MT

PART 8

203

Confidential Filing

Domestic Monetary Policy

ECONOMIC POLICY

Part 1: May 1979

Part 8: March 1981

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~30.3.81~~		~~5.8.81~~					
~~9.4.81~~		Ends					
~~28.4.81~~							
~~4.6.81~~							
~~8.6.81~~							
~~19.6.81~~							
~~31.7.81~~							
~~3.8.81~~							

PREM 19/441

PART 8 ends:-

MAP to Treas 17/8

PART 9 begins:-

August Money Supply 4/9

RESTRICTED

File

Econ Pol

17 Augustut1981

The Prime Minister has seen your letter of 10 August to Tim Lankester, covering the regular monthly note on the CGBR.

She was grateful for the information set out in your letter about the unwinding of the effects of the Civil Service dispute.

MAP

Peter Jenkins, Esq.,
H.M. Treasury.

RESTRICTED

MO

Prime Minister 2

cc Mr Walters

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

TL 11/8

10 August 1981

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

Dear Tim,

MONTHLY NOTE TO THE PRIME MINISTER ON THE CENTRAL GOVERNMENT BORROWING REQUIREMENT

.... I am enclosing this month's note for the Prime Minister. The main points are summarised on the first page. The borrowing requirement in July was again high - £1,981 million - but £1¾ billion of this is attributed to the effects of the Civil Service dispute. In briefing on the money statistics for banking July which were released last Tuesday, we have already revealed that the effect of the strike was large in July, so the outcome for the CGBR in calendar July will not come as a surprise. The note also provides estimates of the "underlying" CGBR to the end of October.

With the strike now ended, it will be helpful for the Prime Minister to have an assessment of the speed with which the delayed revenue may be recovered, and the monetary implications of this. The
.... picture is set out in the attached tables.

You will have seen that in briefing on last week's monetary statistics, the Treasury briefed the Press that clearing the backlog would take several months. Our aims were:

(a) to allay fears that there would be acute pressures on the money markets and hence on interests rates caused by surge of revenue.

(b) To prevent expectations developing that the next two months money figures would be exceptionally good.

The following points emerge from the tables:

(i) By the end of July - the formal end of the strike - the loss of revenue, net of VAT repayments held up, was £6-6½ billion. The table does not include the small amount of expenditure also held up, mainly payments to farmers, which might total £250 million. This is expected to be cleared by the end of September.

/(ii) In the

(ii) In the first 2 months there is likely to be little net recovery. By the end of August there is likely to have been no net progress in reducing the net amount oustanding. This reflects a number of factors. First, Inland Revenue think that it may take some time before even normal tax flows are restored and that arrears will for a time continue to mount. The small payers who have not been paying may not respond voluntarily just to the announcement that the strike is over. Restoration of the normal flow in full will require updating of the computer files. Secondly, relatively little of the backlog of tax is in the form of received but uncleared cheques which can be processed rapidly. Thirdly the net flow of VAT revenue in August should be more or less normal, but because Customs and Excise (on Ministerial authority) are giving priority to repayments, the amount of extra VAT repayments is expected to be approximately equal to extra payments coming in. Even in September the net recovery of revenue to the two Revenue Departments together, is expected to be small.

(iii) By the end of the calendar year there could still be £4 billion outstanding and £2 billion by the end of the financial year.

(iv) The permanent costs of the strike are likely to be between £500 million and £1,000 million. About £200 million of the delayed revenue will probably never be recovered (although we will never really know) and the debt interest costs even in 1981-82 will probably exceed £500 million (see Table 2).

(v) The net effect of the strike on the CGBR in 1981-82 could be over £1½ billion. This is made up of the £2 billion still outstanding at the end of the year, less the £900 million or so carried forward from last year, plus over £500 million of additional interest charges. This could mean that the CGBR/PSBR will exceed the Budget estimate though the underlying picture appears to be somewhat better than forecast though not necessarily by enough to cancel out the strike effect.

It may be that Tax Offices will be able to develop ways of speeding up the inflow and the civil sense of taxpayers will be greater than expected. The Chancellor is asking Lord Cockfield to conduct a special study of unconventional ways in which we may be able to speed up the flow of revenue. Nothing may come of it: the experience of the 1979 Post Office telephone billing dispute suggests that recovery of delayed receipts will be long drawn out; and the estimates already assume that staff in tax offices will be fully co-operative after the strike. However that may be, the attempt should certainly be made.

/The dispute

The dispute has of course substantially distorted the monetary statistics. In the first five months of the target period (to mid-July), £M3 increased by 7 per cent, of which about 4 per cent may have been due to the strike. We cannot be precise as we do not know how businesses have allocated the boost to their liquidity between deposits (which would raise £M3) and repayment of bank borrowing (which would reduce £M3). But our published estimate that the growth of £M3 has been within the target range is based on the reasonable assumption that between 40 and 60 per cent of the deferred revenue has found it way into money. The strike effect on £M3 will fall away as the recovery proceeds. But by the end of the current target period, the level of £M3 may still be 1-2 per cent higher as a result of the strike.

We do not expect the money figures to improve for some time. In banking August, the strike may on balance still be adding to money and in September the effect may be more or less neutral.

One beneficial side effect of the protracted recovery is that it is unlikely that the unwinding will in itself generate acute money market pressures or higher interest rates.

