately, because they, in effect, provide the residual finance for the banking system by offering overdraft facilities.

9.13 One natural response to these uncertainties would be for banks, particularly the clearers, to hold base assets above the level that they thought likely to need. There might frequently then be occasions when changes in the demand for base assets indicated a change in the banks' perception of uncertainty for the demand for deposits in the coming period, rather than the expectation of a definite change of trend. Another response would be for banks to respond to an under-prediction of the level of their deposits by ensuring that business over and above the level for which they had previously acquired reserves was done through channels which did not require reserves (such as, almost certainly, the euro-markets and through the "bill leak"). All the problems associated with such disintermediation would recur. The authorities consider that a lead accounting system must be ruled out on this account.

A Lagged or Current Requirement

9.14 If the requirement were set on a lagged accounting basis, the size of the mandatory reserve requirement would be determined by what had already happened to the past known growth in the monetary liabilities, against which the base is required. The total requirement could well differ from the level intended by the authorities, but it would by then be too late for the banks to adjust. It would therefore be necessary either:-

a. for the authorities to provide the additional base assets to enable the banks to meet the mandatory requirement;

b. to modify the requirement so that it was not absolute, but those banks not meeting it had to pay penalties - as with the SSD scheme now;

c. to set the base at a level which allowed the banks to have substantial excess holdings against unforeseen swings.

Each would carry its difficulties.

9.15 Similar problems would in fact arise over a current requirement, because the clearing banks, with their large networks and who are liable to bear the brunt of any fluctuation in demand for deposits would not know at a time when they still had an opportunity to bid for base assets, what their requirement at the close would be.

9.16 Taking the problems in paragraph 9.14 in reverse order, the difficulty with the third is that the linkage between the growth of base assets and monetary growth becomes very weak as the volume of "excess base assets" fluctuates from month to month.

9.17 The difficulty with the second is that, as with the SSD scheme, the burden of penalties would only be partially spread through financial markets to all borrowers and lenders, as the banks facing prospective penalties sought to avoid them by bidding for funds, so that they had a surplus of cash, or sold off assets to reduce their potential requirement. But to a significant extent, banks could be expected to seek to avoid the risk of penalties by disintermediation, switching business to offshore associates, or into uncontrolled forms, rather than losing the business altogether. This risk of extensive disintermediation effectively rules out a penalty system.

9.18 This effectively leaves the option of the authorities providing the cash requirements of the system as they emerge, and accepting that, as a result, the volume of base assets in existence on any day will differ from the desired level. It had been suggested that this could be reconciled with the

idea of a base control system if either there were a system of progressively higher interest rates for larger amounts of relief for the markets or the authorities were committed to controlling the base over a period to counteract increases on this account, or both. Such arrangements could, if practicable preserve, at least to some extent, the concept underlying the basic monetary base control systems outlined at the beginning of section 5 in that deviations of the money supply from the desired trend would trigger changes in interest rates.

Progressively Higher Rate for Lender of Last Resort Facilities

9.19 But a system under which the rates at which the Bank provided the extra base assets - cash - to meet the extra requirement, but on a scale of interest rates related to the extent of the relief given, runs into the difficulty that it is not possible for the authorities to know when providing lender of last resort facilities what scale of assistance will be required in total, and how far that assistance will cause the base to be above its desired level. This is fairly obvious if applied to, say, a weekly requirement. Conditions in the money markets within a week often swing markedly from day to day, with shortages on some days and surpluses on others: those swings are due, for example, to the particular day on which major taxpayers choose to pay their tax, to purchases of gilts and so on. To some extent these fluctuations are predictable and can be allowed for by the authorities. But the margins of error are very large: the Bank cannot be certain when it gives relief on, say, Monday or Tuesday of one week whether it will be unwound by the end of the week or not. So it could not relate the rate of interest charged on the relief given on one of those days to the scale of relief being given over the week as a whole.

9.20 The problem would not be overcome solely by making the requirement a daily one, and so relating the interest rate charged to the extent of relief

on that day. At the time at which the Bank provides relief in the markets, an hour before close (re 2.30pm) it does not know the amount of the base which will be outstanding at the end of the day, because of receipts to or payments from the authorities which are still in transit and which will be cleared by the end of the day.

9.21 One way round this would be gear the interest rates charged to the extent which relief was provided in excess of the amount which it had been estimated earlier in the day or week would be consistent with keeping the base on its desired path. The risk with this is that it could trigger perverse changes in interest rates. If, for example, the need for additional relief arose because the base was contracted by some factor which also contracted the money supply which had not been allowed for - a large tax receipt or large gilt sales - the higher interest rates would be generated, although the lower growth of the money stock could have required lower ones.

9.22 Another way round the problem might conceivably be to have a daily requirement and to change the basis of settlement for all cheques to a following day basis, so that both the size of the loans and the amount of relief requirement could be computed at the beginning of each day. Such a change would significantly affect the efficacy of the money transmission system [- including particularly the development of systems for electronic funds transfer, especially point of sale systems]. And two further difficulties would remain. First, the inherent fluctuations in the various elements affecting the cash base would inevitably lead to greater fluctuations from day to day in interest rates. Second the fluctuations, and scale of rates for relief, if it involved a significant excess over market rates, might over time erode the value as liquid assets for the banking system of the money market instruments which are rediscountable at the Bank, and so change both the functioning of these markets and the liquidity of the banking system.

The Control of the Base

9.23 Whatever the arrangements for the Bank to meet the cash requirements of the system from day to day, the authorities would have the task of controlling the growth of the cash base over a period. Indeed, as mentioned in paragraph 9 above, some of the advocates of monetary base systems see a commitment by the authorities to controlling the base as the main advantage of a monetary base control system irrespective of the formulation of the base requirement.

9.24 The cash base, defined as bankers balances with the Central Bank, and possibly, notes and coin, is affected as follows:-

i. it is increased by:

a. the central government's borrowing requirement;

b. increases in foreign currency holdings by the Exchange Equalisation Account;

c. credit to the private sector, generated by the use of last resort facilities;

ii. it is reduced by:

d. sales of central government debt, whether to banks or non-banks;

e. increases in notes and coin held outside the banking system (and in that system, if notes and coin were excluded from the base).

9.25 As already mentioned, the cash base fluctuates markedly, and partly unpredictably, because:-

a. the CGBR itself is subject to significant swings from month to month, and from day to day: some fluctuations can be

predicted, but others cannot, from the forecast, eg due to the decisions of companies about the particular date on which to make large tax payments;

b. even with a floating exchange rate, and no significant net intervention over a period, the authorities may need to intervene to avoid excessive swings, so requiring finance for, or releasing sterling from, the Exchequer Equalisation Account (EEA);

c. the provision of last resort facilities - although insofar as these were caused by unexpected movements in the CGBR or EEA transactions they would at least partly offset a. and b.;

d. the public take up of central government sector debt - which can be as much as £1 billion on one day;

e. the general public's use of notes and coin can again swing unpredictably.

The expected swings on this account have been as much as £500 million on a make-up day.

9.26 Given these unpredictable elements it would be necessary for the authorities to commit themselves to controlling the base over a period, with an obligation to sell, or buy, central government sector debt - whether short or long - to offset within a specified time, say one month, any overshoot in the level of the base on a particular date.

9.27 These sales of additional debt would however require either:-

a. securing of sales of Treasury bills, or other Government short-term paper, outside the banking system on a far

larger scale than has been usual hitherto;

or b. a system of gilt sales which gave greater assurance about the level of sales which can be achieved in a particular period than is possible at present.

9.28 Either, if achieved, would certainly bring about changes in interest rates, if the monetary base were expanding faster than the authorities intended due to a faster than desired increase in the money stock. But it is far from self-evident that they would be the changes in rates necessary to bring the growth of the money stock back to the desired level. For example, if the corrective action on the monetary base was to sell additional long gilts, that would reduce the base and the money stock by the same amount: as the base requirement is only a proportion of the stock (say 10%) the amount of sales to correct the deviation in the former would be nothing like sufficient, of itself, to correct the growth of the money stock. As a result the banks would again require more base than planned, and this would have to be offset in the following period - and so on. If a system were devised in which the relief were provided at penal rates, the effect would spread more directly to other short-term rates, and so effect other counterparts of the money stock. The process might be accelerated by the markets anticipating the change in rates, but there would seem to be a real chance that the changes in interest rates generated by this type of system would be inadequate, insofar as there was a deviation of the underlying trend of monetary growth from the target, but excessive insofar as the changes were generated by short-term fluctuations in the components of either the money stock or the base.

Effect on the Short-Term Government Debt Market

9.29 As mentioned above, the control of the monetary base would probably require the development of a wider market outside the banking system in Government short-term paper, such as Treasury bills. Indeed, this is seen by

some as another possible product of a monetary base system which is desirable in its own right. Moreover, it has been argued that if such a market developed, disintermediation would take the form of switching holdings of such paper outside the banking system and that this would be intrinsically less harmful than other forms of disintermediation -such as switching business offshore or the acceptance leak. It is true that such switches might not have some of the unfortunate effects in terms of loss of business to the United Kingdom financial system or prudential risks that these other forms of disintermediation may have. But the resultant changes in the £M3 statistic would still be essentially "cosmetic": the Treasury bill would be no more or less liquid in the hands of its holder than a Certificate of Deposit, but the former would be excluded from £M3 while the latter would be included. It would therefore be little, if any, less damaging than other forms of disintermediation the the credibility of the £M3 statistic as an adequate indicator of monetary conditions, and so as the basis for the monetary target.

9.30 The argument why disintermediation might take this form runs as follows:-

(1) The discount market, together with other parts of the banking system that customarily hold large portfolios of marketable short-term securities, will know that the authorities will respond in a certain way if the monetary base deviates in a defined manner from a known desired path. Such deviations would be observable and, accordingly, official behaviour in the money market will be predictable in respect of interest rate alterations.

(2) The discount market (and banks) will, in effect, respond to knowledge that the base is growing too fast by selling short-term securities. The yield on such securities will then rise a little,

relative to that on bank deposits and CDs, and disintermediation will occur; or vice versa if the base had been observed to grow too slowly. The general level of interest rates will have changed little while the deviation to sterling M3 will have been corrected, albeit in a cosmetic fashion.

9.31 What actually happened could be very different:

(1) The discount houses (and banks) will observe the monetary base rising too fast and will know that this heralds an increase in short-term interest rates. They will also know that the increase might well be quite sizeable, because the official purpose is the control of the underlying growth of £M3, which everybody knows is not to be achieved merely by small changes in rates.

(2) It will also be the case that the expectation of higher rates cannot be confined to discount houses and banks. It will instead be shared among virtually all operators and investors in the money markets. At that point, all investors will wish to sell short-term securities, including negotiable CDs, and get into overnight money until the expected rise in rates has occurred. Simultaneously, banks will try to borrow longer and attempt to issue more CDs before rates rise. This collective behaviour will itself bring about the expected rise in rates and ordinary dealings will recommence at the new level. Nothing discernible will have happened in this process to alter relative interest rates between, for example, negotiable CDs and Treasury bills of comparable maturity and no 'disintermediation' will have occurred.

9.32 An example of this happened under the present system on Thursday, 24 November 1977, MLR was raised to 7% from 5%. This followed a period

in which domestic rates had been driven down by external inflows and the money supply had begun to rise too rapidly in relation to the published target. It also followed a period of some two years during which non-bank holdings of Treasury Bills had become significant. Over the ensuing few days, the rise in MLR to 7% was thought by some operators in the money market to be inadequate to achieve the required correction in monetary growth; and, because of the readiness with which the Rate had been raised in the first place, this, in turn, aroused an expectation that it would soon be raised once more. In a matter almost of minutes, on the following Wednesday morning, this expectation took such hold that Treasury Bills, commercial bills, CDs and other short-term securities were aggressively offered for sale by banks and non-banks alike. The discount houses, as an important element in the secondary market in such paper, retreated straightaway, with the result that an altogether higher level of rates (consistent with an 8% MLR) was at once quoted by them. A subsequent statement by the Bank, reiterating the adequacy of a 7% MLR, then caused rates to fall back to where they had started.

9.33 The above episode sheds some light on what can happen in the money market when an expectation gains ground that is itself founded upon a very firm prediction of official behaviour (even though erroneous in that particular case). Much more familiar is the more gradual process whereby an expectation slowly gains ground in more 'two-way' conditions. Some of the discount houses may then, if rising rates are thought likely, endeavour to shorten their books. This may take the form of outright sales of assets, notably short-dated gilt-edged. It will also show itself as a reluctance to take up fresh short-term paper in replacement of maturing Treasury bills, local authority bills, commercial bills, CDs and local authority bonds. At the same time, some of the banks will allow their holdings of such paper to run off and will endeavour to employ the proceeds at call, while also

endeavouring to raise more 3-month money in substitution for shorter deposits. In addition, some non-bank investors will look for higher yields on newly acquired liquid assets. In response to all these pressures, the whole level of rates will move up in an orderly manner in two-way markets, provided that the balance of expectations points in that direction. In the process, and depending haphazardly on the distribution of expectations within and outside the banking system, short-term securities may move either into or out of that system, but without the pattern of relative rates altering in any particular way.

9.34 In the absence of direct controls, the pattern of relative rates under the present system mainly reflects differences of liquidity and credit risk between short-term securities of similar term. But it can occasionally reflect also a condition of relative plenty or scarcity. For example, if a growing money stock is associated with large governmental borrowing and a depressed state of private sector loan demand, the banking system will tend to become very liquid. Banks will then not wish to acquire additional Treasury bills if their counterpart has to be additional 3-month wholesale money, for the latter normally costs more than can be earned on a Treasury bill. They may instead buy higher-yielding gilt-edged which, if supplied by the authorities, will eliminate the unwanted supply of Treasury bills. But if, because of adverse expectations, intermediation into gilts is not attractive, the banks will simply reduce their wholesale money rates somewhat and cease intermediation at the margin. The unwanted supply of Treasury bills will then flow into non-bank hands. This has happened on various occasions over the past decade, helped by the marketing skills of the discount houses. But it bears little resemblance to the processes required for short-run control of sterling M3. For this can hardly be expected to be achieved by, for example, deliberately rendering the banking system over-liquid when £M3 is rising too fast.

9.35 It has to be concluded that the evidence in favour of the hypothesis that base control would produce favourable disreintermediation, except occasionally and by chance, is weak. To succeed in this, the control would need to create an expectation that a small but significant change in interest rate relativities was going to occur, and nothing much else. But control of the money stock, except in a very transitory sense, in fact requires periodic substantial alteration in the level of interest rates. The markets know this, and their expectations are formed accordingly; the processes whereby such expectations become translated into a change in the level of rates are likely to be neutral in their effect on the relativities between rates.

An Alternative Approach - Negotiable Entitlements

9.36 It has been suggested that the problems in controlling the conventional cash base could be side stepped by having as the base instead "negotiable entitlements" (NEs) specifically designed for the purpose. In its simplest form, this approach would involve the creation by the authorities of a supply of such entitlements (NEs) which banks would be required to buy in proportion to the deposits that they wish to take. The authorities would be the sole source of supply of NEs and they could increase that supply in line with the growth of deposits that they though desirable. The banks would bid for new entitlements and trade the existing stock. Competition would ensure that, if the flow of deposits into the banks tended to rise above the level implied by the stock of entitlements then the market price of NEs would rise. This would effectively raise the marginal cost of additional deposits to the banks taking them, because they would have to pay the going market rate for deposits and buy the entitlement as well. The banks would, in turn, raise their lending rates or otherwise restrict their loans; the process would continue until the total credit granted had fallen to the point where the total deposits that the public wished to hold with the controlled institutions at the ruling market rates of interest were within the total allowed by the stock of entitlements.

9.37 The effects of such an approach would be those of a direct control, such as the SSD scheme, but in which the adverse effects of a permanent control on competition and efficiency within the controlled sector were mitigated by making NEs saleable. As with the present SSD scheme, the impact of a tight montary policy (in which the demand for deposits was rising faster than was compatible with the authorities' target) would effectively be to tax the banks covered by the scheme obliging them to raise the margin between their lending and deposit rates and/or to pass the business on elsewhere.

9.38 Even before the abolition of exchange controls, experience with the so-called bill-leak and with other forms of disintermediation during the operation of the SSD scheme demonstrated the ease with which direct controls can be avoided. As explained in Section 2, to the extent that such avoidance can be measured, it is still possible for an adequate picture of the stance of monetary policy to be established, but there may even then be significant adverse effects on competition between the controlled and unregulated sectors and, possibly, problems of prudential supervision as well. With the abolition of exchange controls, any form of monetary control which did not affect equally the cost of off-shore as well as on-shore intermediation would generate even more serious problems of disintermediation (and of measurement and supervision) than any direct control used hitherto.

9.39 There seems to be no satisfactory way out of these problems if the control is to be effective. Thus, for example, the extent of the discrimination could be limited by allowing controlled institutions to pay only a modest penalty if they held an inadequate volume of entitlements. This would effectively put a ceiling on the market price of entitlements and limit the implicit tax. However, some discrimination would inevitably remain and, of course, the lower the penalty, the less the effect of the control on the total of deposits.

PM
Seen

Mr Lankester

Present draft, subject to further comments by Chancellor, Govr & others. Sidelined passages reflect changes in an attempt to meet Bank concerns.

JW

7/3

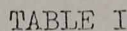
MEDIUM-TERM FINANCIAL STRATEGY

Objectives and Instruments

The Government's objectives for the medium-term are to bring down the rate of inflation and to create conditions for a sustainable growth of output and employment.

2. To reduce inflation it will progressively reduce the growth of the money stock and will pursue the policies necessary to achieve this aim. After 1980-81, for which a target range of 7-11 per cent has been announced for £M3, the Government intend to set a target range consistant with the annual growth of money supply being reduced to about 6 per cent in 1983/84. It is the Government intention that there should be a progressive deceleration over the period producing the profile shown in Table I. The precise target rate of growth in the intervening years will be decided at the time.

TABLE I



12 - 4

RANGES FOR GROWTH OF THE MONEY STOCK

	1979-80	1980-81	1981-82	1982-83	1983-84
Percentage change in year	[12½	7-11	6-10	5-9	4-8]

3. The aim is to bring inflation down until it is roughly in line with the monetary target. The speed with which inflation actually falls will depend crucially on expectations both within the United Kingdom and overseas. It is to provide a firm basis for those expectations that the Government has announced its firm commitment to a progressive reduction in money supply growth. Public expenditure plans and tax policies and interest rates will be adjusted as necessary in order to achieve the objective. At the same time the Government will continue to pursue policies to strengthen the supply side of the economy, by tax and other incentives and by improving the working of the market mechanism.

4. It is not the intention to achieve this reduction in monetary growth by excessive reliance on high interest rates. The Government will therefore plan for a substantial reduction over the medium-term in the PSBR as a percentage of GDP. The relationship between the PSBR and the growth of money supply is not a simple one; it is affected both by the economic cycle, the rate of inflation and by the structure of the tax and public expenditure flows generating the borrowing requirement. But although the relationship between the PSBR and £M3 is erratic from year to year, there is no doubt that public sector borrowing has made a major contribution to the excessive growth of the money supply in recent years. The consequence of the high level of public sector borrowing in recent years has been a high level of interest rates and a reduced availability of funds to the private sector. It has become clear that high nominal rates, even in the context of rapid inflation, are themselves a deterrent to investment. If interest rates are to be brought down to acceptable levels the PSBR must be substantially reduced as a proportion of GDP over the next few years. The projections summarised in Table V below show that the Government's fiscal plans are consistent with a progressive reduction in the PSBR to around 2 per cent of GDP, which would be roughly in line with the average ratio recorded in the 1960s. The fiscal plans are thus fully consistent with the monetary objective.

[paragraph to be added]

Public Expenditure

6. A key element in this strategy is a reduction in public expenditure. The plans announced in the Public Expenditure White Paper (Cmnd) show a reduction of [4] per cent in volume of public expenditure between 1979-80 and 1983-84 and on the assumptions about GDP described below imply a fall in expenditure as a proportion to GDP from [42]per cent to [ ] per cent over the period. Table II below shows the expenditure plans in cost terms at 1978-79 prices and allowing for shortfall. Total Government expenditure in these terms is gradually reduced over the next four years - from [£75] billion in 1979-80 to [£69] billion in 1983-84. The financial framework described below sets these expenditure projections against an illustrative projection of Government revenue.

TABLE II

GENERAL GOVERNMENT EXPENDITURE

(£ billion)	1978-9	1979-80	1980-81	1981-82	1982-83	1983-84
General government expenditure at 1979 survey prices*	68.1	70½	69½	69	68	67½
Total Expenditure in cost terms at 1978-9 prices	64.3	66	65	64	62½	62
Shortfall	+0.4	0	-¾	-¾	-¾	-¾
Interest Payments	7.8	8	8	7½	7	7
National Accounts Adjustment	1.3	1	1	1½	1½	1½
Total Expenditure in National Accounts Terms	73.8	75	73½	72½	70	69½

*Total spending on programmes by central government and local authorities plus the contingency reserve. Debt interest is excluded.

Revenue in the Medium-Term

7. The growth of Government revenue over the medium-term is dependent upon the growth of national output. This is heavily conditioned by the underlying growth of productivity, the growth of the world economy, and the speed of reduction of the recent high rate of inglation.

8. Since 1973 growth in output has fallen both in the UK and in the rest of OECD (see Table III). Over this period growth in OECD output and in world trade in manufactures has roughly halved. It seems unlikely that world output and trade will grow faster over the next few years than in the past five years. In most of these countries there is strong evidence of a slow-down in productivity growth in recent years. In Britain, recorded productivity growth (for the whole economy excluding the North Sea sector) over the period 1973-1979 averaged [¼] per cent a year - compared with an average of 2½ per cent in

the preceding decade. One consequence of the slower growth in productivity in the 1970s is that there has been less excess capacity in the economy than might have been expected, on earlier experience, given the slow growth of output.

TABLE III

WORLD AND UK GROWTH RATES

(Annual average per cent)

	1964-73	1973-78	1978-80
Growth of Output			
OECD*	5.2	2.6	2
United Kingdom ≠	3.0	1.0	-1

* Weighted average of GNP of OECD countries, excluding UK.
≠ GDP

9. The process of reducing Britain's high rate of inflation may entail some transitional losses of output. A stricter monetary policy is likely to involve a tighter fiscal stance, higher interest rates and a higher exchange rate, and these will have some depressing effects on activity in the short-term. The size and duration of these effects, however, will depend in large measure on how quickly behaviour, particularly in pay bargaining, takes account of the new monetary environment. As inflation subsides, nominal interest rates can come down and, for any given nominal exchange rate, competitiveness will be better and the basis will be laid for sound, sustainable growth. If inflation comes down the monetary growth set out in Table I will permit a return to an acceptable rate of economic growth.

10. Although it is hoped to do better it would be imprudent, in the light of all these considerations, to assume that the average growth rate of the economy over the next few years will be above the 1 per cent a year recorded between 1973 and 1979. Since the growth of the economy strongly affects the growth of Government revenue at unchanged tax rates the illustrative projections in Tables III-V make the deliberately cautious assumption of an average growth rate of [1] per cent a year for the years after 1980, giving an average of [ ] per cent for the period 1979-83 as a whole.

11. The implications for Government revenues of this illustrative growth rate are shown in Table IV. Revenue is projected on the conventional assumption of constant indexed tax rates and allowances at current, 1980-81 levels. The low average growth of the economy over these years is reflected in a virtually flat profile in real terms for revenues from the traditional major taxes. However, the rapid rise in revenues from the North Sea in the later part of the period adds substantially to total tax receipts. Over the period 1979-80 to 1983-84 as a whole total Government receipts (at 1978-79 prices) rise by about £4 billion.

TABLE IV

GENERAL GOVERNMENT RECEIPTS

General Government Receipts at 1978-79 prices (£ billion)	1978-9	1979-80	1980-1	1981-2	1982-3	1983-4
Taxes on Income, Expenditure and Capital	48.2	51½	51½	50	53	55½
[of which North Sea taxes]	[0.6]	[2]	[2½]	[2½]	[4]	[4½]
National Insurance etc	10.2	10	10	11	11	11
Interest and other receipts	6.3	4½	5½	5½	5	5
Total Receipts	64.7	66	67½	66½	69	71½

Money Supply and Public Sector Borrowing

12. This revenue profile, in conjection with the declining profile of public expenditure produces a progressive reduction in the PSBR after 1980-81. This is shown in Table V.

13. This particular path for the PSBR is not to be interpreted as a target. It is a projection of the course of the PSBR based on the

assumed growth of GDP, present public expenditure plans and the assumptions about the tax structure described in paragraph 11 above. Fiscal policy will be operated so that the PSBR for any particular year will be consistent with declining monetary growth in the particular circumstances of the time. The chosen PSBR could be higher or lower, according to circumstances, than that shown in the table. The PSBR path shown requires, on the assumptions made, a 'fiscal adjustment'. If such adjustment turns out to be necessary for a particular year the Government would assess nearer the time whether it should adjust public expenditure, tax, or some combination of the two, and also the precise items within these that would be changed.

TABLE V

PUBLIC SECTOR BORROWING

1978-9 Prices (£ billion)

	1978-9	1979-80	1980-1	1981-2	1982-3	1983-4
Total Expenditure	73.8	75	73½	72½	70	69½
Total Receipts	64.7	66	67½	66½	69	71½
Fiscal Adjustment	0	0	0	0	-3½	-5½
GGBR	9.1	9	6½	6	4½	3½
PSBR	9.3	7½	6½	5½	4½	3½
(as % of GDP at market prices)	(5½)	(4½)	(4)	(3½)	(2¾)	(2.0)

14. As is now generally recognised projections of this sort are subject to wide margins of error not just because they depend crucially on the assumptions about developments in the rest of the economy, but because even with reasonably firm knowledge of such developments it would be difficult to predict revenue and expenditure with any precision. Nevertheless if their limitations are borne in mind the projections described above suggest that if GDP growth after 1980 were at about the same rate as in 1973-79 there should be scope for tax reductions in the later years.

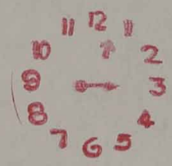
15. The path for the PSBR set out in Table V is consistent with achieving the planned reduction in the growth of money supply over the medium-term with lower interest rates. It is not possible to predict the path of interest rates year by year, but the strategy set out above implies that though financial conditions must remain quite tight in the immediate future while inflation remains high relative to the monetary target, there should over the period as a whole be a progressive reduction in nominal rates and a better environment for investment.

Responses to alternative outcomes

16. The projections shown in Tables III-V are within a wide range of possible outcomes. Events could develop so as to produce a very different situation. World trade could grow faster or more slowly than assumed; the supply response of the UK economy could be very different, with consequences for productivity and trade performance; oil and other commodity prices could show different movements; and the behaviour of earnings is always difficult to predict. Any of these outcomes, and many others, could significantly change the growth rate of the economy over the next few years, and hence the finances of the public sector. This is true even with a large change in prices, such as a rapid rise in commodity prices, because this will feed back on to output growth.

17. To maintain a progressive reduction in monetary growth in these circumstances it may be necessary to change policy in a way not reflected in the above projections. The Government would face a number of options for policy changes to keep to the monetary targets, including changes in interest rates, taxes and public expenditure. If events developed in such a way that it became easier to achieve monetary deceleration, it would even be possible to keep fiscal stance and interest rates unchanged and to allow monetary growth, and hence inflation, to fall faster. But if the opposite happened, and it became more difficult to achieve monetary develeration, there would be no question of relaxing the money supply policy, which is the centrepiece of the Government's economic strategy.

-7 MAR. 1980



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16/3

CHIEF SECRETARY

MEDIUM TERM FINANCIAL STRATEGY

Thank you for your minute of March 4th about the financial strategy. Your anxieties partly match those of the Bank of England, which will, I trust, be largely met in the latest draft. With these amendments, I see the case for publication as still being very strong.

2. Our economic strategy has no real precedent. Under the Labour Government, monetary control was only of central importance for a short period, in 1976-7. For most of their time Labour had no long-term economic strategy, and changed direction every few months. Not surprisingly, therefore, their monetary policies did not have the lasting, radical impact on behaviour and attitudes which both circumstances and our approach now demand.

3. Since the election we have only succeeded in stopping the rot we inherited. To achieve positive success - which you may at moments doubt to be possible - our policies must do more. The business world, financial institutions, labour markets and ordinary people (particularly our supporters) must have a vision of how we intend to proceed hereafter. They want to know the course we intend to steer in relation to expenditure and taxes, and what our commitment to monetary discipline might mean. Furthermore, the way the policy works implies that they need to be given a clear indication of the limits within which we intend to manage public spending and the money supply, so that they can adjust their behaviour rationally to fit in with those limits. But they also need a demonstration that our intentions and the policies which will realise them are consistent, technically sound, and will bear fruit . At present there is a measure of uncertainty about all of these.

4. We need, therefore, to illustrate the modest realism of our goals and to marshal the wider support which will follow from so doing. The more we do so the more we can hope to get into the virtuous circle in which the greater credibility of our policies makes them more effective and their effectiveness increases their credibility.

5. It is this line of reasoning which leads me to take issue with your numbered points:

(1) The demand for a strategy certainly comes from the commentators. This is surely not an argument against it, not least because of their crucial role in shaping public opinion. If the heavy-weights believe our policies are credible, they can do more than any other group to make them credible to the world at large. That is no mean prize. But it is not the commentators alone who are, by and large, in favour. I believe there are many in the commercial world who welcome the idea, too. However the central issue is not who is advocating a financial strategy, but whether it could be helpful. For the reasons already given, I believe it can be.

(2) You fear that the statistics published in the strategy have to be forecasts rather than "illustrative" figures if they are to be credible. Of course as it happens some of them are undoubtedly straight forecasts or plans - most obviously the public spending proposals. Others - the possible path of Government revenue and PSBR - are prudent "worst case" projections. In neither case is credibility a serious issue. The indications of the intended path of M3 are not forecasts at all and are not intended to be. They are statements of firm intent. With proper presentation and acknowledgment of the need for some year to year flexibility there is nothing intrinsically incredible about them. One might, of course, wish to question the figures presently adopted, but that is a quite separate issue.

(3) and (4) We would all agree that no "mechanistic" connection between monetary expansion and subsequent inflation can be demonstrated. However, you go on to suggest that a published financial strategy is only credible if it also includes estimates of "recorded inflation" [I assume you mean "forecast inflation"] of a kind which are unattainable without such a mechanistic relationship. At that point I would part company with you.

What matters is our monetary policy and that we adhere to it, not that it is accompanied by precise RPI projections which no one believes. For surely you would accept that the reason for a policy of steady reduction in monetary growth is that there is a firmly established, if imprecise, relationship between trends in the money supply over time and inflation at a later date. Provided one accepts that as unchallengeable, then the absence of accompanying figures for inflation does not matter. Indeed, for just the reasons you give it would be foolish to offer any such figures at all, as they would imply greater claims for the efficacy of the policy than any of us would wish to make or defend.

It is worth stressing, in passing, that the essence of such a financial strategy is that it describes one's plans in relation to those things one can control fairly directly, so as to increase one's power over factors such as inflation over which the Government's influence is only indirect.

(5) Your final anxiety is that a published financial strategy will convey an impression of certainty about pace and direction which we do not possess. I entirely agree that we should not claim an ability to foresee or manipulate the future which we do not have. However, provided that we do not make the money supply figures unduly precise, and provided we do not publish RPI projections, I do not see this as an insuperable problem. Indeed my own anxiety is rather the opposite of yours, namely that

without such a strategy we could end up conveying no sense of pace or direction whatever. To allow that to happen would certainly be an unmitigated disaster.

6. I trust that these comments go a good way towards answering the points you have raised.

7. I am sending copies of this minute to the Prime Minister and Sir Douglas Wass.

7.3.80

PM Seen

TELEPHONE
01 · 601 4444

Hurriedly comm to PM, and read.
R. 1/3
(no need to reply).

BANK OF ENGLAND
LONDON EC2R 8AH

7th March, 1980.

My dear Prime Minister

In the last ten days, I have been discussing with the Chancellor, and my assistants with his, the proposals for a statement of medium-term financial strategy. These discussions have been most helpful; and the presentation which the Chancellor will now be submitting to you has, as I think the Chancellor would also agree, been considerably improved. I have, however, all along had rather fundamental misgivings about it and I think I should let you know what these are.

I appreciate that the object of the strategy is to demonstrate the way through the difficulties the country faces; and to help to ensure that we go through with it, by committing the Government to a particular path of monetary growth.

The difficulty is that some of the elements in the picture are hard to present in a persuasive way. The clear impression is given that economic growth in the years ahead is going to be no better than the 1% a year achieved in the years 1973-1979. This does not square with hopes of a more dynamic economy. Before we get to 1983, a period of recession is promised, and (implicitly) growing unemployment. The object is to defeat inflation; but as no figures are given for future inflation rates - no doubt this would be difficult - this must appear uncertain.