By contrast the strike is likely to delay the start of taxation of unemployment benefit beyond the planned date of April 1982, but it should be possible to start the scheme early in the financial year.

Yours ever
Peter

P.S. JENKINS

TABLE 1

CONFIDENTIAL

CIVIL SERVICE STRIKE AND RECOVERY - EFFECTS ON CENTRAL GOVERNMENT REVENUE

£ million

	1980-81	1981-82						1982-83	
	1981 Q1	1981 Q2	1981 Q3			1981 Q4	1982 Q1	Whole year	Irrecoverable
			July	August	Sept				
Inland Revenue and National Insurance	-610	-3140	-1400	-50	+730	+1950	+1540	+830	150
Customs and Excise receipts	-470	-1780	-800	+400	+300	+650	+700	+950	50
Customs and Excise VAT repayment	+200	+1300	+500	-300	-500	-1200	-	-	
NET REVENUE	-880	-3620	-1700	+50	+530	+1400	+2240	+1780	200
Cumulative net effect on CG revenue	-880	-4500	-6200	-6150	-5620	-4220	-1980	-200	

TABLE 2: INTEREST COST OF THE STRIKE(1) £million

	1981Q1	1981Q2	1981Q3	1981Q4	1982Q1
Approximate cumulative effect of strike on CGBR					
(including effect on expenditure and debt interest as well as lost revenue)	900	4500	5900	4600	2500
Interest costs					
Within quarter		75	185	180	110
Cumulative		75	260	420	530

(1) Assuming that short-term interest rates stay near their current level for the remainder of the financial year.

MONTHLY NOTE ON THE CENTRAL GOVERNMENT BORROWING REQUIREMENT

Outturn for July and Forecast to end-October 1981

Summary

- the provisional estimate of the CGBR in July is £1,981 million, including the effects of the strike.

- about £1¾ billion reflects delays in tax and national insurance collected. Apart from this, the CGBR would have been about £¼ billion, £½ billion better than forecast a month ago, mainly due to timing differences.

- the cumulative CGBR to the end of July is estimated at £9,377 million.

- for the seven months to end-October the underlying CGBR (excluding strike effects) is forecast to be £6-6½ billion, somewhat lower than last year. The actual CGBR will be considerably higher.

CGBR IN JULY

1. The provisional estimate of the CGBR in July is £1,981 million bringing the cumulative total for the financial year to £9,377 million. The figures will be published on Tuesday 11 August.

2. It is estimated that up to £1¾ billion of tax and national insurance receipts were delayed as a result of the civil service dispute in July. Apart from this the outturn would have been just over £¼ billion, that is, nearly £½ billion better than forecast. As in previous months, lower lending to local authorities and public corporations accounted for much of the difference. The improvement on other items are thought to be largely problems of timing.

3. Table 1, attached, presents a detailed comparison of the forecast and outturn for July. The presentation below identifies the main differences, distinguishing between effects of the strike and other factors. Taken together, the CGBR in July was around £1¼ billion higher than the forecast excluding the strike included in last month's note.

Outturn: July: Difference from forecast

	Effect on CGBR (-means adverse)
Strike effects on revenue	
Inland Revenue taxes National Insurance contributions (included in 'other funds and accounts' in table 1) National Insurance Surcharge (Included in Consolidated Fund "other" receipts in table 1)	-1,350 (approx)
Customs and Excise taxes (net of blocked VAT refunds)	-300
	-1,650
Other strike effects (net)	
Payments not made (+), some wages not paid (+), additional interest (-)	0 to +30

Other factors

Timing effect of receipts from purchases of certificates of tax deposits (1)		-120
Lower net lending	to local authorities	+100
	to public corporations	+ 80
Payments across the exchanges to the European Community		+ 70
Payments of Housing Subsidies		+110
Miscellaneous receipts in respect of supply expenditure		+ 60
Other		+160 to +190
		+460 to +490

(1) the offset of the June purchases mentioned in last month's note.

Strike effects in July

4. As foreshadowed in last month's note the amount of Inland Revenue receipts delayed by the strike during July was, at £1,350 million, rather higher than in June. The Inland Revenue Staff Federation announced its intention of halting receipts of Inland Revenue taxes other than PAYE from the beginning of the month. Nevertheless, the percentage of revenue delayed (27 per cent) was no greater than it had been in April or May.

5. Around £300 million of Customs and Excise net receipts in July were delayed by the strike, about the same amount as in June although rather less in percentage terms.

6. Other financial effects of the strike continued to be small in comparison with the revenue delayed. Selective strikes at MAFF/IBAP continued to delay payments whilst pension payments to former public employees were held up by the escalation of the dispute in the Paymaster General's Office. Partly offsetting these savings, there was a further £60 million or so of interest costs accruing during the month.

Cumulative strike effect to date

7. It is estimated that the cumulative backlog of revenue at the end of July, and hence the end of the strike, was £6-6½ billion. This has been released in the preliminary press notice on the banking-July money supply figures on 4 August.

8. Interest costs on the additional borrowing caused by the strike has risen to an estimated £140 million up to the end of July. This will continue to rise even though the strike is over until such time as the bulk of the revenue delayed has been collected.

Other effects in July

9. We continue to be without much of the usual detail because of the dispute.

10. Net Lending to local authorities and public corporations in July was, once again, nearly £200 million below forecast. Local authorities continue to make large repayments to central government, indeed they borrowed very little in total, at least to the end of June.