What the projections say about the economic prospect could possibly be correct. But by publishing them in this way, the Government will appear to be taking responsibility for what they show, and will appear to be saying that this is the result its policies are intended to produce.

These are largely political considerations which it is for you, not myself, to weigh. They do, however, affect my own task. Monetary policy is at the centre of strategy; it is difficult to carry through; and needs to be defensible in ordinary terms.

/...

I also see dangers, from the point of view of implementing monetary policy, from the rigidity of the presentation. I appreciate that efforts have been made to soften it, but the impression remains that the Government is committing itself in advance to follow a certain line of policy, irrespective of circumstances. This indeed is the essence of what the statement is intended to convey, and I know the arguments for it. Nevertheless, I feel greatly uneasy about accepting too binding a commitment.

Let me mention some of the considerations. We think hard each year what the monetary target should be: it is always a difficult matter of judgment. It is clearly still more difficult - not to say hazardous - to seek to determine now the targets for four years ahead. The dangers are that if the structure of wages and prices remained stubbornly unresponsive to the severity of our pre-determined monetary path, the consequences for interest rates, the exchange rate and activity could become very serious indeed.

I myself want to see progressive deceleration in the rate of monetary expansion. But I believe we are sufficiently committed to this as we are, without going further.

In the light of these considerations I doubt whether publication of the strategy would strengthen the credibility of policy.

I should be grateful for an opportunity to develop the points in this letter, of which I am sending a copy to the Chancellor.

Yours sincerely

Gordon Richardson

The Rt.Hon. Margaret Thatcher, MP.

Original filed Econ Pol (Budget) Pt 3 5.3.80

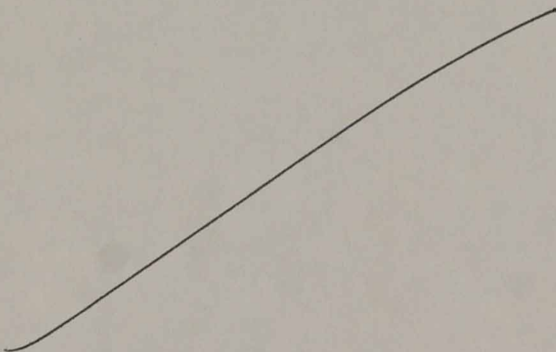
SECRET

PRIME MINISTER

MEETING WITH THE CHANCELLOR
THURSDAY 6 MARCH 1980

The Chancellor would like to cover the following at the meeting tomorrow:

(i) The indirect tax package in the budget. He told you last



(ii) The disposals programme in 1980/81. Papers on this are at Flag A. The short point is that the Chancellor is looking for £500 million, and he has identified about £400 million which is fairly firm. The other main possibilities lie with Mr. Howell's responsibilities, but he so far has been unco-operative. The best option here would be for BGC to sell off its interest in the Wytch farm oilfield - this would raise £100 million. BGC will resist because the field has been developed almost entirely through their own efforts, and because it would be hard to get an accurate evaluation - the size of the recently discovered oil reservoir below the existing reservoir has not been determined yet. You will of course want to support the Chancellor in general terms, but I wonder whether it would be right to support him on any particular scheme of disposals in the energy field without hearing Mr. Howell's case.

The Chancellor will also probably bring you up-to-date on where he has got to on the medium-term financial strategy. The paper which you saw last week has been revised to take on board some of the Governor's worries; the Chancellor is awaiting his further comments before putting it back to you. TL

Prime Minister Econ Pol 2

The Treasury are re-writing this paper to take account of some of these, and the Governor's, worries. You will need to discuss again with the Chancellor and possibly the other two.

No. 3 of 4 copies

CHANCELLOR OF THE EXCHEQUER

MEDIUM TERM FINANCIAL STRATEGY

Over the past few weeks I have made known to you my reservations about the publication of a set of economic statistics covering the expected life span of this Parliament. As you know I have privately assured you that I would accept the collective judgement on this matter, and I have not committed views in writing lest there was any danger - however remote - of our differences of opinion becoming known and possibly magnified.

I did, however, explain that I would send you a short minute following the meeting held on March 3 to consider a Medium Term Financial Strategy.

It seems to me there are at least five reasons which militate against the publication of these statistics as a Medium Term Financial Strategy.

1. The demand for such a Financial Strategy comes from journalists, academics and commentators rather than from those in the commercial world.
2. If the statistics are to generate confidence they will have to become forecasts backed by government authority rather than illustrative tables.
3. If the Strategy statistics are to establish the credibility of a monetary policy over several years they will assume some mechanistic relationship between public sector borrowing requirement, monetary aggregates, and recorded inflation. I do not believe such a relationship can be thus demonstrated.

4. Indeed the omission of recorded inflation (the RPI) from the proposed Financial Strategy underlines the difficulties I have observed in point 3 above; particularly as the price index is the statistic of supreme political importance which justifies the policy.

5. Our monetary policy is still at the stage of apprenticeship. The Financial Strategy, on the other hand, will suggest a certainty about pace and direction that we do not possess, either technically or politically.

I could elaborate my reservations at greater length - but the above points serve to illustrate my main anxieties.

I am sending copies of this minute to the Prime Minister and to Sir Douglas Wass only.

W. J. B.

JOHN BIFFEN
4 March 1980

Financial Times Thursday February 28 1980

ECONOMIC VIEWPOINT

Why the time has come to have a proper budget

THE PUBLIC Expenditure White Paper will be published this year on Budget Day, March 26. At least two major documents will appear that day: the Financial Statement or "Red Book," which normally gives the revenue and economic background to the Budget, and the Expenditure White Paper itself, which will announce the results of the latest spending review, together with projections several years ahead.

The present intention is to transfer most of the economic analysis from the Public Expenditure White Paper to the Red Book. The probability is that it would also contain the medium-term framework necessary to make sense of the Chancellor's borrowing and monetary decisions.

A mythical Martian, or even a foreign visitor unversed in British ways, might suppose that this bringing together of expenditure and revenue was common practice. In fact it has largely happened by accident, due to the Government's third attempt to cut public spending, which has delayed the publication of the Expenditure White Paper. Even so, the tax decisions will have been taken a couple of months after the spending ones. The detailed analysis of public spending in the White Paper will be in a different kind of monetary unit from the tax decisions and not easily comparable with them.

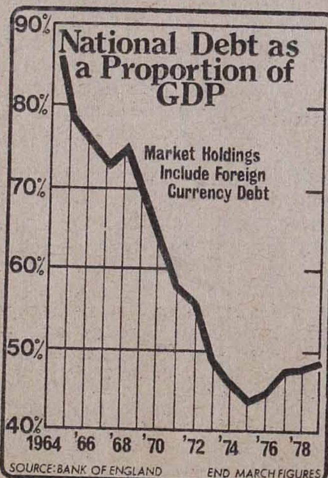
The idea of even an outline of expenditure and revenue projections on a common basis, stretching a comparable distance ahead and clearly related to monetary objectives, is the subject of a quiet but intense battle between the exponents of an articulated economic policy and the "know nothing, say nothing" school. This is an internal discussion among economic ministers and their advisers far more important than the populist cries of "Down with the PSBR!" "Prior in, Joseph out!" "Give them the money!" or "We want a U-turn."

Much more relevant is the Committee of the Institute of Fiscal Studies set up under the chairmanship of Lord Armstrong, a former Treasury Permanent Secretary, in November, 1978, to study the changes required to enable government expenditure and revenue plans to be considered together without the benefit of timing accidents. Those unversed in the British governmental system may indeed wonder that it was necessary to set up such a committee to recommend what should have been happening in any case. As a member of the committee, I must bear my share of responsibility that it has not already reported.

The problem is twofold. First the British spring Budget differs from nearly every other budget in being mainly devoted to taxes designed to finance spending decisions which have already been announced on entirely separate occasions—usually in the preceding summer and autumn as part of a procedure known as "PESC" (Public Expenditure Survey Committee) and then announced in a White Paper during the winter.

Secondly, while tax decisions are made on a year-to-year basis in terms of actual money, public spending plans are announced for several years in terms of an entirely different unit. Contrary to what is often supposed, public spending plans are not indexed in any true sense—as they would be if set out in today's money on the understanding that they would be adjusted for the rate of inflation. They are expressed in "volume" terms, or what I have often called "funny money."

This means, very roughly that expenditure is controlled in physical units—so many tanks, teachers, hospital beds and so on. If the price of any of these things varies, it does not count as an increase in the volume of expenditure, even if the price



increase is several times the rate of inflation. If more hospital porters are employed, this counts as an increase in spending. If instead existing porters are paid more—however much more—it counts as no increase at all. To this is added estimates of cash transfers, such as pensions and National Debt interest, all on different price bases, and combined together to give a total whose meaning no one understands.

Not surprisingly, this kind of "funny money" has had disastrous effects. Programme controllers have had little incentive to take into account relative cost changes to carry out their plans in the most efficient way. As the cost of public spending has risen on average 2 per cent per annum faster than prices in general (but sometimes much more), the announced plans in the Public Expenditure White Paper often seriously underestimate their eventual costs. This is one reason for the frequency with which rounds of public spending "cuts" have succeeded each other.

To remedy the worst absurdities, a system of cash limits has been added covering just over half of total public spending. But this grafting of one system on top of another has, hardly surprisingly, been less than a complete success. For one thing, the cash limits which are announced about Budget time are for a year at a time, and play no role in the longer term plans. For another, both Mr. Denis Healey and Sir Geoffrey Howe have left deliberately vague what happens if either the general inflation rate, or the cost of particular public services, rises more than expected.

Last year Sir Geoffrey adjusted the cash limits to take into account public sector wage awards, but by slightly less than the full amount so as to exert a gentle added squeeze, as his predecessor had also been planning to do. Nevertheless, public spending has still been tending to rise as a proportion of the national product.

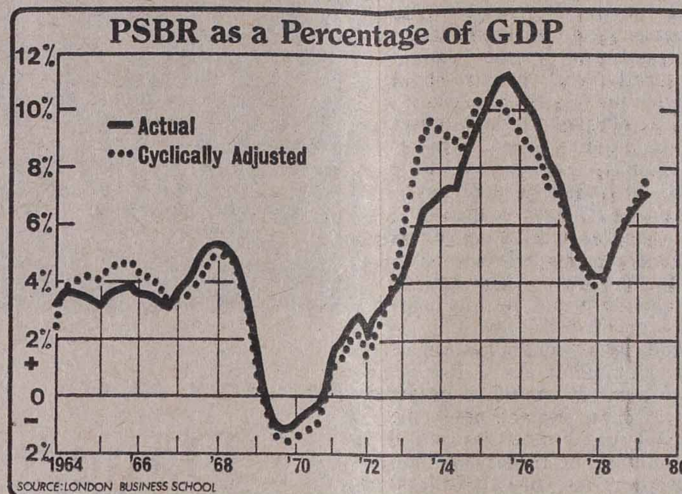
Nearly everyone who has investigated the matter has come to the conclusion that the minimum reform required is that public spending and tax decisions should be made and announced at the same time and in the same kind of units. To link them together, the Government would have to express some view about the desirable movement of the Public Sector Borrowing Requirement as a proportion of either the actual national product, or its trend rate, abstracting from cyclical fluctuations.

A fiscal framework of this sort is also indispensable if the Chancellor's repeated undertakings to secure a gradual reduction in monetary growth are to have any credibility. People will believe that money supply growth will be reduced only if it looks as if it can be done without paying a prohibitive political price in interest rates.

In practical terms, a phased decline in monetary growth requires a phased reduction in the Public Sector Borrowing Requirement as a proportion of the national product. Other things are required, too, such as the end of non-indexed long-term borrowing, which is simply a way of telling the financial markets that the authorities expect double-digit inflation until well into the 21st century.

But a set of declining monetary targets over the next few years, with correspondingly reduced fiscal deficits, is the starting point of any counter-inflation strategy which deserves to be taken seriously. So far we have had merely a rolling forward of annual targets under both Sir Geoffrey Howe and Mr. Healey, targets which have been breached even on paper, before allowing for distortions to the figures.

The logical order for a coherent financial strategy is first to decide on declining money supply targets, or ranges stretching for some years



ahead. Secondly, a PSBR path consistent with these targets must be announced. This can be a little more flexible, with above-trend borrowing in recession and below-trend in recovery periods, so long as there is a clear downward path over, say, a four-year cycle.

Thirdly, tax and spending plans consistent with these objectives should be announced —their size being of course a political decision. Both can be varied, so long as they are kept in line with each other; but it is far from obvious that spending requires a longer planning horizon than taxes.

The increasing unreality of the PESC projections, as one moves into the third, fourth and fifth years is widely recognised, but equally unreal are revenue projections confined to one year. Many tax decisions have their main impact more than a year ahead. The VAT increase announced in the 1979 Budget will yield over £4bn in 1980-81, compared with £2bn in the year it was announced. The greater part of any concessions Sir Geoffrey announces on March 26 on capital taxes will have their main effect in 1982-83 and beyond.

The case both for announcing intentions a little way ahead, and being prepared to alter them in the light of events applies even-handedly on both the expenditure and the revenue sides.

As a matter of fact, something a little like a medium-term exercise already took place towards the end of last year. It was the work on this which revealed the need for a further round of public spending curbs if the Government was to have a ghost of a chance of carrying out both its tax-cutting and its anti-inflation objectives. But if the whole exercise remains a private one, the potential effect on expectations is wasted, the transitional unemployment costs are increased and the desired effect on prices needlessly postponed. Indeed, this has already happened as a result of announcing last year's VAT increase without any medium-term strategy to put it in context.

Finally, I should like to go, one by one, through the main objections to the idea of a medium-term financial framework. The first is the uncertainty of the future. It is precisely because of this uncertainty that a few fixed points in the financial, as in the legal, framework are so necessary.

Behind this objection there lies a frequent confusion between forecasts and statements of intentions. For instance, it is precisely because forecast oil revenues are so uncertain that it is necessary to have firm commitments on public sector borrowing. It offers some insurance that, if hopes are disappointed, spending and taxes will be adjusted rather than a resort made to the printing press.

'Margin' for tax cuts

If I were in charge of the March budget documentation, I should have a highly conservative oil revenue projection to which public spending plans would be related. But I should also publish the more optimistic possibilities rather than wallow in the doom and gloom that some elements in the Treasury prefer. The difference between the two projections would establish a "budget margin" to be used for tax reductions, or public service improvements in accordance with the preferences of the Cabinet of the day. The same principle of the margin applies to arguments about the likely growth rate. The *decisions* requiring to be made are about monetary and PSBR objectives, not about forecasts.

The argument about political hostages to fortune cuts both ways. Nothing on earth will prevent industrial rescue operations and all kinds of special programmes—some good, some bad—if and when the magic figure of 2m unemployed is even approached. The only way of distinguishing between emergency help in a recession and the dreaded U-turn is to attempt a realistic costing. "Does the programme taper off or build up in future years?" should be the key question.

Of course, estimates may be wishful or otherwise wrong, but a certain way to ensure such a result is to refuse to subject forward estimates to outside critical scrutiny. No published piece of paper can prevent political changes, but at least it can make them transparent and discourage self-deception. A Prime Minister and Chancellor who do not want to settle for Latin American inflation should *want* to give some hostages to fortune.

A more technical objection is that the relation between the PSBR and interest rates may be wrongly estimated. If it is too pessimistic, there is little problem; interest rates can come down faster. If the error is on the side of optimism and interest rates are still unacceptably high, then the sooner that the need for a change of course is demonstrated the better.

How about the monetary targets themselves? The real danger is not that they will be too tight, but they will be too lax—because, say, of the ingenuity of the business and banking community in finding substitutes for the monetary aggregate which is being controlled. A switch to a "monetary base" control can reduce, but not remove, this danger. It is surely clear that although the target must be defined in terms of one measure—probably sterling M3—a wide variety of alternative measures should be monitored as well.

The usual mistake of the anti-publication sceptics is to underestimate other people's intelligence. It really will not be difficult for the financial markets to distinguish between statistical adjustment and the abandonment of basic objectives. Indeed, it is the "unbelieving monetarists" who will be content to see the literal fulfilment of one statistical target, irrespective of what is happening to the actual amount of money in the economy.

Finally, I cannot resist observing how frequently the following four attitudes are related: (1) opposition to a medium-term financial framework; (2) opposition to indexation; (3) hyper-pessimism for the future, secretly based on much-scoffed-at Treasury forecasts which assume that the monetary strategy will fail; (4) a belief that high import demand is the real constraint on output, despite the existence of a floating exchange rate and the lip service paid to the "supply side." These combined beliefs constitute the "enemy within" and are much more harmful than the more obvious nonsense of the "enemy without" which I discussed last week.

Samuel Brittan

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

27 February, 1980

Dear Gordon

MEDIUM TERM STRATEGY

As you will have realised, I was rather dismayed to learn, when we spoke last Friday, that the Bank felt it had been less than fully informed about the development of Treasury Ministers' thinking on the Medium Term Financial Strategy. Since I have been very anxious that the Bank should participate fully in the development of our thinking in this area, I looked again into what had been happening.

As you remarked, you and Douglas Wass have discussed the topic of a medium term plan/strategy on more than one occasion; and you took part in the meeting we had with academic and outside "experts" last October. Thereafter we did not try to make any further serious progress until the discussions about public expenditure were substantially complete, and the February forecast was largely crystallised.

The next round of activity started with the submission I received at that stage in the discussion. I was glad to find that it was shown to the Bank very shortly after I received it; and that the further submission on the basis of which I sent my minute of 20th February to the Prime Minister was again conveyed to your people without any delay. I am sorry, however, that we failed to ensure a Bank presence when I discussed the official Treasury submission with my Ministerial colleagues here.

On the substance of the issue, I appreciate, of course, that the arguments do not all point the same way. Indeed the anxieties you expressed are well represented here in the Treasury. Against these we have to bear in mind that practically all the material we are contemplating

/including

The Rt. Hon. Gordon Richardson, MBE

including in a statement of our medium term financial strategy is likely to be extracted from us in the context of the examination of our Medium Term Public Expenditure plans, and that failure to present this information in the context of our strategy will deprive us of the opportunity of demonstrating its consistency with steadily reducing monetary growth over the period. It is my clear view that the advantages of publication definitely outweigh the disadvantages; and the Prime Minister, who initially shared your and my anxieties, has come to the same opinion. For my part I would favour making the best of our various analyses of the medium term prospect, as a means of helping to secure the best outcome we can from our policy of monetary control, to which we both attach such importance.

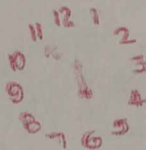
Because I realise that these issues are central to the Bank's concerns, we must clearly find an opportunity for a further discussion in the next few days when you have recovered your breath following your return from the Middle East. Since we need to include the medium term strategy material - if it is to be published at all - in the Financial Statement and Budget Report, we need to press ahead fairly quickly. However, in order to ensure that I am able to take Bank views fully into account, I have made arrangements for any necessary Cabinet discussion to take place on 13th rather than 6th March.

I am sending a copy of this letter to the Prime Minister and Sir Robert Armstrong.

Yours ever
Geoffrey

(GEOFFREY HOWE)

28 FEB 1980



CONFIDENTIAL

Ref. A01531

MR. LANKESTER

Medium Term Financial Strategy

You sent me a copy of the Chancellor's minute of 20th February, and I have seen Sir Kenneth Berrill's note of 25th February.

2. I understand that there is a degree of commitment to publish something of the kind proposed, and I see the disadvantages of not doing so. But I share Sir Kenneth Berrill's anxieties about it.

3. It offers the prospect of "blue skies" in 1982-83 and 1983-84. But it does not make clear how draconian a squeeze it implies in 1980-81 and 1981-82, or the implications of that for growth and unemployment. It talks of an increase in M3 of $7\frac{1}{2}$ per cent in 1980-81 (compared with $12\frac{1}{2}$ per cent in 1979-80). The forecast of inflation for that year is in the upper 'teens. Unless the PSBR is to be further reduced - more public expenditure cuts or higher taxation - it is hard to see how the money supply target can be attained without not merely holding interest rates up at present levels but, more probably, driving them up still further. Commentators would certainly point to the probable effects on interest rates; and the expectations thus created could add considerably to the difficulty and cost of selling Government debt, and thus to the difficulties of meeting the M3 target. Another effect would be to hold the exchange rate up, despite the level of inflation, since it could be kept down only at the cost of inflows of funds that would be inconsistent with the money supply target.

4. And, as Sir Kenneth Berrill says, the projections allow nothing for the unforeseen, or for slippage. We are already seeing that the nationalised industries' external financing limits - being differences between two very large magnitudes - can easily come unstuck by large amounts, the effect of which upon the PSBR swamp the effects of painfully agreed reductions of public expenditure. The risk would be of having to push nationalised industry prices up by even more than is already planned, in order to keep within the money supply targets.

5. The publication of annual projections of this kind would give the Government very little room for manoeuvre during the next two years, and would provide a benchmark against which developments would be constantly monitored. My fear is that it would make life even more difficult than it is in any case bound to be.

6. If it is necessary to publish some kind of medium term objective, I wonder whether it might be possible to publish the figures for 1983-84 but not the figures for the intervening years. That would hold out the hope of the "blue skies" but at least not chart in detail the steps in the path to get there. The general trend would of course be clear; but that would be consistent with various possible paths. Indeed if it were thought to be unsatisfactory to give no indication of the path to the target, it might be possible to indicate a number of possible paths, so that at least the Government would not be tied to a particular single set of annual figures.

RtA

(Robert Armstrong)

26th February, 1980

cc Mr Hoskyns
Mr Wolfson
Mr Whitmore

cc Questions filing

Prime Minister

The first note sets out the points Ken Berrill made last Thursday. The second argues the case against the Chancellor's medium term financial plan. Shall we discuss again when we have the Governor's comments?

TL
25/2

CONFIDENTIAL

Qa 04447

To: MR LANKESTER

From: SIR KENNETH BERRILL

1. I attach two personal notes of mine which the Prime Minister might like to read.

2. The first is on "the UK problem" as I see it which the Prime Minister might find useful as background for the forthcoming Censure Debate. I have deliberately written it in note form to save time and space.

3. The second is on the Chancellor's proposed medium term monetary plan. I have some doubts, which I believe the Prime Minister may share, on the wisdom of the Government hooking itself on a programme for the reduction of M3 over the years ahead, and the note covers my first reactions to reading the Chancellor's paper on Friday.

Not copied as above

KB

25 February 1980

Atts

CONFIDENTIAL

NOTES ON "THE UK PROBLEM"

1. There is general agreement that the UK problem is basically one of fast inflation since the early 1970s and economic growth which, for the last third of a century at least, has been slow in comparison with our competitors.

2. With slow economic growth has come falling competitiveness in every important aspect - quality, design, reliability of delivery, concern for the customer, etc. Some of these failings are due to labour but many of them are at least equally the responsibility of management.

Why has this happened?

3. For the 25 years after 1945 we failed to join in the great period of expansion in world trade - and the expanding years of the EEC. We lived on Beveridge (demands that the State protect us from all adversity) and on myths (that British craftsmanship is the best in the world). At the same time, the balance of power in the labour market was shifting - partly due to the law but mainly due to changes in practice (e.g. picketing and blacking).

4. Governments of both parties concentrated on demand rather than supply. They aimed to keep demand sufficiently high to create near full employment (under half a million unemployed) but not so high as to cause unacceptable inflation. The belief was that strong demand would produce strong responses in terms of investment and improvements on the supply side. Small changes in the level of demand would be sufficient to alter the bargaining strength of the unions and hence the level of wage settlements and inflation.

5. There was a continuous refusal to recognise how fast and how far the UK was slipping and continuous optimism in the sense of planning increases in public expenditure which could only be justified on assumptions of economic growth and balance of payments performance which were seldom achieved.

6. The balance of payments constraint forced continuous rounds of stop-go economies. But when the brakes were applied they were not allowed to affect the most uncompetitive parts of the economy. Every effort was made to cushion the effects by regional policy and unemployment protection measures.

7. The efficient operation of the market was further inhibited by Government action in many fields - particularly by recurrent bouts of incomes policy.

8. By the 1970s the world was about to shift from 20 years of unprecedented fast growth to what now looks like 20 years of much slower growth, and the UK was badly organised to adjust to this - membership of the EEC at this particular time did not help.

9. The most important event was that the unions discovered just how much power had really had in the three-day week and at the Saltley coke depot. The Labour spending spree of 1974 (which followed a Tory spending spree at the end of the previous Administration) made things worse. The balance of payments and the IMF eventually put the brakes on the spending but only after a great deal of damage had been done (a 20 per cent increase in public expenditure over a period when the GNP had risen hardly at all).

10. In the face of the evident imbalance in the labour market (union power) the Labour Party was constitutionally incapable of trying to move the power balance back. The alternative for them was either a "social contract" under which unions would agree to hold their power in abeyance (temporarily) or mitigating that power by whatever level of unemployment proved necessary.

11. Naturally they chose the "social contract" - incomes policy in exchange for social security spending plus further changes in the law in favour of the unions, including health and safety, redundancy, etc.

12. The combination of an incomes policy (£6 a week) which squeezed differentials and the inability under the social contract to raise indirect taxes adequately meant that with inflation the impact of direct tax spread right down through the income levels creating major and unforeseen problems of the 'in-and-out' of work trap and the poverty trap.

13. By 1979 the stage was set for a major increase in inflation as soon as incomes policy was removed and, despite cut backs in public expenditure programmes following the IMF, there was still sufficient growth remaining in public expenditure programmes to present major headaches in a period of no economic growth and a long wait ahead for the fiscal benefits of North Sea oil and gas.

14. Given that the UK problem is how to reduce inflation and increase growth against a background of slow growth in the world economy, the main areas of adjustment have to be -

(i) how to get a better balance of power in the labour market - changes in law, changes in practice under the law, move to smaller units. All this accompanied by efforts to change worker attitudes towards the need for their companies to be productive (and profitable) in order that higher real wages may be possible. A major task for management is better communications with the work force (not necessarily along Bullock lines).

(ii) How to improve incentives - level and structure of direct taxation; the in-and-out of work problem; the poverty trap.

(iii) How to 'roll back' the size of the public sector and to achieve more accountability and efficiency within what remains - including local government.

(iv) How to move away from the emphasis on the large firm and the large plant by encouraging demergers, break up of nationalised industries, small firms, etc.

(v) While improving productivity, how to encourage an emphasis on quality as well as quantity - British standards, public sector purchasing, R and D policy.

15. In the short run, as far as inflation is concerned, the present imbalance in the labour market means that the choice is between unions not using their strength (incomes policy) or having their strength sapped by a weak market for labour (unemployment) and stronger employer resistance. This last can be brought about by fiscal measures to

weaken demand and by monetary constraint which reduce the ability to pay higher wages. Unfortunately, given the present power and attitudes of trades unions in the UK, we do not know how severe the restraint would have to be to weaken that power and hence what damage would need to be done in terms of reduction of investment, bankruptcies, etc. - the incidence of which could be both capricious and unfortunate.

16. Against this background, what are the Government's main achievements so far?

17. They have begun the process of monetary restraint and the process of shifting the balance of power in the labour market through the operation of trades union law and practice. The immediate effects of the monetary squeeze are obviously unfortunate. How long it will need to last it is impossible to say. Only when the balance of power and attitudes in the labour market make free collective bargaining compatible with very modest inflation can the constraints be eased and significant economic growth be resumed.

18. On incentives the first moves have been made on both direct tax and the overlap of tax and social security payments. Public spending programmes have been cut but the inheritance of the Labour Government (including Clegg) was such that, broadly speaking, we will have to wait for the arrival of North Sea oil and gas receipts before going much farther.

19. A start has begun on rolling back the nationalised sector on breaking up into smaller units and on the improvements in efficiency and accountability (Rayner). It will all take time.

20. But what are the alternatives?

21. Back to incomes policy and the social contract under which union power is increased and public spending expanded?

22. Back to continued support for inefficient production in the nationalised sector - steel, shipbuilding, British Rail, postal services - and British Leyland.

23. How would this begin to tackle the twin British problems of inflation and inefficiency?

MEDIUM TERM FINANCIAL STRATEGY

1. The Chancellor is proposing to publish a document which commits the Government to progressive reduction in the rate of increase in the money supply (sterling M3) over the coming four years. The document would necessarily include figures for the possible growth of GNP over the period as well as figures for the growth in public expenditure and public receipts (including in particular receipts from North Sea oil and gas).

2. The main arguments for publishing such a document are that the Government's commitment to monetary policy has led markets to expect such a document. To be effective, monetary policy needs a medium term approach. Publication of this programme would show how determined and how ambitious the Government was in its attack on inflation by both monetary and fiscal means. It would bring cheer to the markets and be a severe warning to employers on the struggles ahead.

3. It would bring cheer to the public generally and to the Government's supporters by showing that towards the end of the period North Sea oil and gas would bring opportunities for reduced taxation and some relaxation on public expenditure. The 'blue skies' should indeed be there before the next Election.

4. These are compelling arguments but there are strong ones on the other side, and the judgement between them is both difficult and primarily political.

5. First, the paper itself could give ammunition to the Opposition. It assumes a very small annual growth in GNP over the whole of the life of the present Government. It produces no figures for unemployment and these will, of course, depend on productivity changes - higher productivity the worse the unemployment. But even with low productivity rise the unemployment prospects look poor. Equally, it gives no data on the rate at which inflation is expected to be brought down to the rate of increase in the money supply; no figures on the exchange rate or the rate of interest: nothing, in fact, on the cost of this policy beyond a very bland sentence that it "may entail some transitional losses of output".

6. The monetary targets are expressed in terms of M3. It is a small point, but the Treasury is about to produce a consultative document on monetary base control and the choice of variables for monetary policy. It seems odd to produce such a consultative document if the medium term financial strategy is to be based on M3.

7. Also the document does not discuss the extent to which contraints on M3 can be avoided by market operations and how these avoidance problems might increase. The Bank of England will, of course, have views on all this. As I understand it, they were not consulted on the final version of the medium term paper nor its recommendations.

8. But by far the biggest question mark has to be placed against the whole concept of Government deliberately hooking itself on a programme for M3 which it intends to stick to come what may. Giving such complete primacy to M3 means, almost certainly, giving up joining EMS for the time being. But it also means sticking to M3 targets irrespective of what unforeseen things happen either internationally (OPEC, minor wars, etc.) or domestically.

9. Domestically the plan fact is that we do not know how severe will be the effect of the deceleration in the real money supply implied in the Chancellor's paper. In the early years the squeeze is Draconian (given our present inflation rate) - it eases later on. This battle (which has only just begun) is between the irresistible force (trades union power) and the immovable object (the money supply). Given British conditions, it could be a very bloody battle indeed with interest rates, exchange rate, reduced investment, bankruptcies, at unknown levels. By declaring its determination to plough on with its monetary targets regardless the Government is giving itself very little elasticity.

10. Also the timing of the 'blue skies' could slip. Not so much from the receipts side - the output of North Sea oil and gas can be relied upon and the world price is unlikely to fall, but on the expenditure side. The history of PESC programmes is that 'present policies' always seem to cost more two or three years' hence when you actually get there.

11. Both the above could be important in terms of the timing of an Election.

12. As has been said, there are difficult and important considerations for and against a medium term financial strategy. We live in a very uncertain world; forecasting is inevitably imprecise and room for manoeuvre to deal with the unexpected an important element of policy. This is one of many decisions which is, in the end, more a matter of political than economic judgement.

25 FEB 1980

PERSONAL

FINANCIAL TIMES

BRACKEN HOUSE 10 CANNON STREET LONDON EC4P 4BY
TEL: 01-248 8000

22 February, 1980

Dear Mr. Wolfson,

As this article appeared on an inside page on an unusual day, perhaps you could put it among the Prime Minister's Papers, especially the marked passage.

Yours sincerely,

Samuel Brittan

Samuel Brittan

David Wolfson, Esq.,
10, Downing Street,
London, S.W.1.

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TEL: 01-248 8000 TELG. FINANTIMO LONDON TELEX: 886341-2 (EDITORIAL) 885033 (ADVERTISEMENT DEPT)
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LOMBARD

A low surprise in the PSBR

BY SAMUEL BRITTAN

THERE IS every sign that the Chancellor is planning to take the City by surprise by budgeting in 1980-81 for a Public Sector Borrowing Requirement lower than the £9bn to £10bn that had been expected. There is a regular cycle in PSBR estimates from the shock horror figures that come out around November and to later revisions early in the New Year. This time the downward change has been greater than usual, partly because of increased revenue expected from higher North Sea oil prices and deferred receipts of tax due in 1979-80.

These have more than offset the gloomy initial reports from the forecasters which are being revamped to reflect the different views of both Ministers and top officials, who expect an output drop of "only" 2 per cent. The real technical argument, however, appears to be not on the forecasts themselves, but on the relation between economic activity and the PSBR.