11. Other effects on central government own-account borrowing in the month were mainly favourable, although thought to be largely timing effects. In particular, last month's forecast included provision for a payment of £70 million across the exchanges by the European Community; in the event only a small payment was made, but the payment in August is now larger than previously allowed for. Also, the expected catching-up in July on a backlog of claims from local authorities in respect of housing subsidies did not materialise.

FORECAST FOR THE NEXT THREE MONTHS

12. Even though the strike is now over, the detailed forecasts for August, September and October presented in table 2 do not take account of the expected profile of recovery from the strike and hence will provide a good base against which to monitor the recovery. The effects of the strike will continue to dominate the figures for many months to come. The latest view of the profile of recovery of delayed receipts is discussed in the covering letter.

13. Table 3 shows the outturn/forecast month by month and cumulatively to the end of October both including and excluding strike effects. The underlying 'strike-free' forecast to the end of October would bring the cumulative CGBR to £6-6½ billion, compared with the 1980-81 CGBR of £8 billion in the same period. In particular, the underlying CGBR in October is forecast to be a net repayment compared with small net borrowing in the month last year; the first instalment of the special tax on banking deposits and receipts from the forthcoming sale of Cable and Wireless (each worth just under £200 million) are expected in the month.

14. After allowing for the effects of the strike, the cumulative CGBR to the end of October is expected to be almost £11 billion. Virtually no recovery of the outstanding net revenue delayed by the strike is expected in August; a little more is expected in September and October. By then, the bulk of the money owed by government in VAT refunds should have been cleared and the revenue should begin to come in a little faster.

CONFIDENTIAL

TABLE 1

CENTRAL GOVERNMENT BORROWING REQUIREMENT - JULY

	Forecast (excluding strike effects)	Outturn (including strike effects)	Difference on CGBR
RECEIPTS			
Consolidated Fund			
Inland Revenue	3,470	2,499	- 971
Customs and Excise	2,600	2,295	- 305
Other	830	447	- 383
National Loans Fund			
Interest, etc receipts	140	132	- 8
Total Receipts	7,040	5,373	-1,667
EXPENDITURE			
Consolidated Fund			
Supply services and Contingencies Fund	5,800	5,855	- 55
Other	320	314	+ 6
National Loans Fund			
Service of the National Debt	1,440	1,453	- 13
Net Lending	300	181	+ 119
Total Expenditure	7,860	7,803	+ 57
Other funds and accounts	-	+449	+ 417
CGBR	- 820	-1,981	-1,161
of which: estimated strike effect	-	-1,650	-1,650
: excluding strike effect	- 820	- 331	+ 489

TABLE 2

CENTRAL GOVERNMENT BORROWING REQUIREMENT

	Latest Forecast (excluding effect of strike		
	August	September	October
RECEIPTS			
Consolidated Fund			
Inland Revenue	2,350	4,460	3,470
Customs and Excise	1,880	1,850	2,590
Other	820	750	810
National Loans Fund			
Interest etc, receipts	290	800	410
Total receipts	5,340	7,860	7,280
EXPENDITURE			
Consolidated Fund			
Supply services	5,800	6,100	6,100
Other	420	310	280
National Loans Fund			
Service of the national debt	780	1,220	370
Net Lending	330	800	550
Total expenditure	7,330	8,430	7,300
Other funds and account	+70	+210	+170
CGBR excluding strike effect	-1,920	-360	+150

TABLE 3

CENTRAL GOVERNMENT BORROWING REQUIREMENT

	1980-81		1981-82			
			Outturn/Forecast excluding estimated strike effect		Outturn including strike effect	
	In Month	Cumulative	In Month	Cumulative	In Month	Cumulative
April	0.9	0.9	1.0-1.2	1.0-1.2	2.4	2.4
May	2.4	3.3	1.6-1.7	2.6-2.9	2.7	5.1
June	1.3	4.6	1.0-1.1	3.6-4.0	2.3	7.4
July	0.8	5.4	0.3-0.4	3.9-4.4	2.0	9.4
August	1.6	7.0	(1.9)	(5.8-6.3)	(1.9)	(11.3)
September	0.8	7.9	(0.4)	(6.2-6.7)	(-0.1)	(11.2)
October	0.2	8.0	(+0.2)	(6.0-6.5)	(-0.5)	(10.7)
November	2.8	10.9				
December	2.2	13.1				
January	-1.8	11.3				
February	0.7	12.0				
March	0.9	12.9				

Notes: - Forecast for 1981-82 in Financial Statement and Budget Report is £11,497 million.

- Some rows may not add across because of rounding.

0LO

H. M. TREASURY

Parliament Street, London SW1P 3AG, Press Office: 01-233-3415
Telex 262405

5 August 1981

R

MONETARY CONTROL

1. The Chancellor of the Exchequer said in the Budget Speech that a number of improvements in monetary control would come into effect later in the financial year. The Bank of England has now completed its discussions with the financial institutions; the agreed detailed arrangements are set out in a note issued by the Bank today. They will come into effect on 20 August - the first day of banking September.

The Reserve Asset Ratio

2. Among the changes to come into effect on that day is the abolition of the requirement that the banks should maintain a minimum reserve asset ratio. The institutions to which it has been applied will discuss in advance with the Bank, as part of normal prudential supervision, any changes in their policies on liquidity management.

The Cash Requirement

3. The previous requirement on the London clearing banks to hold 1½% of their eligible liabilities with the Bank in non-interest bearing form will also be abolished. Instead there will be a uniform requirement on all banks and licensed deposit-takers to hold ½% of their eligible liabilities with the Bank. The fulcrum for the Bank's money market operations will in future be the balances - over and above the ½% requirement - which the clearing banks hold voluntarily with the Bank for clearing purposes.

Money Market Operations

4. Besides these changes, 20 August will mark a stage in a period of transition which we have been going through since last November. The Bank now relies mainly on open market operations - buying and selling bills - rather than on direct lending to the

money markets. Dealing rates are no longer quoted; the Bank responds to bids and offers from the market, making public the rate at which it has done business. In future, the Bank will aim to keep interest rates at the very short end of the market within an undisclosed band which will be moved from time to time.

5. The new arrangements are intended to reduce the "bias to delay" in changing interest rates - in both directions - which was identified in the Green Paper on Monetary Control. And the market will have a greater role in determining the term structure of short interest rates. Market pressure will show itself mainly in movements in rates at the longer maturities which the Bank does not influence so directly - and this experience of market conditions will be one of the factors taken into account in deciding on the position of the interest rate band.

Minimum Lending Rate

6. The Bank will cease to post a continuous Minimum Lending Rate from 20 August, as this would be inconsistent with the objective of the new arrangements to give the market more influence over the structure of interest rates. The option will, however, be retained for use in some circumstances of announcing in advance the minimum rate which for a short period ahead the Bank would apply to any lending to the market.

Changes in the Interest Rate Band

7. The undisclosed interest rate band will be changed by the Bank with the agreement of the Chancellor of the Exchequer primarily in response to the requirements of the annual monetary target, taking account of a range of factors indicated in the Budget Speech.

Press Office
HM Treasury
Parliament Street
LONDON SW1P 3AG

Tel: 233 3415

117/81

NOTES TO EDITORS

The new monetary control arrangements announced today flow from work begun in 1980 with the publication of the Green Paper on Monetary Control (Cmnd 7858).

In the months following publication of the Green Paper the Treasury and Bank of England received submissions from and consulted a wide range of commentators and market participants on the issues raised in the Paper. In his statement to the House on 24 November 1980 the Chancellor reported on the outcome of these consultations and outlined a number of improvements in monetary control which it was proposed to introduce. These included the ending of the Reserve Asset Ratio requirement, and changes in the Bank's money market operations to allow the market a greater role in the determination of the structure of short-term interest rates. The Bank issued a background note on "Methods of Monetary Control" on 24 November (published in the December 1980 Quarterly Bulletin).

In his Budget speech on 10 March the Chancellor described some of the changes that had already taken place and explained that the Bank would be discussing further changes with the financial institutions. He said that when these consultations were complete the Bank would aim to keep interest rates within an unpublished band, but without an announced Minimum Lending Rate. On 12 March the Bank issued two papers "Monetary Control: Next Steps" and "The Liquidity of Banks" (published in the March 1981 Quarterly Bulletin).

On 2 July the Chancellor told the House that the Bank had issued on 22 June the final draft of the detailed provisions ands that discussions with the financial institutions were well advanced. On 31 July he said in answer to a question from Mr Newens that the full system would come into operation on 20 August, the first day of banking September.

Today's Treasury Press Notice explains the major changes and their rationale. At the same time, the Bank of England are issuing a paper entitled "Monetary Control: Provisions", which sets out the details of the new arrangements.

MRS GILMORE (10 copies)

cc Chancellor
Sir D Wass
Mr Middleton
Mr Monck
Mr Turnbull
Mr Lennon

Mr Coleby
Mr Foot
Mr Quinn
} Bank

Prof Walters
Mr Ingham
Mr Lankester
} 10 Downing Street

NEW MONETARY CONTROL ARRANGEMENTS: BRIEFING

I attach a revised version of the briefing circulated yesterday, now agreed within the Treasury. The Bank are broadly content, though they have not had time for close textual scrutiny. You already have the Statement and Notes to Editors.

2. I also attach (not to all) a note from Mr Turnbull to Mr Monck on the implications for £M3 statistics of the announced changes, and the final version of the Bank paper.

Howard Davies

H J DAVIES
5 August 1981

MONETARY CONTROL: NEW ARRANGEMENTS

Positive

The principal objectives of the new arrangements are described in paragraph 5 of the statement. They represent the conclusion of work which began with the publication of the Green Paper on Monetary Control in March 1980. The broad outlines of the system were described in the Chancellor's statement accompanying his November 1980 package, and amplified in the Budget speech. Since then the Bank of England has been in negotiation with banks and other financial institutions about the detailed arrangements. These negotiations were concluded in July.

By removing the 'bias towards delay' in changing interest rates and allowing the market to play a greater role we hope to improve our ability to control growth in the monetary aggregates. Interest rates will be more responsive to changing market conditions and should therefore act more expeditiously to check swings in monetary growth than in the past.

The changes are beneficial and justified in their own right. No decision has been taken on Monetary Base Control but these changes would, as the Chancellor said in the Budget speech, be consistent with a gradual evolution to MBC.

RECENT INTEREST RATE DEVELOPMENTS

What has been happening to short-term rates?