For what it is worth, present estimates are for a PSBR of £8½bn to £9bn. The Chancellor is likely to strain every nerve and every asset sale or massaging idea which can be produced to secure a figure nearer £8bn, and thus a clear drop from 1979-80.

A respectable reason—or at least talking point — is Sir Geoffrey's Celtic background, which makes him suspicious of talmudic justifications for high borrowing. But the serious reason is that the Chancellor and his advisers are desperately concerned to reduce nominal interest rates as soon as possible.

On the main point Sir Geoffrey is right. It is certainly best for industry and employment to use any extra £1bn or £2bn to create conditions in which interest rates are able to move down and thus remove the artificial element in the sterling exchange rate. This is surely better than to give an old-fashioned fiscal support to demand from a high PSBR. The issue is too important to be left to highly inadequate forecasting models. But I fear that the link between public sector borrowing and interest rates is more long-term and less mechanical than Ministers would like to think; and political inhibitions about letting interest rates rise in the very short-term—evidenced by the extremely unfortunate special help given to the banks last week—are undermining the credibility of counter-inflation policy.

But it would be a hollow victory, if a slight *forecast* reduction in the PSBR were made an excuse to jettison the idea of a medium-term monetary framework. The forecast could go wrong in many ways.

In the context of a medium-term strategy for reducing monetary-growth public sector borrowing, a PSBR overshort in a recession year could be seen for what it is. So could short-term year-end fluctuations in the revenue yield. It is absurd that public sector finances should still be tied to a period based on the crop cycle.

If one remembers that the 11 per cent monetary target—which is at least 13 per cent allowing for distortions—is still to be achieved; that there is a reluctance to reduce it much if at all; and there is a risk of over optimism on interest rates; and that a fall in sterling is itself inflationary, something other than a hopeful PSBR figure is needed. There must be some background analysis or explanation — which would be meaningless if confined to one year.

If the Prime Minister realised how much ground she has already lost from the delay in publishing medium-term objectives last year, and that a further Budget on traditional one-year only lines would be a sign that we were settling down to Latin American inflation rates, she would cross over from the ranks of sceptics to that of enthusiastic demanders to see the monetary framework "this instant."

Of course, actions speak louder than words. But actions are rather limited in view of the political hang-up over interest rates and taxes. But at the very least, a coherent explanation of those actions which are taken, and some guidelines which will distinguish short-term departures by spending Ministers from a Heath-style policy reversal, are essential if anti-inflationary policy is to carry the slightest conviction.

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Econ Policy
MO 1

PRIME MINISTER

Medium term financial strategy

The Governor rang me this morning to say that he had just received a copy of the Chancellor's minute on the above subject which you discussed yesterday morning. He said:

(i) He had not been consulted on the document;

(ii) If he had, he would have expressed serious misgivings. In particular, he feels the quantification of monetary targets so far ahead is likely to put the Government in an undesirable strait-jacket as far as interest rates and fiscal policy are concerned, and he questions the realism of some of the figures. He said he was also concerned about the implications for unemployment which are likely to follow from the slow rate of GDP growth which is assumed.

I said I was very surprised that he had not been consulted on such a vital issue relating to monetary policy. In fact, I had automatically assumed that the Bank had been closely involved in the exercise. I also said that no irrevocable decision had been taken, and that there was still an opportunity to express his views.

He said that he would let the Treasury have written comments early next week, and I will ensure that we get a copy as well. I also said that, if he really was unhappy with the proposals, you would almost certainly want to hear them at first hand. (We could no doubt fit this in towards the end of next week). In the meantime, I have told the Treasury that they should not circulate their paper to Cabinet until we have the Governor's views.

/ I have asked

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I have asked the Treasury why the Governor was not consulted. They admit that he did not see a copy of the final document before it came to you, but they claim his officials have been consulted frequently over the last few months on the whole question of a medium term plan. Douglas Wass had also discussed it at various times with Gordon Richardson. They were aware of the Bank's general misgivings, and as far as they were concerned, these were reflected in the minute. Nonetheless, it does seem pretty inexcusable that there was no consultation on the final document. Robert Armstrong will take this up with Douglas Wass.

22 February 1980

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21 February 1980

When the Prime Minister and the Chancellor met this morning, they discussed his minute of 20 February on Medium Term Financial Strategy.

The Prime Minister said that the Treasury had produced and extremely good paper, and she agreed that the Chancellor should set out a Medium Term Financial Strategy in quantified form in the Budget on the lines proposed.

The Chancellor said that it would be desirable to have Cabinet endorsement for the strategy. The Prime Minister agreed, and suggested that the Chancellor should bring it to Cabinet the week after next. She thought that Ministers might find it helpful if the Chancellor were supported at Cabinet by a presentation by Sir Kenneth Berrill and Mr. Terry Burns. The Chancellor said that he would consider this, and the timing of the Cabinet discussion further.

The Chancellor pointed out that one of the implications of the projected slow growth of GDP over the next few years was rising unemployment. This was going to raise difficult political and presentational problems for the Government, and Ministers ought to be considering how the problem should best be handled. He would be considering this with some of his colleagues, and would report back to the Prime Minister in due course.

I am sending a copy of this letter and a copy of the Chancellor's minute of 20 February to David Wright (Cabinet Office).

T. P. LANKESTER

John Wiggins, Esq.,
HM Treasury

CONFIDENTIAL

cc Mr Wolfson
Hoskyns.

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

PRIME MINISTER

MEDIUM TERM FINANCIAL STRATEGY

As I have mentioned to you on previous occasions, I have been considering whether it would be possible to present our monetary and financial strategy for the medium-term in a manner and context that would strengthen its credibility and help to demonstrate what we have been saying so often - that by sticking to our monetary and fiscal intentions we shall be able in the longer term to achieve a lasting reduction in inflation and the conditions necessary for resumption of sustainable growth.

2. My thorough discussions with officials in the Treasury and with outside economists and commentators have convinced me that there would be advantage in setting out our strategy in quantified form in the Budget. There is, of course, widespread expectation among economic commentators that we shall do so. This is not itself a sufficient reason for proceeding; but I fear that if we fail to do so it will be widely assumed that this is because the medium-term numbers do not add up and that prospects are worse than in fact is the case.

3. My main doubts have centered on whether, on the evidence available, we could present a fiscal picture that would be thought credible and consistent with our monetary objectives. As you know, it was my concern about this that led me, with your support, to urge before Christmas that we should look again at the public expenditure plans both for next year and the later years.

/4. We have now

4. We have now constructed projections for the medium-term on the basis of the revised public expenditure plans and other more recent developments. Although the situation in the next two years is still likely to be extremely tight, the prospect thereafter - as we feel the full benefit of higher North Sea oil revenue - is a good deal easier and offers the prospect of substantial fiscal relaxation.

5. Although, therefore, there are still great uncertainties, and any figures we present would need to be heavily qualified as being no more than illustrative, I believe it would be possible to present a picture for the medium-term which hangs consistently together and fully supports our monetary objectives. Accordingly, what I would propose is that our strategy should be presented in the medium-term section of the Financial Statement and Budget Report, after the usual section on the short-term forecast. I attach a draft "mock-up" of what I envisage it might look like. (The figures are provisional; those published would need to take account of the Budget decisions).

6. As you will see, the draft seeks to concentrate attention on the money supply in the medium term - which is in any case the only period over which we can credibly control it - and makes it absolutely clear that fiscal and other policies will be subordinated to its achievement. There is no explicit commitment or assumption about the rate of inflation or the particular path of interest rates, but it is made clear that, though the timing is necessarily uncertain, we would expect inflation to fall until it is roughly in line with the monetary target; and that the PSBR path described would be consistent with a progressive reduction in nominal interest rates and a better environment for investment.

/Above all

Above all, the crucial point is made - and this has been the corner stone of our economic strategy since we took office - that if the economy develops in a way different from that illustrated, fiscal policy, and not the money supply objective, would be reassessed.

7. The PSBR projections for the medium term are set out in Table V, and start with the expenditure figures as we have recently agreed them. You will see that they also contain what we have called a "fiscal adjustment". This is the adjustment necessary to reach the PSBR that seems consistent with the target for the money supply and lower interest rates, and the figures imply that, although the budgetary position is likely to be tight in the next two years, there could be scope for substantial tax reductions in the last 2 years. The implication is, of course, that it should be possible to go a long way towards the achievement of our 25 per cent basic tax rate objective in the life of this Parliament. But I think it would be a mistake to be too precise or committal on particular fiscal priorities at this stage. The key point is that, although the projections must remain illustrative and subject to margins of error, they do, on the basis of the lower public expenditure plans we now have, show a credible path in the medium-term towards our monetary, inflation, and taxation objectives.

8. I should welcome an early opportunity to discuss these proposals with you. There are, of course, risks in exposing figures that could be invalidated if the economy develops in a way significantly different from that which now seems likely. But even if we do not publish them in this form, most of them are likely to emerge in one way or another anyway, if only under pressure from the new Treasury Committee who have been severely critical of the thinness of last November's

/public expenditure

public expenditure White Paper, and will be looking for a substantial analysis of the medium-term economic outlook in the second White Paper or in the Budget.

9. If this is so, we run the risk of making available figures for everything except the one policy to which we wish to be committed - a progressive reduction in monetary growth and the PSBR. Far better to take the initiative and to take credit for demonstrating in a credible way how we propose to achieve these objectives. Moreover, I think there is a good deal of force in the argument that by displaying a credible strategy for the medium-term we shall be better able in the Budget to ride out the immediate problems of high monetary growth and interest rates which, whatever course we follow, are still likely to take some time to bring under control.

G.H.

(G.H.)
20 February, 1980

20 FER 1980

MEDIUM-TERM FINANCIAL STRATEGY

Objectives and Instruments

1. The Government's objectives for the medium-term are to bring down the rate of inflation and to create conditions for a sustainable growth of output and employment.

2. To reduce inflation it will progressively reduce the growth of the money stock (£M3) to about 6 per cent in 1983-84, and will pursue the policies necessary to achieve this aim. The Government intend to control the growth of the money supply in order to achieve the following path for the total money stock (£M3):

TABLE I

PATH FOR GROWTH OF THE MONEY STOCK

	1979-80	1980-81	1981-82	1982-83	1983-84
£M3: end-year nominal level (£ billion)	[58½	63	68	73	77½]
percentage change in year	[12½	7½	8	7	6]

This path is consistent with the annual growth of money supply being reduced by 1 per centage point a year after 1980-81.

3. The aim is to bring inflation down until it is roughly in line with the monetary target. The speed with which inflation actually falls will depend crucially on expectations both within the United Kingdom and overseas. It is to provide a firm basis for those expectations that the Government has announced its firm commitment to a progressive reduction in money supply growth. Public expenditure plans and tax policies and interest rates will be adjusted as necessary in order to achieve the objective. At the same time the Government will continue to pursue policies to strengthen the supply side of the economy, by tax and other incentives and by improving the working of the market mechanism.

4. It is not the intention to achieve this reduction in monetary growth by excessive reliance on high interest rates. The Government will therefore plan for a substantial reduction over the medium-term in the PSBR as a percentage of GDP. The relationship between the PSBR and the growth of money supply is not a simple one; it is affected both by the economic cycle, the rate of inflation and by the structure of the tax and public expenditure flows generating the borrowing requirement. But although the relationship between the PSBR and £M3 is erratic from year to year, there is no doubt that public sector borrowing has made a major contribution to the excessive growth of the money supply in recent years. The consequence of the high level of public sector borrowing in recent years has been a high level of interest rates and a reduced availability of funds to the private sector. It has become clear that high nominal rates, even in the context of rapid inflation, are themselves a deterrent to investment. If interest rates are to be brought down to acceptable levels the PSBR must be substantially reduced as a proportion of GDP over the next few years. The projections summarised in Table V below show that the Government's fiscal plans are consistent with a progressive reduction in the PSBR to around 2 per cent of GDP, which would be roughly in line with the average ratio recorded in the 1960s. The fiscal plans are thus fully consistent with the monetary objective.

Public Expenditure

5. A key element in this strategy is a reduction in public expenditure. The plans announced in the recent public expenditure White Paper (Cmnd) show a reduction of about 4 per cent in the volume of public expenditure between 1979-80 and 1983-84 and imply a fall in expenditure as a proportion to GDP from [42] per cent to [ ] per cent over the period. Table II below shows the expenditure plans in cost terms at 1978-79 prices and allowing for shortfall. Total government expenditure in these terms is gradually reduced over the next four years - from [£75] billion in 1979-80 to [£69] billion in 1983-84. The financial framework described below sets these expenditure projections against an illustrative projection of government revenue.

TABLE II

GENERAL GOVERNMENT EXPENDITURE

(£ billion)	1978-9	1979-80	1980-81	1981-82	1982-83	1983-84
Total general government expenditure at 1979 Survey Prices	68.1	70½	69½	69	68	67½
Total Expenditure in cost terms at 1978-9 Prices	64.3	66	65	64	62½	62
Shortfall	+0.4	0	-¾	-¾	-¾	-¾
Interest Payments	7.8	8	8	7½	7	7
National Accounts Adjustment	1.3	1	1	1½	1½	1½
Total Expenditure in National Accounts Terms	73.8	75	73½	72½	70	69½

Revenue in the Medium-Term

6. The growth of government revenue over the medium-term is dependent upon the growth of national output. This is heavily conditioned by the underlying growth of productivity, the growth of the world economy and the speed of reduction of the recent high rate of inflation.

7. Since 1973 GDP growth in the major OECD countries and the growth rate of trade in manufactures have both roughly halved (see Table III). It seems unlikely that world output and trade will grow faster over the next few years than in the past five years. In most of these countries there is strong evidence of a slow-down in productivity growth in recent years. In Britain, recorded productivity growth (for the whole economy excluding the North Sea sector) over the period 1973-1979 averaged [¼] per cent a year - compared with an average of 2½ per cent in the preceding decade. One consequence of the slower growth in productiviy in the 1970s is that there has been less excess capacity in the economy than might have been expected, on earlier experience, given the slow growth of output.

8. The process of reducing Britain's high rate of inflation may entail some transitional losses of output. A stricter monetary policy is likely to involve a tighter fiscal stance, higher interest

rates and a higher exchange rate, and these will have some depressing effects on activity in the short-term. The size and duration of these effects, however, will depend in large measure on how quickly behaviour, particularly in pay bargaining, takes account of the new monetary environment. As inflation subsides, nominal interest rates can come down and, for any given nominal exchange rate, competitiveness will be better and the basis will be laid for sound, sustainable growth.

9. In the light of all these considerations it is only realistic to expect that the average growth rate of the economy over the next few years will be less than the 1 per cent a year recorded between 1973 and 1979. In the illustrative projections in Tables III-V an average growth rate of [1] per cent a year is assumed for the years after 1980, giving an average of [ ] per cent for the period 1979-83.

TABLE III

WORLD AND UK GROWTH RATES

(Annual average per cent)

	1964-73	1973-78	1978-80	1980-83
World Trade in manufactures	10.1	5.7	5.5	5
Growth of GDP*				
OECD	5.2	2.6	2	3½
United Kingdom	3.0	1.0	-1	1

≠ Weighted by UK markets

* Weighted average of OECD countries, excluding UK

10. The implications for government revenues of this illustrative growth rate are shown in Table IV. Revenue is projected on the conventional assumption of constant index tax rates and allowances at current, [1980-81] levels. The low average growth of the economy over these years is reflected in a virtually flat profile in real terms for revenues from the traditional major taxes. However, the rapid rise in revenues from the North Sea in the later part of the period adds substantially to total tax receipts. Over the period 1979-80 to 1983-84 as a whole total government receipts (at 1978-79 prices) rise by about £4 billion.

TABLE IV

GENERAL GOVERNMENT RECEIPTS

General Government Receipts at 1978-79 prices (£ billion)	1978-9	1979-80	1980-1	1981-2	1982-3	1983-4
Taxes on Income, Expenditure and Capital	48.2	51½	51½	50	53	55½
[of which North Sea taxes]	[0.6]	[2]	[2½]	[2½]	[4]	[4½]
National Insurance etc	10.2	10	10	11	11	11
Interest and other receipts	6.3	4½	5½	5½	5	5
Total Receipts	64.7	66	67½	66½	69	71½

Money Supply and Public Sector Borrowing

11. This revenue profile, in conjunction with the declining profile of public expenditure produces a progressive reduction in the PSBR after 1980-81. This is shown in Table V.