It is not our practice to comment on day to day movements in interest rates. And that will still apply when the new system comes into full operation.

short

But it is clear that over the last few weeks/rates have firmed throughout the yield curve. The market has been reacting in large part to overseas developments - in US rates - the exchange rate - the outcome of the Ottawa summit. Rates at three months and longer moved up in response to uncertainty about these and [If pressed] other factors [and the Bank dealt at the very short end so as to keep these rates more in line with the longer short term rates.]

The new system a smokescreen for a backdoor rise in interest rates?

No. Important to distinguish clearly between the new techniques, the independent effect on the market of factors such as high US interest rates. It is evident that there is pressure on UK interest rates generally. We have been gradually moving towards the new system in our market dealings so that market pressures have quite properly begun to have an impact on the Bank's dealing rates.

Have the authorities encouraged a rise in rates for exchange rate reasons?

The level of the exchange rate has been a factor influencing market sentiment, and is one of a range of factors we take into account in setting interest rates. But in our market dealings recently we have essentially been responding to market pressures.

Are you satisfied with the present position, with 7 day interbank rates above the bank's intervention levels? (About 13% over 12½%).

Clearly there are dangers if an interest rate structure like this persists (round-tripping). Though there has been little evidence of this so far. We shall need to watch market developments carefully in the coming weeks.

INTEREST RATE DETERMINATION IN THE FUTURE

Is the Government giving up control of short-term interest rates?

The purpose of the new arrangements is to give the market a greater role in signalling the course of interest rates. This necessarily means less influence for the Government particularly at the higher end of short maturities. Does not mean Government has relinquished all control. It will be aiming to keep very short term rates within a band and in some circumstances it will post a rate at which it is prepared to deal for a short period ahead. Ultimately the Government has to ensure that interest rates are at levels which are consistent with its monetary objectives.

Is "giving the market a greater role" a genuine change?

Yes. We are not saying 'the market will set interest rates'. But we do intend to allow market forces a greater role in influencing the Bank's behaviour. We believe that movements in the market rates we do not directly influence - further along the yield curve - can provide useful information for the authorities on the market's view of the course interest rates should take.

What is the purpose of the band? How wide is it? Why is it undisclosed?

The Bank will aim to keep interest rates at the very short end of the market within an undisclosed band which will be moved from time to time. For the Government to declare the limits to the band would be inconsistent with our objective of allowing the market a greater role for the same reasons as continuing to have a posted MLR would be. The band will be wide enough to accommodate fluctuations caused by changes in liquidity conditions in the market, and to allow the Bank some flexibility in its dealing operations.

What are the factors determining the level of the band?

The principal objective remains to meet the annual monetary target. This means, therefore, that recorded and forecast movements in £M3 are the prime factors. But we shall also take account of market conditions and of the range of indicators referred to by the Chancellor in his Budget speech.* The most important are:

- movements of other monetary aggregates, in particular, M1 and the wide monetary base.

- movements in the exchange rate and costs as indicators of underlying monetary and inflationary conditions.

<u>Market conditions</u>?
(See para 5 of statement.) Market conditions will be taken into account. But monetary targets are not set or achieved by the market alone and the authorities will not always follow the market.

<u>But what weights are attached to these different factors</u>?
It would not be sensible to try to ascribe percentage weights to different factors. Their relative importance will, in any case, change in differing circumstances. It is important to take account of all of them in making a rounded assessment of monetary conditions.

<u>Who will decide the band</u>?
As now the Bank of England with the agreement of the Chancellor.

*relevant sections attached.

[Sir Geoffrey Howe]

special circumstances of last year, the growth of sterling M3—the measure of money used to express the strategy—has been well outside the first year target range of 7-11 per cent. I said in November that I expected it to slow down in the new year. Recent figures, including the preliminary figures for banking February, published today, are fully consistent with that.

MONETARY GROWTH IN 1980-81

The first reason for rapid monetary growth over the year is the abolition of the so-called corset. That was long overdue. All that the corset achieved was to make the published figures artificially low. since its removal last summer those distortions have been reversed, and the figures have been artificially high. By their very nature, such distortions are impossible to measure accurately. They are likely to have been substantial. But purely statistical changes have no implications for future inflation. The distortions have now largely worked their way out of the system. In that respect, sterling M3 will from now on be a better measure.

Again, the growth of sterling M3 was increased last year by the special nature of the recession. Public borrowing increases in a recession, but that is normally offset by lower private sector borrowing. Over the past 12 months,. public borrowing has been exceptionally high. But on this occasion bank lending did not fall away as quickly as might have been expected.

Because of the exceptional imbalance between business and personal incomes, both sectors, for different reasons, have borrowed heavily. Faced with an unexpectedly severe recession and the consequences of previous pay increases, businesses borrowed to tide them over while they reduced costs. Many people, on the other hand, have seen their living standards rise to an extent unusual in a recession, and have been willing and able to borrow as well. The combined effect of that borrowing has been an important expansionary influence on sterling M3.

At the same time, there has been a high level of private investment in financial assets. That can be seen as an attempt by the private sector to rebuild its holdings of such assets, whose purchasing power had been sharply eroded by inflation. It has included an increase in holdings of interest-bearing money. But to the extent that it merely involves returning towards a more normal level of financial assets it need not fuel inflation.

Other indicators also suggest that the underlying financial conditions have as the Government intended, been tight. Our Green Paper on monetary control, published a year ago, stressed the need to watch a range of measures of monetary conditions. Over the past 18 months, the narrower measures of money have not grown at all rapidly. The pound has certainly been higher than would be expected from the behaviour of the money supply. That external pressure has reinforced the monetary squeeze and contributed to the fall in inflation. And inflation has fallen so much relative to interest rates that the real cost of borrowing has risen significantly.

Financial behaviour should now revert to a more normal pattern. The private sector has been moderating its borrowing from the banks, and the exceptionally rapid build-up of personal sector liquidity should come to an end as the growth of prices and incomes continues to slow down.

THE MEDIUM-TERM STRATEGY AND THE TAR[illegible] 1981-82

It is important to express the medium-term [illegible] terms of a wide measure of money, because it [illegible] links with public spending and borrowing. [illegible] maintaining continuity by keeping sterling M[illegible] yardstick for medium-term policy. The aim [illegible] reduce monetary growth to 4-8 per cent. by 198[illegible] new target range for next year, based on the act[illegible] for sterlingM3 in banking February, will be an [illegible] of 6-10 per cent. over the 14 months to April [illegible]

The special factors at work last year are unli[illegible] repeated. In any event, they should have n[illegible] implications for future inflation. But we cannot [illegible] that they were the only causes of the rapid grow[illegible] money supply. So it may be desirable to recove[illegible] the past year's high monetary growth in the form[illegible] growth over the medium term. But the most [illegible] requirement is a lower growth of the broad me[illegible] money in the years ahead.

However, the short-term response of sterli[illegible] interest rate changes is particularly uncertain an[illegible] effect can be spread over many months. The [illegible] measures, which we also monitor, include fewe[illegible] bearing types of money and are more sensitive to [illegible] in interest rates. But because they are so sensitive, [illegible] overstate the effect of interest rate changes on u[illegible] monetary conditions. Moreover, their relationshi[illegible] aspects of policy is less clear.

I am taking steps, therefore to improve the in[illegible] available about the narrower measures. Publi[illegible] figures for monetary base will begin later thi[illegible] Arrangements for a new statistical series for [illegible] deposits of the banking system, M2 are [illegible] advanced. That will be publishted later this yea[illegible]

We shall continue to monitor M1. In doing so [illegible] take account of its normal tendency to grow q[illegible] nominal interest rates come down with inflation. [illegible] reason we may now find M1 growing rather fas[illegible] time, than it did last year.

PUBLIC SECTOR BORROWING

I turn next to the public sector borrowing require[illegible] PSBR. Some people, I know, are tempted to re[illegible] PSBR as something mystical, of interest [illegible] economists. How I wish that they were right. But [illegible] is not true. The size of public borrowing is, as it [illegible] a critically important constraint, for Governmen[illegible] different from individuals. The PSBR, in plain l[illegible] is broadly the difference between what the Gov[illegible] spends, or lends to others, and what they co[illegible] revenue, mainly through taxation. It necessarily [illegible] what the nationalised industries borrow. Most [illegible] comes from the Government and where they borr[illegible] other sources, the Government stands behind them[illegible] PSBR is the amount central and local Governmen[illegible] public corporations have to borrow. It is the expe[illegible] Governments around the world that if they try to [illegible] too much either interest rates or inflation, or bo[illegible] to soar.

Britain's experience tells the same story. If w[illegible] stay on course for lower inflation and lower inter[illegible] then we must borrow less. Public borrowi[illegible] proportion of national income must be brought do[illegible] is why the medium term financial strategy env[illegible]

SMOOTHING THE FLOW OF REVENUE

I am proposing some new measures which will help short-term monetary management by smoothing the uneven flow of tax revenue. The most important area is that of North Sea oil taxation, to which I shall come later. Other proposals will be described by my hon. and learned Friend the Minister of State later in this debate, if he is fortunate enough to catch your eye, Mr. Speaker.

MONETARY CONTROL

These initiatives will be accompanied by other improvements in monetary control. Following extensive consultations based on last year's Green Paper I outlined last November some changes that were desirable in their own right and would be consistent with a gradual evolution to monetary base control. These will come into effect during the coming financial year.

The reserve asset ratio has complicated monetary control. The first step in phasing it out was made in January. In the next month or two, at the conclusion of talks now to be undertaken with the banks, the ratio will cease to be a minimum requirement. Thereafter it will be adapted to have a transitional role as a prudential norm round which there will be variation, until the detail of the new arrangements has been settled.

The Bank of England has already made some useful changes in its money market operations. In its dealings with the discount houses it now relies mainly on buying and selling bills. Direct lending to the market has been greatly reduced. The interest rate on this lending is also now generally somewhat above comparable market rates, while the rates at which the Bank conducts its open market operations have become more flexible. In conducting its operations in bills the Bank no longer quotes rates for more than one month ahead. Instead, it responds to bids and offers. This has the great advantage of allowing the market a greater role in determining the structure of short-term interest rates.

Discussions are now to take place with the financial institutions about these and other changes, including the future of the cash ratio. When they are complete, the Bank will aim to keep very short-term interest rates within an unpublished band, and in due course suspend altogeher the practice of having an announced MLR, which would by then have lost its operational significance.