12. This particular path for the PSBR is not to be interpreted as a target. It is a projection of the course of the PSBR based on the assumed growth rate of GDP, present public expenditure plans and the assumptions about the tax structure described in paragraph 10 above. Fiscal policy will be operated so that the PSBR for any particular year will be consistent with declining monetary growth in the particular circumstances of the time. The chosen PSBR could be higher or lower, according to circumstances, than that shown in the table. The PSBR path shown requires on the assumptions made a 'fiscal adjustment'. If such adjustment turns out to be necessary for a particular year the Government would assess nearer the time whether it should adjust public expenditure, tax, or some combination of the two, and also the precise items within these that would be changed.

TABLE V

PUBLIC SECTOR BORROWING AND MONETARY GROWTH

1978-9 Prices (£ billion)

	1978-9	1979-80	1980-1	1981-2	1982-3	1983-4
Total Expenditure	73.8	75	73½	72½	70	69½
Total Receipts	64.7	66	67½	66½	69	71½
Fiscal Adjustment	0	0	0	0	-3½	-5½
GGBR	9.1	9	6½	6	4½	3½
PSBR	9.3	7½	6½	5½	4½	3½
(as % of GDP at market prices)	(5½)	(4½)	(4)	(3½)	(2¾)	(2.0)
£M3 (end-year nominal level)	52	58½	63	68	73	77½
(percentage change)		12½	7½	8	7	6

13. As is now generally recognised projections of this sort are subject to wide margins of error not just because they depend crucially on the assumptions about developments in the rest of the economy, but because even with reasonably firm knowledge of such developments it would be difficult to predict revenue and expenditure with any precision. Nevertheless if their limitations are borne in mind the projections described above suggest that if GDP growth after 1980 were at about the same rate as in 1973-78 there should be scope for tax reductions in the later years.

14. The final row of Table V shows the target path for £M3 (as in Table I). The path for the PSBR set out there is consistent with achieving the planned reduction in the growth of money supply over the medium-term with lower interest rates. It is not possible to predict the path of interest rates year by year, but the strategy set out above implies that though financial conditions must remain quite tight in the immediate future while inflation remains high relative to the monetary target, there should over the period as a whole be a progressive reduction in nominal rates and a better environment for investment.

Responses to alternative outcomes

15. The projections shown in Tables III-V are within a wide range of possible outcomes. Events could develop so as to produce a very different situation. World trade could grow faster or more slowly than assumed; the supply response of the UK economy could be very different, with consequences for productivity and trade performance; oil and other commodity prices could show different movements; and the behaviour of earnings is always difficult to predict. Any of these outcomes, and many others, could significantly change the growth rate of the economy over the next few years, and hence the finances of the public sector. This is true even with a large change in prices, such as a rapid rise in commodity prices, because this will feed back on to output growth.

16. To maintain the target growth of money supply in these circumstances it may be necessary to change policy in a way not reflected in the above projections. The Government would face a number of options for policy changes to keep to the monetary targets, including changes in interest rates, taxes and public expenditure. If events developed in such a way that it became easier to achieve monetary deceleration, it would even be possible to keep fiscal stance and interest rates unchanged and to allow monetary growth, and hence inflation, to fall faster. But if the opposite happened, and it became more difficult to achieve monetary deceleration, there would be no question of relaxing the money supply policy. Other policies, especialy fiscal instruments, would have to be tightened in order to keep the money supply on target. The monetary targets are the centrepiece of economic policy, and the Government will adjust other policies to the extent necessary to ensure that they are met.

PRIME MINISTER

Meeting with the Chancellor : Thursday 21 February

The Chancellor wants to discuss his proposals for a medium term financial strategy. A paper setting out the arguments and key figures will be coming over later this evening. *Now enclosed*

The Chancellor will be ready to talk about the possibility of foreign exchange inflows and/or negative interest rates but it might be better to wait until we have the promised Treasury note on this - due by the weekend. *A Treasury note enclosed*

You have not yet discussed the Budget with the Chancellor. He will now have a forecast, and may have some idea of his broad approach to the Budget. You may be asked about the Budget strategy on Panorama on Monday, and it would be worth getting a steer from the Chancellor. If he is not ready to give this to you tomorrow morning, we can ask for a note for the weekend box.

I have told the Treasury that you want to discuss the timing of the Public Expenditure White Paper publication with the Chancellor. He proposes to publish it on 18 March; it would be much better, if possible, to publish it with the Budget. I am told that he is not yet ready to discuss this with you.

TL

20 February 1980

Copied to

Econ Pol : Exchange Rate

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

20th February, 1980

Dear Tim,

We spoke last week about some questions in the monetary policy area Mr. Peter Tapsell indicated he might raise at Question Time. Subsequently, Mr. Tapsell spoke to Sir Keith Joseph, who recorded some of his criticisms of Government policy. These were in the direction that we should not be seeking to avoid increases in interest rates occuring as a result of market forces, and that we should impose exchange controls on inflows as a way out of the dilemma that inflows are likely to result either in an appreciation of the exchange rate or in undesired increases in sterling M3. Mr. Tapsell further suggested that quantitative controls over bank lending would provide a means of reducing upward pressure on interest rates.

Officials concerned here have been considering how Ministers might respond to criticisms on these lines. The attached note, which the Prime Minister may care to see, is the result. We suggest, however, that the arguments in paragraph 10 should be used with caution; although exteral flows have had relatively little impact in recent months on monetary growth, sterling could become the object of very sharp speculative pressure as a result of the petro-currency mentality in international markets, and we should not wish to rule out absolutely some use of inflow controls if the situation demanded it.

Yours

John

(A.J. WIGGINS)

T.P. Lankester, Esq.,
Private Secretary,
10, Downing Street

COMMENTS ON CRITICISMS OF GOVERNMENT POLICY FROM MR PETER TAPSELL AS RECORDED BY SIR KEITH JOSEPH

1. "The logic of monetarism" requires that the Government has to be ready to move interest rates to whatever level may be necessary to achieve the monetary target, for a given fiscal stance.

2. This does not necessarily mean letting interest rates go up or down (say, under pressure from inflows as happened in 1977) with the market. Mr Tapsell's criticism would have had more force if the upward pressure on interest rates had been because the market thought that higher interest rates were necessary to achieve the target - but that was not the cause: it was rather technical factors related to the annual pattern of Government payments and receipts.

3. Given the reassessment of both the monetary target and the fiscal stance which is due in the Budget, within 6 weeks, it would seem wrong to act on one weapon alone - namely interest rates - in isolation, unless it was made essential to do so because of, say, a collapse in confidence in the markets which had to be corrected without delay - but that was not the situation. It would seem the more wrong to do so, given that the way things have turned out in 1979/80 has meant that, if anything, the Government can be criticised for relying too much on interest rates and too little on fiscal policy.

4. It would be wrong to pre-judge what the Government has done on spending and taxing, until the Public Expenditure White Paper and the Budget.

5. Mr Tapsell criticises the Government for "window-dressing". But his remedy of directions to the banks in respect of bank lending would have only led to even more window-dressing, with liquidity and credit channelled into forms outside the control and outside the statistic.

6. The ending of exchange control has not significantly affected the problems of domestic monetary control - it is true that it may have made them a bit harder, but the effect is marginal in relation to the general gains from greater freedom from control brought about by the ending of exchange controls, along with the other controls abolished by the Government.

7. The Governor has only asked the City not to use the freedom from exchange controls in one narrow respect, namely he has asked the banks based in London not to get round the SSD scheme/corset by putting business offshore.

8. Mr Tapsell's suggestion that the Government should relieve pressure on business by reducing the exchange rate seem inconsistent with his first complaint that the Government is not prepared to carry through the logic of monetarism. A tight domestic monetary policy inevitably means a high exchange rate. Indeed, the high exchange rate is one of the quickest ways in which the tight monetary policy feeds through into the price level, and so the rate of inflation.

9. The high exchange rate inevitably squeezes companies, but that is one of the purposes of a tight monetary policy - without such a squeeze on companies, and on activity, we will not get the lower rate of wage settlements. It is at least arguable that the high exchange rate has the least effect on those companies which are competitive on grounds other than price, and it is those companies which need to have the relative advantage in the interests of the long term growth of the economy.

10. Controls on inflows to lower the exchange rate would involve foregoing one of the benefits of the tight monetary policy. They would almost certainly lead to the creation of channels of evasion. There would be a grave risk that they would worsen the task of domestic monetary control by causing inflows to switch from forms which do not have much effect on the money supply - flows into Government debt and into non-resident bank deposits, which can be fairly readily controlled - into forms which do affect the money supply - flows into the non-bank private sector, which cannot be so effectively controlled.

F/E3

Mr Lankester

2

SIR DOUGLAS WASS

c Chief Secretary)
Financial Secretary)without
Minister of State (C))attachment
Minister of State (L))
Mr Burns
Mr Middleton
Mr Bridgeman
Mr Britton
Mr Shepherd
Mr Riley
Mr Cropper
Mr Cardona

Prime Minister

This summary of outside views worth reading (pages 1 and 2).

R 22/2

THE MONETARY SITUATION AND RELATED MATTERS

In the course of the last few days I have taken the opportunity to sound out the views of a number of outsiders. The attached notes constitute a hurried and compressed record of their observations which you and the other recipients of this minute may be interested to see. Copies have gone separately to Ministers.

2. By and large the conclusion to be drawn from what they have to say is not as distressing as one might at first have supposed. While there are many things about which they are anxious, some problems have every prospect of becoming less serious with the passage of time, and many of the others are amenable to appropriate action. However, I must stress that I cannot banish the suspicion that no outsider is quite au courant with the very latest developments and hence that their attitudes would be somewhat less sanguine if they had full access to all the information which we have here. In the broadest terms, their views point to little major change in the Government's policies in the short-run.

3. At the risk of gravely distorting a large number of finely nuanced opinions, I would summarise the more specific conclusions to be drawn from what they have said as follows:

a. There are still good grounds for thinking that the growth of sterling M3 and bank lending will fall back shortly. Interest rates will have an effect,

and we are facing an awkward period partly because of the time lags before they operate, partly because of the dependence of monetary trends on the reduction of involuntary stock building.

b. Under the circumstances there is no case for raising interest rates - indeed most would feel that they should come down as soon as possible. In that context it was absolutely right to release special deposits and to carry out the release and sell back gilt-edged. It would be also right to go on doing so.

c. When rolling forward the sterling M3 target, no-one is looking for any great change, though the centre of gravity of opinion is that in some way a degree of downward movement should be signalled.

d. The problem of the bill leak (i.e. evasion of the 'corset') can be solved in any of a number of technical ways. The key issue is to explain clearly what is being done in advance and not to take markets by surprise, or to suggest that there is any attempt at deceit on the part of the authorities.

e. By and large no great contraction in the PSBR seems to be needed next year, in real terms. A more clearly articulated medium-term strategy - most would want a financial plan - would greatly help in gaining acceptability for whatever is decided.

f. There are considerable anxieties about the exchange rate. Some would say it is excessively and gratuitously damaging to industry. Others see it as generating a really serious threat to monetary growth before long. This line of reasoning reinforces the feeling that interest rates can and should fall before long.

AR

ADAM RIDLEY
18 February 1980

CONFIDENTIAL

CONGDON

General

Not markedly sombre. Vital that Govt sticks to its strategy. Present institutions viable if worked properly, ie not keen for MBC. Monetary trends not disastrous.

Monetary and inflation trends

Surprised at momentum of inflation, and that monetary policy has not pulled wage settlements down more. But feels it will bite before very long.

SDs, released buy-back of gilts

Given tolerable monetary prospect, such a technical manoeuvre acceptable.

M3 target

Since monetary prospect not really too bad, some modest tightening when the target is rolled over is feasible, as well as being self-evidently desirable, if not vital, in building up perceived momentum towards the gradualist policy of monetary contraction. Essential not to be seen to be "bending" statistics, or "fudging" the target. What about, say, 6-10% for the roll forward?

Acceptances/bill leak etc

If corset comes off, the leak won't grow further, since the pressure for it will have disappeared. Nor is there any clear reason why acceptances should actually fall and re-enter M3. If acceptances are "brought back" into the record of the past, or target for the future (which is much less desirable), then recognise they are less liquid than other aggregates. [AR note: provided they remain as acceptances, ie do not revert to being very short term loans/deposits].

PSBR

Particularly if M3 target is lowered, but even if not, err on the side of caution (ie low figure). Best means to achieve this is

further pressure on the indirects. The structure of Govt revenue must be shifted more in that direction. De facto indexing (if de jure is ruled out) would obviously help greatly. That said, income tax allowances much more important than standard rate. Concerned less we should, following Brittan's recent article, move too far away from tax indexation. Recalls that failure to do so '73-78 responsible for much of our present trouble. Weakening the (till now) growing presumption it will be respected each year will have costs in the future. Imagine the next Labour Chancellor's temptations.

Monetary Control

Key issue here to make bank liabilities (ie deposits) and assets (ie loans) less liquid, as Germany does. Longer term market for CDs an obvious answer, or more MT and LT term loans. To get this you may well have to look at definition of banks' reserve assets. Longer term loans/borrowing by definition less liquid, and out of M3. However this won't happen while corset is on. [AR: Of course this process is an alternative to the redevelopment of a market in private sector fixed interest paper - the difference lies in the Banks' role as intermediaries in the SD case.]

MTFP

Still thinks it important, indeed perhaps central. But notes growing vulnerability to financial disturbances arising from growing risk of volatile oil prices - a subject he will probably write about shortly.

ROBERT THOMAS - GREENWELL's

Only a brief discussion. Stressed:

(1) SD and Govt release an acceptable technical change;

(2) Sterling far too high; equally dangerous is sucking in £s from overseas and creating gratuitous and excessive pressure on company sector. This in itself an argument for lower interest rates.

(3) Present prospect puzzling. CGBR low, yet M/ growth considerable. Worries that public sector other than CG is borrowing heavily - eg LAs. [AR: they are .....]

GRIFFITHS

General

Sombre above all because of his own and others fear the Govt has no MT strategy or courage. Much reassured even by modest indication of spending trend next PEWP would describe. Fear, all the same, that if policy is not pulled together very soon, it will swiftly disintegrate, and U-turns will shortly follow. Said, en parenthèse, that some degree of intervention in BSC dispute was not a U-turn, and would not generally be interpreted as such.

Present trends

Monetary policy not really restrictionary when bill leak is allowed for. True monetary growth at circa 15% pa won't get inflation down to a lower figure. Reasons for high growth clear: fiscal policy too expansive, and £ being supported by too much intervention. [AR: ie BG not worried, one infers, by relatively high interest rates sucking in foreign money which is, I am sure, more important.] Not surprised that higher MLR has not yet worked wonders. The lags are long after all. To allow higher MLR or Bank base rates would be not merely unnecessary, but foolish and panicky.

SDs and release of gilts

It follows that "technical easing" to prevent higher MLR is acceptable, providing easing does not go as far as fully accommodating and indicating that the heat is off.

£M3 target

Precise figures or presentation an arbitrary or at least secondary matter. Only essential is to indicate a tightening, and a MT gradualist strategy which is viable. Tightening could be achieved in many ways. You can lower by a little, any or all of the "centre" of the £M3 range, the upper limit, or the lower.

Bill leak presentation

No real problem about this provided markets can understand what is being done and suspect no monkey business.

PSBR

Next year's precise figure of less importance than the long term goals which Govt is believed to be aiming for. The more it is credible in the MT or LT, the easier the ST. A slight reduction in the GDP share of the PSBR should suffice for 1980/81 given the recession.

ROSE

General

Not too worried, but less "hawkish" than last year.

Monetary Trends

Barclays have always seen loan demand strong till the end of this (1980 I) quarter. And so it is proving to be, with personal borrowing slack, but corporate still firm. Surprised B of E have come up with such a big estimate of the seasonally adjusted M3 increase for Jan. Debiting of interest should not affect M3 for technical reasons [AR: I suspect because in crude terms interest is credited to Bank's reserves]; there has been heavy payment of taxes; and CGBR is small. Anxious lest the high Bank estimate be attributable to bad seasonal adjustment. That could be very disruptive. In the real world, expects considerable improvement shortly for varied reasons such as de-stocking, interest rates biting, continued low level of Govt borrowing. Growing corporate deficit will require much less bank finance than stocks - experience shows £1 of stocks takes 70p of bank advances, while £1 of underlying deficit in co. sector only takes 30p.

SDs; gilts release/buy-back

Since prospect is not that alarming, technical easing is justifiable. No case for higher MLR or base rates. All this assuming PSBR for '79/80 is not out of hand!

Roll-forward

Hasn't considered precise arithmetic of targetry. But estimates 9% increase in M3 feasible during calendar '80, consistent with falling interest rates. This suggests a modest lowering of the range is feasible, provided one is reasonably confident one would not excee the upper end. [AR: Doubtful we can have such confidence ....] However there is more to consider in this connection.

Budget and other policy

Degree to which a figure is accommodating is determined also by extent of future action on prices by Govt, and extent of TU reforms. To have continued union strength and to give a further hefty jolt up to, eg, indirects like last year would be excessive. At most one of these contingencies is tolerable. Co-existence of both part of last year's problem.

Bill leak

The vital point that it has happened. Key question now, therefore, that one "confesses", and does not allow market to be unsettled by what, if it happens, would be a bad statistical performance as past errors are revealed to the naive through reintermediation. The key thing is not how the statistics are juggled. There are many ways of doing that. Rather it is that markets should be fully aware of the problem in advance, ie be softened up by the right sustained guidance; that the device ultimately adopted be honest, transparent and not catch them by surprise. [Barclays aim to do their bit as soon as possible, starting in their next monthly bulletin.]

Exchange rate

Definitely too high. Lower interest rates and a reduction in the £'s speculative attractions should help promote a lower rate 'ere very long, when speculation in commodities may become more attractive than holding pounds.

PEPPER

General

Not sombre about recent developments, but concerned about several important issues. The latest MS figures (for Jan) and their causes could be interpreted relatively favourably in their implications for underlying trends, justified the release and re-purchase of gilts; but pointed up yet again weakness of monetary instruments and threats to policy. Immediate message: steady as she goes.

January Money Supply

By record gilt sales and a very low CGBR, authorities drained money out of the system by a record amount, just as the same 2 factors had injected a record amount in October 1979. The vacuum thus created inevitably led to partly compensating increases in bank advances and inflows from abroad.

In total the authorities drained over £1.2 bn from the system. In the UK Treasury bills are the residual form of Government finance - ie when Government is in deficit in the short run, it sells bills, when in surplus it buys them back from private holders. Bills are one of the most important reserve assets of the Banks, hence support advances of a large multiple of the Banks' holdings. Massive run-down of, ex ante, over £1 bn put them in a very difficult position. Even with £900m of Government help (SD and gilt release) they were several £100m short, even of what was needed to support their existing lending

In the event they had to have recourse to every expedient and, since the Bank was not very quick to help them they were fairly desperate in their search. Without going into technicalities, the unsurprising outcome was massive pressure on interest rates as clearers bid for deposits; "manufacture" of IBELS, helped by the discount houses; inflow of overseas money; and, most important, arbitraging and round-tripping (encouraged by corset) which inflated the money supply figures The latter is one of the reasons Pepper is less worried than most by the superficial trends suggested by January's figures.

Lessons for future of monetary instruments

Government's residual financing means - Treasury bills - should not be a reserve asset of the banking system.

Underlying loan demand

Evidence available suggests it is evolving as one suspects: personal demand drying up, voluntary corporate demand withering, involuntary demand to finance stocks (till they run down) still strong, but likely to come off shortly. If February's figures improve, there would be a case for a MLR cut in the Budget.

Inflows

Could, however, swiftly ruin things.

1. UK monetary policy much tighter than overseas, the only country's to involve contraction in real money supply. Elsewhere the recession has been postponed. Overseas monetary conditions could remain loose generally for another 6 months or more. Until they tighten too, and recession begins, we will be unusually vulnerable to massive inflows. To "aim off" too much in the degree of tightness of our policy relative to others a great danger - cf Switzerland and Germany in 1977 and 78.

2. It could already be too late to avoid the danger - in which case temporary inflow controls quite vital, however unappetising. The methods in the ST not a complicated matter. EG orders to gilts brokers not to sell gilts to foreigners would be respected and effective. Controls could just about buy one the 6 months needed to carry us through till monetary conditions tightened overseas - which would take the heat off us automatically.

3. The current alarming problem of inflows must, as far as an outsider can judge, have been aggravated by intervention by the Bank of England when sterling was under pressure. The criticism is not of gentle massaging or smoothing, or of intervention to acquire finance needed for subsequent payments overseas by the authorities.

Rather it is that the correct response to gusts of speculation in favour of the £ cannot always be to "cream" off (even at a subsequent profit), and have clearly perceptible and foreseeable restraint on upward movement in the exchange rate.

4. Such intervention is predictable, offers speculators a one-way option in the short-term, and attracts more people and money before long. As a result what could have been a short gust which quickly blows itself out becomes a bigger and lengthier affair. Before very long leakages into the domestic money supply are probably. That could well provoke a further tightening of interest rates, and then a doubly vicious circle is set up. The intervention should rather be unpredictable, or even apparently perverse on some occasions. Let the rate ride up without intervention,and then bounce down, help it on the way down and burn speculators fingers.

[AR Note: I am summarising a lengthy discussion. The basic argument is the same as that applicable to gilt-selling tactics. I attach, for those who wish to pursue it, an extract from Pepper's unpublished talk on that theme.]

Greater instability in the rate in the short-run will follow from such tactics - but it would purchase greater stability in the long run, since it would make "speculators" discount more heavily the potential gains from short-term switches into and out of sterling. The Swiss and Germans already pursue such tactics from time to time, so they are not untried.

5. To sum up, proper handling of intervention could well be one of the most important considerations in the near future.

£M3 roll-forward

The target is quite tight enough now, and will continue to be as long as "12-month inflation" is rising. The time to lower it is when one is confident inflation is clearly falling. On balance the 7-11%

target should be rolled forward as it was in the autumn. But very clear and firm announcement should be made to the effect that: inflation about to fall; and target will be brought down when it is.

PSBR targets

The PSBR a bad measure to steer by. "People getting less and less impressed when PSBR is lowered by cosmetic tricks like BP borrowing £250m off a bank in order to buy oil forward from BNOC at year end".

The PSD infinitely superior, and not to shift to thinking and (in part) talking in terms of it will increasingly cost credibility. No precise view yet as to suitable figure except on a full employment basis. Convinced some allowance for recession appropriate, suspects on very much the basis Mr Burns favours. The reason for this that growth in private sector demand for credit falls back in recession - cf 1975 when it actually fell for a whole year in current price terms, a fact people ignore. This cycle will enter a comparable phase before long, in which "undershooting" will rear its head, and problem of interest rates will greatly diminish.

Gilt sales

Favours one more grand excursion of the Duke of York before hoped for switch to monetary base later in the year.

Bank profits

Very frightened by effect of wage settlement. Since date has for this year been advanced from July to May, and a 20% settlement seems likely, bank employees could well end up with circa 40% increases in 9 months. Wider consequences considerable in both numbers of other sectors affected, and scale of influence on settlements. Clearers affect City firms which affect London Labour Market generally, which affects Government and LA employees .... Authorities should either lean most violently on Clearers, tax "endowment element" in profits due to high interest rates, or do both. The alternative course - that Clearers pay interest on current accounts - has its attractions, but would raise problems for monetary control, particularly under MBC. The need for inflation accounting to reduce declared bank profits also self-evident.

The decisions of when and by how much to lower a tap price are complex. It is important to avoid the precedent of the market usually having a further fall after a tap price has been reduced, because this would lead to a delay before any stock is sold. The market tends to fall because the reduction of a tap price increases the potential supply of stock from the GB close to a current market price. Very often, though, the authorities reduce a tap price only when they consider either that the market has fallen to a level which is sustainable or that favourable news implies that prices should rise. Thus, the bearish implications of the additional supply of stock are offset by official expectations being signalled to be bullish. In this way the authorities avoid the precedent of the market falling whenever a tap price is reduced.

(The reason why the offer for sale price of a new issue is pitched in line with the market or slightly dear is similar. If a new issue were priced cheaply relative to other stocks, the whole market would fall on the announcement of the issue.)

If a market that has been falling rallies before a tap price is dropped, the authorities can sell stock without adjusting tap prices by supplying "unofficial taps", i.e. they can sell some of the Issue Department's holdings of stock acquired when the authorities have assisted switches going longer.

Overall, it should be realised that the tap method of issuing stock is extremely flexible. The U.K. authorities can act much faster to take advantage of favourable news items and unexpected events than can the U.S. authorities who use the tender (or auction) method of issuing bonds.

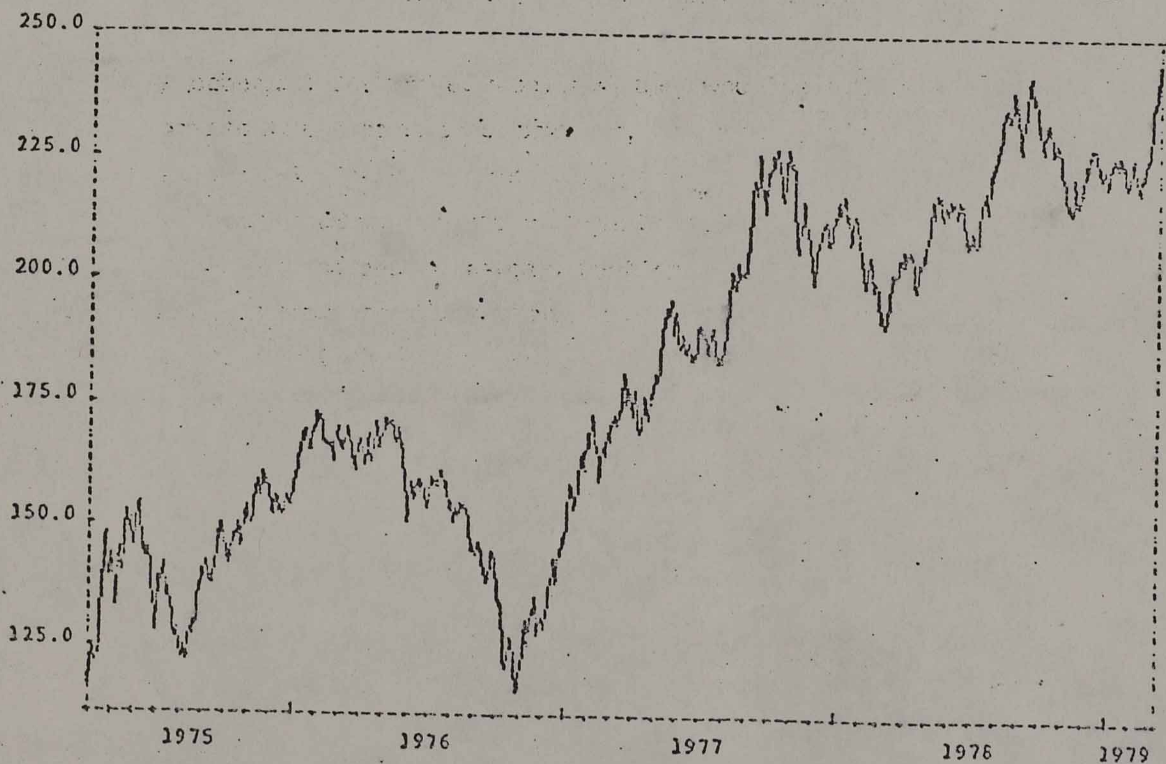
PART II - A PROBLEM PRIOR TO CCC

After the 1939/45 War the Bank was worried about the problems which might arise at the redemption of the large war-time issues. Later the Bank was worried about the redemption of the post war nationalisation issues. The Bank was afraid that it might not be possible to roll over this debt. Accordingly, until the introduction of CCC in 1971 the Bank's first aim in debt management was "to maximise investors' desire to hold gilt-edged stock in the long run". The Bank tried to do this by maintaining an "orderly" market. The theory was that over the years gilt-edged investors would buy more stock if they thought that they would always be able to sell at a reasonable price. A reasonable price was thought to be close to the middle market price, which should not be too far below the

Extract from "Official Transactions in the Gilt-Edged Market".
Gordon Pepper - Privately Circulated

previous day's price, which in turn should not be too far below the one the day before, and so on. The authorities, therefore, supported the market when it was falling - the GB used to be willing to buy stock offered by jobbers - in attempts to smooth falls. They also smoothed rises because a sharp rise was thought to indicate the presence of speculators who might subsequently sell suddenly and cause a disorderly fall in prices.

Ironically, this method of operation eventually led to more disorderly markets. In the face of rapidly changing events an official resistance to changing prices encouraged speculation. Further, the extent of official smoothing damaged the gilt-edged market's own self stabilising mechanism, which in the long run is necessary for its efficient functioning. Such mechanisms are reflected in secondary fluctuations. All uncontrolled markets have these. Those in the equity market during the last four years are illustrated, as an example, in Chart III (this graph shows the equity market rather than the gilt-edged market because the pattern of ordinary share prices is not distorted by official intervention). The broad picture is one of rising prices until early 1976, a sharp fall in the middle of 1976 and a rise since then which has gradually been slowing down. Superimposed on this broad cycle are numerous secondary fluctuations. They occur for two main reasons.



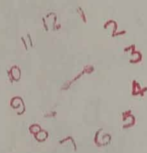
Firstly, there is an uneveness in the stream of news reflecting economic and political developments. Prices fall in spates of bad news and rise when there is a run of good news. Secondly, there are technical reactions. A rising market always attracts loose holders. Speculators are attracted by other people making money. A rising market also creates confidence, which attracts even more investors. If markets have been rising, the announcement of some unexpected bad news will always put downward pressure on prices; the question is the amount of the pressure. Speculators threatened with losses usually react very quickly - they sell. Speculators who still have profits may also sell; they are only short term investors. Falling prices upset confidence and some other investors are frightened into selling.

A set back to a rising market that is sufficiently sharp to frighten investors fulfils a most useful function; it shakes out the froth of loose holders. These set backs are called technical reactions; following one a market is much more resistant to further bad news and the chance of a more substantial fall in prices is thereby reduced.

Technical reactions also occur in falling markets. A falling market undermines confidence. This discourages some financial institutions from committing funds to the gilt-edged market as they flow into the institution. Sharp upward technical reactions tempt these institutions to invest their surplus liquidity.

Prior to CCC, official smoothing of gilt-edged prices discouraged technical reactions. For example, when prices were falling, the authorities used to take stock offered by jobbers; if the market recovered, they would re-sell the stock when the price had recovered to its earlier purchase price (or, perhaps, a $\frac{1}{4}$ point higher). The authorities undercut anyone in the private sector who had initiated a technical reaction and who had to pay brokers' commission and jobbers' turn. Because technical reactions were impeded, investors were not induced to bargain hunt on a falling market. The private sector progressively withdrew and the authorities had to provide more and more support in a falling market. Eventually the burden became too onerous and the authorities stopped supporting the market following the publication of CCC in May 1971.

21 [illegible] 19[illegible]



Original & Sparrow's letter on ECON POL: May 79 2

PRIME MINISTER

MONETARY POLICY

You raised some questions on John Sparrow's latest letter:

(i) Would it be possible to reduce interest rates by a tiny amount if at the same time we got an undertaking from the banks that they would limit credit on credit cards?
I think this is not feasible for three reasons. First, as you know, there is considerable pressure for an increase in interest rates at the moment because of the pressure on the banks' liquidity. This in turn is due to the heavy borrowing by the company sector, and to the recent very heavy sales of gilts to the non-banks. Second, personal lending by the clearers was actually negative in January. Third, it is unlikely that the clearers would agree to limit credit on credit cards unless limits were also brought in on in-store credit cards. The latter have become much more important recently, and it would be difficult to get the stores to agree.

(ii) Could we let MLR go free again?
When it was free, MLR was calculated on the basis of the Treasury bill rate plus ½ per cent and rounded to the nearest ¼ per cent. This would put MLR at 16¾ per cent. However, the Treasury and the Bank would resist a return to the old system since they believe we were getting the worst of both worlds under it: we were being blamed for the level of interest rates and yet we had less control over them than we do now.

(iii) You were told that there is no limit on the amount that local authorities can borrow in relation to their rating income even though the loans are secured on the rates.
There are two types of LA borrowing:-

/(a)

(a) Short-term borrowing through the issue of bills - these are secured on the rates but only for one year at a time. In other words, borrowing at the beginning of the year cannot exceed the total revenue expected from the rates during the course of the year.

(b) Long-term borrowing for capital expenditure. There are no controls on this borrowing as such, but there are controls on capital spending. So the borrowing is controlled by a round-about route.