Decisions about short-term interests rates will continue to take account of the whole range of monetary indicators referred to earlier and other factors that affect the significance of the numbers, especially the progress of inflation. Modest reductions in interest rates were made in the second half of last year. Progress in reducing inflation, strongly positive real interest rates, a noticeable slackening in the growth of sterling M3 in recent months, and a marked fall-off in bank lending point towards a further reduction in rates. The increases in taxation that I am proposing in the Budget will make it possible to have an immediate reduction. Accordingly, the Bank of England is today, with my approval, reducing its minimum lending rate by two percentage points.

PUBLIC EXPENDITURE

Further progress towards lower inflation interest rates does not depend primarily on imp in funding techniques or in managing the mone important though these are. The overriding n more effective restraint of public spending. In th public expenditure has put a severe strain on th Much of the increased spending has been caus effects of the recession being worse than expect has been an increase of £¾ billion in spe unemployment benefit and on special em measures, notably the temporary short-time scheme. On many central Government prograr expected shortfall in expenditure has not happen the total has been higher than expected.

The recession has also—inevitably—had a effect on the financial situation of most na industries. It has meant an increase in the total industries' external financing limits for 1980-81 £900 million, over half of which has been for industry. Some of the nationalised industries taking steps to reduce the overmanning and inc which have built up over the years. But that too more money initially.

These, however, have not been the only s upward pressure. On defence there has been su overspending—to the tune of £260 million— above a cash limit that had already been increased million. Local authorities' total cash spending a have been a good deal higher than allowed in Budget—and the position would have been muc without the firm action taken by my right hon. F Secretary of State for the Environment.

Because of all these developments we have able, in the course of 1980-81, to secure the full 5 cut at which we were aiming in our predecessors' volume of expenditure. We have nevertheless ac reduction of about 3½ per cent.—or £3½ billion. M since the Government came into office numbers e in the Civil Service have fallen by 35,000, an equivalent of about 40,000 full-time staff government.

THE COMING YEAR

In the coming year, some of the upward pres public sector spending are bound to remain with u in mind, for example, last November's decision more on industrial support and on special emp measures to ease the effects of recession. Next cost of special employment measures will be no l £1 billion. This will make it possible to offe unemployed school leaver a place on the opportunites programme by Christmas. And we offer other 16 and 17-year-olds, unemployed f months, places within a further three months. 440,000 opportunities will be offered—twice as in 1979-80. In addition, the temporary short-time compensation scheme is currently supporting 700,000 people.

However, this need to spend more on programmes cannot justify accepting the wron balance. That is why we took the decisions announced last November to reduce most Government's other programmes by £1,400 millio Those substantial cuts will go a good deal of the

<u>MINIMUM LENDING RATE</u>

<u>Why has MLR ceased to be posted?</u>

It is an essential feature of the new arrangements that the Bank should not, as a matter of course, announce in advance the rates at which it will deal in the money market. By changing from a posted rate to an undisclosed band we shall allow the market a greater role in determining interest rates.

<u>What does this mean to borrowers, whether companies or individuals?</u>

The suspension of MLR will in itself have no effect. Banks will still set their base rates, and associated rates for all borrowers, in the same way as before e.g. in relation to their cost of funds. In essence the change is simply that the Bank will no longer announce in advance the rates at which it will deal in short-term money.

<u>Does the suspension of MLR mean base rates will rise?</u>

No. Nothing in what we announce on the structure of monetary control today carries any implications for the <u>level</u> of interest rates. But the banks and other financial institutions will need to make their own judgments to a greater extent than before.

<u>Will interest rates be more volatile than in the past?</u>

Possibly. We don't expect to see anything like the volatility seen in the US. Our system is ~~quite~~ different (see Q and A on US-UK differences). But it is likely that there will be more frequent moves in both directions. This is a good thing if it removes the bias for delay, and improves our ability to control monetary growth.

<u>What kind of circumstances would require advance announcement of the minimum rate at which the Bank would deal?</u>

There are a number of possible circumstances in which the Authorities might wish to announce in advance that rates are to be moved up or down. As part of a Budget or package of economic measures, for example. Or perhaps as a response to rapid movement in the exchange rate. It is clearly sensible to retain a backup power to signal dealing rates in advance.

Is MLR not used in legislation?

There are very few cases where legislative provisions depend exclusively on MLR. Where necessary amending orders will be brought forward in due course.

What about the use of MLR in contracts?

This is a matter for the contracting parties, who must reach agreement on an alternative reference rate. It may be that interbank rates provide the most appropriate benchmark. The Bank of England will of course be ready to help in any way they can by advising on the choice of suitable rates but will not be publishing any new alternative interest rate series for this purpose.

MONETARY BASE CONTROL

Has any decision been taken about Monetary Base Control?

No. There remain considerable uncertainties about the way in which an MBC system would operate in the UK and, indeed, what the advantages of such a system might be. The new system will allow us to learn more about MBC, though that is not the main objective of this change.

What do the new arrangements enable you to learn relevant to a decision on MBC?

The banks will now voluntarily be holding operational cash balances whereas in the past they were constrained by the cash ratio, and levels of bank balances did not necessarily reveal anything about the banks demand for base money. Over time, therefore, we shall now begin to build up a picture of the behaviour of the base and its relation to the other aggregates, and inflation.

Will the new system be like the US arrangements?