(iv) John Sparrow suggested that high interest rates are themselves inflating the monetary aggregates by encouraging round-tripping, by attracting money out of the building societies and into the banking system by bringing in money over the exchanges, by increasing the amount of interest which gets debited to over-drawn accounts, and by discouraging domestic deposits from moving overseas. There is some truth in all of these charges, but the question is how to get interest rates down? When we are trying to run a tight monetary policy and the demand for credit from the private sector remains high, interest rates are bound to stay high also. If we were to reduce MLR at the moment the market would almost certainly take no interest. It might even have a perverse effect in suggesting that we no longer were worried about the monetary target. In short, although the high level of MLR and of interest rates generally may be inflating the monetary aggregates, the money supply would probably go even higher if they were to fall at the present time. On the specific point of round-tripping, the answer to this is either for the Bank to ease the liquidity of the clearers (as they have done today), or for base rates to rise still further.

T P L

13 February 1980

SECRET

HS

cc BofE 4

13 February 1980

Monetary Situation

The Prime Minister has considered the Chancellor's minute of 12 February, and has approved his proposals for entering into purchase and resale agreements with the clearing banks for some £500 million of gilts so as to ease the pressure on their liquidity.

I am sending a copy of this letter to John Beverly (Governor of the Bank of England's Office).

T.P. LANKESTER

John Wiggins, Esq.,
H.M. Treasury.

SECRET

TPL

T.L/CW

The attached was seen + approved by the PM c. 1 a.m this morning @ UdK – A returned to me by I.G: but I thought you'd like the original for your files

G.U.

3

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

PRIME MINISTER

MONETARY SITUATION

I mentioned to you last week that we might be faced with the choice of letting the Banks raise their base rates, or intervening to ease pressure on their liquidity. Two of the clearing banks have told the Bank that, in the absence of such intervention, they will have to raise their base rates to-morrow by 2 per cent: we would then have little option but to follow with MLR on Thursday.

2. I have discussed this with the Governor and we are agreed that the right thing is to intervene in order to avoid the rise in bank rates. This will involve entering into purchase and resale agreements with the clearing banks for some £500 million of the gilts held by them. It will need to be made public - so that it can affect money market rates before noon to-morrow. This will be done in as low key as possible. The inference which we will want to be drawn is that the authorities consider that interest rates should not change before the Budget.

3. One clear implication of this action will be to put a greater onus on the Government to take fiscal action in the Budget which will help with the control of the money supply. But I think that it is right to accept that.

/4. There are also

SECRET

4. There are also risks involved - there may well be criticism that we are backing away from allowing our policies to be carried through to the point at which they take effect. The advocates of monetary base control, and other means of giving the market a greater say in interest rates, will claim this is another example of the authorities mis-using the discretion they have under the present system. This criticism will be heightened if other events in the next six weeks mean that we cannot hold interest rates - we cannot be certain that we shall succeed either over the February make-up day or later.

5. I consider that we should take these risks and answer the criticism, if it arises, by saying explicitly, if necessary, that monetary control depends on a combination of fiscal policy and interest rates, and that at this stage and close before the Budget, it is right to decide on the two together, rather than to pre-judge now the balance to be struck between them. Moreover, we can point out that now, in contrast to earlier, the other monetary aggregates appear to be growing less quickly than Sterling M3.

6. Perhaps we can have a word before 9 a.m. to-morrow if you have any points to raise.

7. I am sending a copy of this minute to the Governor.

G.H.

(G.H.)

12th February 1980

Approved by the Prime Minister.
13/2/1980.
T.L.

SECRET

PRIME MINISTER

PERSONAL AND CONFIDENTIAL

10 DOWNING STREET

8 February 1980

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON SW1

Dear Geoffrey.

I enclose a copy of a letter from Professor Christopher Foster, which is self-explanatory.

I think the Prime Minister, to whom I copy this, met Foster a few months ago.

Yours
John

JOHN HOSKYNS

PERSONAL AND CONFIDENTIAL

SHELLEY HOUSE,
3, NOBLE STREET,
LONDON, EC2V 7DQ.
TELEPHONE: 01-606 4040.

7th February 1980

John Hoskyns, Esq.,
No. 10 Downing Street,
LONDON S.W.1.

Dear John,

Following our conversation this morning, I am dashing this note off literally as I go abroad, so please forgive its brevity. There are many arguments in it that I would like to elaborate upon when I return next Wednesday.

A number of my fellow economists in the City and in universities whom I meet quite frequently - and who, in varying degrees, are monetarists - are rather worried about what kind of Consultation Document on Control of the Money Supply may soon emerge from the conversations between the Treasury and the Bank of England. There have been rumours in the Times and FT suggesting that it may come down against a base money approach broadly of the kind which Volcker of the F.R.S. adopted. Of course the rumours may be false but the issue is surely important because:-

(a) the Government has pinned its flag to a firm monetary policy and any sign of weakening could be widely misinterpreted;

(b) the failure to control the money supply last autumn produced an instant adverse reaction in the City and abroad from which we are still suffering. Interest rates are higher than they might otherwise have been because of the Bank's management over a period and because the extra inflationary expectations built into interest rates will take a time to dissipate, even if most things go well; and

(c) controlling the money supply is, in present circumstances, the best instrument of economic control even though it does not work perfectly and other policies must be consistent.

The difference of view between the Bank of England and monetarist opinion as represented by the Treasury is in principle just what it was in the great days of debate before the Radcliffe Committee, though rightly we have all become more sophisticated and quantitative since then. At the risk of over-simplification the Bank's arguments are two:-

(a) the money supply cannot be controlled because there are many channels through which lending can pass, and one cannot control all of them, especially those that flow from overseas; and

(b) even if one could, the fluctuation in short term interest rates would be too unsettling.

The first argument really turns into one about how far one is ready to go to make control effective. In part it depends on being ready to control the Bank's cash ratios enough to have the right effect. In part on being ready to control the cash ratios of many other institutions; and in part on being ready to switch tactics and keep the market guessing over the maturities of the debt one is going to buy and sell next. And it is probably impossible to avoid special measures to make capital inflows unprofitable such as are taken by perfectly monetarist governments overseas.

The opposition to monetarism here under both heads mostly arises because inevitably it would restrict the ability of the City to lend profitably when a squeeze is on - but that is what monetarism implies. It would also imply a much more adventurous and unpredictable policy on behalf of the Bank.

It is all too easy to get drawn into developing these arguments further. The concern of some of us, however, is that the Bank's unwillingness to believe in monetary policy does not shine through whatever is proposed and cause alarm. There really are very strong arguments for being steadfast here; and I only hope they are being given sufficient weight - that is weight enough to win.

On a very different matter, I have argued in a quiet way for years that the Government must enforce financial discipline over the nationalised industries if their productivity is to improve. Giving way in the past has been disastrous so I can only applaud the Government's stand. I do wonder, though, if Ministers are explaining it enough to the general public. I am sure there is great latent sympathy for the Government's point of view. I would have thought Ministerial broadcasts really would pay off - all the more, I am afraid, because the Opposition would find it rather hard to define its position unanimously if it exercised the right of reply.

Yours sincerely,

R. J. Kirk
for

Christopher D. Foster

S E C R E T

Prime Minister

Econ Pol 2

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

4th February, 1980

Dear Tim,

MONETARY DEVELOPMENTS

You will want to warn the Prime Minister that the monetary figures for banking January are somewhat disappointing, and that this will become apparent to the market when the eligible liability figures are published tomorrow, Tuesday, 5th February.

Eligible liabilities rose by 2.5 per cent in banking January: the Bank's guidance to the Press will explain why the growth of the money supply was less, and point fairly explicitly to a growth in £M3 of about 1 per cent in banking January. The London clearing banks' figures, published at the same time, will show that sterling advances increased by £1¾ billion (not seasonally adjusted), an all-time record. The clearers' press release will, we understand, explain that the underlying figure was substantially less, because the banking January figures include interest charged to accounts. It will also point out that there was a switch of business to them from the rest of the banking system, because of relative interest rates just before make-up day. The market is now expecting a fairly high figure for the money supply and for bank lending, but will probably nevertheless be surprised both at the high bank lending figure and at the money supply figure, given the good gilt sales.

The attached table shows the current estimates of the counterparts of the growth in the money supply: the actual figures for these will be published on Thursday of next week, 14th February. The Central Government Borrowing Requirement was only £0.15 billion after seasonal adjustment. (The actual figure was a surplus of £0.9 billion.) There were exceptionally high gilt sales outside the banking

/system of

T. Lankester, Esq.,
Private Secretary,
10, Downing Street

S E C R E T

system of some £1.6 billion. However the banking system lent some £1.5 billion to the private sector and overseas, and £0.5 billion to the rest of the public sector. The net effect of these elements was to bring Domestic Credit Expansion to £0.5 billion - not in itself a worrying figure.

The increase in the money supply was somewhat greater, largely because external factors added £0.1 billion, This external effect probably partly reflects the tightness in the money markets, produced by the Exchequer surplus and high gilt sales, and partly the deteriorating position of the company sector.

The guidance to the Press will point to the fluctuations from month to month in these counterparts of the money supply: the average of banking lending to the private sector in the two months of December and January was just under £800 million which is very much in line with the level in preceding months. We understand that most of the increase in lending by the clearers was to the manufacturing and "other services" sectors. A small increase in lending to persons was more than accounted for by lending for house purchase and the half-yearly charging of interest to accounts.

At first sight these figures, though disappointing after the good gilt sales, are worrying rather than alarming. The cumulative figure for £M3 since mid-June is still slightly above the top of the target range. The Chancellor and the Governor will be considering the implications as the full analysis becomes available in the next few days. It will in particular be necessary to consider how far, if at all, the authorities should relieve the present squeeze on the liquidity of the banking system, since if it were not abated that squeeze could well lead to an increase in clearing banks' base rates before the next make-up day on 20th February. A further report will be made to the Prime Minister on this later.

yours

John

(A.J. WIGGINS)

STERLING M3: COUNTERPARTS

£ billion
seasonally adjusted

	banking July-November (average of five banking months)	banking December	banking January
CGBR	+ 0.88	+ 1.47	+ 0.15
Less purchases of central government debt by non-bank private sector total:	- 0.47	- 1.25	- 1.62
of which gilts:	- 0.57	- 1.16	- 1.63
Net other public sector	- 0.03	- 0.14	+ 0.50
Sterling bank lending to:			
private sector	+ 0.64	+ 0.16	+ 1.30
overseas	+ 0.03	- 0.02	+ 0.19
DCE	+ 1.05	+ 0.22	+ 0.52
External and foreign current finance	- 0.43	+ 0.18	+ 0.13
Net non-deposit liabilities etc	- 0.06	- 0.14	- 0.02
Change in £M3	+ 0.56	+ 0.26	+ 0.63

£ billion, not percent. (= about 1%.).

R.

Subject on Econ Pol: Pt 7 Public Expenditure

10 DOWNING STREET

From the Private Secretary

17 January, 1980.

As you know, the Chancellor called on the Prime Minister this morning. He first reported on the public expenditure bilaterals. He was still a long way short of reaching agreement on savings which would total £1,000 million in 1980/81. It would be necessar to obtain additional savings on the housing programme over and abov what the Secretary of State for the Environment seemed willing to offer; he would probably have to press for the limitation of child benefit uprating to 50p - even though this would be difficult because of the associated need to limit the uprating of the child supplement on supplementary benefit; it would probably be necessar to look for further savings from the education programme; the aid programme, and also from defence. In the latter connection, the Secretary of State for Defence had written to the Chief Secretary saying that further savings were impossible, and he (the Chancellor was intending to reply to the effect that defence could not be immune from the latest public expenditure exercise. However, he wanted to have the Prime Minister's view on whether he should proceed in this way.

The Prime Minister said that it would be right to look for savings on the defence programme, but procedurally it would be better if the Chancellor were to see Mr. Pym - rather than write to him. She also suggested that the Home Secretary might be invited to the meeting. As regards the possible scope for savings, the Prime Minister drew the Chancellor's attention to a letter from the editor of Jane's Fighting Ships (copy enclosed). [not attached.] She also referred the Chancellor to briefing which Sir Derek Rayner had provided her with before her recent visit to the Ministry of Defence. (I enclose a copy of the brief; but I should emphasise that this was prepared for the personal use of the Prime Minister, and the fact that you have a copy should not be revealed to the Ministry of Defence.) - not attached.

The Chancellor also reported briefly on the monetary situation. He was proposing to authorise the issue of a new tap stock the following day, in order to provide further funding

/ in

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in February - which would be the last banking month before the Budget. He was also considering with the Governor the possibility of issuing some kind of indexed stock: there was a case for considering this because of the heavy burden which the current high cost of borrowing would impose on future generations. The Prime Minister took note.

A.J. Wiggins, Esq.,
HM Treasury.

PRIME MINISTER

Original on Defence May 1979 The Defence Budget

MEETING WITH THE CHANCELLOR

Econ Pol Domestic Monetary Policy

I am told that the Chancellor will wish to discuss the following:-

(i) The monetary situation

Money supply figures for December are to be published tomorrow. We were told last week that sterling M3 grew by 0.4 per cent largely because of a big reduction in lending to the private sector. The CGBR remained high. After the heavy gilt sales last week, the Bank are in something of a dilemma. They want to continue the funding programme in order to get M3 firmly within the target range; but the recent heavy sales have put severe pressure on the reserve asset position of the banks - and this is tending to push short-term interest rates up. The Chancellor will, I believe, want to discuss his plans for funding. You might like to ask him about the prospects for getting interest rates down. The latest building society figures suggest that, if interest rates do not fall soon, the rate of mortgage lending will have to fall significantly.

(ii) Public expenditure

The Chancellor will want to report on his bilaterals - in particular, his meeting with Mr. Heseltine today; he may also be able to say how close he is to reaching the £1,000 million target. There is, in addition, the problem of defence expenditure. Mr. Pym's letter in this folder indicates that he is not willing to provide any further savings. Our view is that it would be pointless for Mr. Biffen or the Chancellor to reply to this letter in writing; if the Chancellor is to get anything - he should not give up trying - he should have a meeting with Mr. Pym. (One argument for seeking at least some savings from defence is that we have let defence off lightly on cash limits: we agreed that they should be negotiated with the Treasury in the

/light of

light of further indications of the likely level of defence pay. On the other hand, as I need hardly remind you, Mr. Pym was most reluctant to agree even the compromise formula which was arrived at in November: this was that defence expenditure over the coming years should grow at 3 per cent per annum in cost terms subject to further provision from the contingency reserve for Polaris replacement).

TGRobertson
f N Th.

16 January 1980

SECRET

Prime Minister

Econ Pol

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

PRIME MINISTER

MONETARY SITUATION

You ought to know that the monetary figures for December are likely to show that the improvement shown in the November figures has been maintained.

2. The eligible liabilities figures will be published tomorrow, Tuesday 8th. They show a fall of 1.2 per cent compared with an increase of 1.9 per cent last month. As last month, however, this gives a misleading indication of monetary growth. In fact we expect sterling M3 to have grown by about 0.4 per cent. As usual, briefing by the Bank on the eligible liabilities will point the markets in the right direction; the Bank will probably follow last month's practice and give an explicit indication of the sterling M3 figure. Domestic Credit Expansion is expected to have been about £260 million, considerably less than the average figure of £1 billion since mid-June. Preliminary estimates of the components are shown in the Annex.

3. Central Government borrowing in December was nearly £1.5 billion; but this was almost entirely offset by sales of gilts and other Central Government debt to the public. The growth of bank lending was only about £200 million. There was some further leakage of acceptances outside the banking system. But underlying growth appears to have been less than in recent months. It is difficult to say to what extent this

SECRET

deceleration reflects the rise in MLR on 15th November, or marks the slowdown we have been expecting for some time. Preliminary indications for banking January suggest that we would be unwise to count on the slowdown being sustained.

4. The overall money supply figure is thus again fairly encouraging. It was achieved in spite of a positive external adjustment, in contrast to last month when the adjustment was very substantially negative. The lower figure for DCE is gratifying. But we cannot be complacent with a Central Government borrowing requirement as high as last month's, and the possibility that bank lending might bounce back upwards.

5. I am copying this minute to the Governor.

G.H.

(G.H.)

7 January, 1980

	Average of 5 months July-November	£ billion Banking December
CGBR	+0.87	+1.47
less sales of CG debt outside the banking system		
Gilts	-0.59	-1.13
Other	+0.10	-0.13
Bank and overseas lending to the rest of the public sector	-0.02	-0.15
Bank lending to:		
Private	+0.64	+0.21
Overseas	+0.03	-0.01
DCE	+1.03	+0.26
External Adjustment	-0.42	+0.17
Other	-0.06	-0.21
Change in £M3	+0.55	+0.22
	(1.0%)	(+0.4)

7.1.80

r'd 21.50

PART 2 ends:-

NFR PM / Chancellor 20.12.79

PART 3 begins:-

Chanc. to PM 7.1.80