No. The difference is that the US authorities operate a quantity-based system. They estimate an amount of intervention (non borrowed reserves) consistent with their targets for growth in the monetary aggregates, and interest rates must then find their level consistent with the amount of intervention, within the limit of a range that is very wide.

THE BANK'S INCOME

<u>Will the new arrangements allow the Bank to make an even larger profit as all deposit taking institutions and not just the clearers are required to hold non-interest-bearing deposits? (This year's gross profit figure was £47 million up from £19 million in 1980.)</u>

The provisions set out in the Bank's paper on monetary control issued today have been designed to provide, initially, broadly the same amount of non-interest-bearing balances (operational and non-operational combined) as did the previous arrangements with the London clearing banks alone.

(Questions on the Bank's income should of course be referred to the Bank if possible.)

PRUDENTIAL CONSIDERATIONS

Does the abolition of the Reserve Asset Ratio weaken the Bank's prudential control?

No. The RAR was not intended primarily as an instrument of prudential control. Prudential supervision by the Bank under the Banking Act 1979 of all deposit-taking institutions will remain unaffected. The Bank will continue to ensure that all such institutions maintain adequate liquidity to meet their obligations. Those institutions to which the RAR applied have given the assurances mentioned in the Budget speech that they will discuss with the Bank in advance changes in their policies for the management of their liquidity and its composition.

A new prudential regime?

The Bank is resuming discussions with the banks on a new prudential régime, on the basis of a new paper on liquidity measurement.

OTHER ISSUES

<u>The Budget Speech referred to a new statistical series for the deposits of the banking system - M2. Is this going ahead?</u>

Yes. Agreement has been reached with the banks on the basis of the new series. Publication will begin later this year.

<u>What about the new short gilt</u>?

Work is continuing on the appropriate characteristics of a new short-term Government funding instrument. But no firm decision on its issue has yet been reached.

MR MONCK

NEW MONETARY SECTOR: IMPLICATIONS FOR £M3 TARGET

I have spoken to Mr Foot who has relayed the following from Mr Coleby.

(i) The provisions paper still contains the reference in para 22 "As soon as possible thereafter (probably in respect of make up day in banking November) currently reporting institutions will be asked to produce figures for one reporting date both on the basis used hitherto and on the basis of the enlarged list of institutions comprising the new monetary sector." Seventy institutions not on the list will join the reporting network. This cannot be retrieved - 4,000 copies have been printed and are ready for distribution (final version attached).

(ii) There is no reference in the Bank's Press Notice or Notes to Editors to the date of the transition and Bank briefing will be very low key and stress that no final commitment has been made.

(iii) To delay beyond November would cause an outcry.

(a) it would delay the date at which the new institutions begin paying the "tax".

(b) those paying would complain first about the inequity of this and secondly that the quantum on which their balances was being calculated was not correct, i.e. no allowance was being made for funds deposited with the new entrants.

The Bank very much hope the question can be put aside for today. They see no reason why it has to be settled right now.

p.p. A TURNBULL
5 August 1981

MONETARY CONTROL - PROVISIONS

Introduction

1 On 24 November 1980, the Bank published a Background Note describing a number of improvements to be made to the existing framework of monetary control. On 12 March this year, in a paper entitled "Monetary control: next steps", more detailed proposals on a number of the subjects covered in the Background Note were sent to all recognised banks and licensed deposit-takers (LDTs). The present paper sets out the provisions resulting from discussions since then with the various associations, as well as with a number of individual institutions.

The cash ratio

2 A substantial part of the Bank's resources and income in recent years has been provided by the average of 1 1/2% of Eligible Liabilities (ELs) maintained by the London clearing banks in non-interest-bearing accounts at the Bank. This sum has also served as a fulcrum for money market management. The Bank's paper in March proposed that this latter purpose should in future be served by the volume of operational funds which the London clearing banks would retain voluntarily at the Bank for clearing purposes, while the Bank's resources and income should additionally be secured primarily by a uniform requirement on all banks and LDTs to hold non-operational, non-interest-bearing deposits with the Bank. The provisions set out in this section have accordingly been designed to provide, in aggregate, broadly the same amount of non-interest-bearing funds initially as did the previous arrangements with the London clearing banks alone.

3 This non-operational requirement will be 1/2% of an institution's ELs and will apply to institutions covered in paragraph 16(i)-(iii) below having ELs which average £10 million or more in the latest period over which the requirement is calculated. The level of an institution's non-operational balance will be set twice a year in relation to its average ELs in the previous six months[1].

---

[1] A deposit calculated in, say, May would relate to the monthly average of ELs from November to April inclusive.

4 For institutions not on the present statistical list of banks and whose business mainly comprises the provision of fixed rate finance for periods in excess of one year, the Bank accepts that the introduction of the 1/2% cash ratio may present a special transitional problem. The Bank will be prepared to consider individual representations from such institutions for some temporary alleviation of the requirement. In addition, in recognition of the special conditions in Northern Ireland, the Bank has reduced to 1/4% the cash ratio to be observed by institutions for which Northern Ireland is the principal place of business in the United Kingdom. This concession will apply in respect only of the ELs of their Northern Ireland offices and will run for two years, when it will be reviewed.

5 ELs are to be redefined to reflect the changes set out in this paper. In future, offsets will be allowed in the calculation of ELs in respect of:

(i) funds (other than cash ratio deposits or Special Deposits placed with the Bank) lent by one institution in the newly defined monetary sector[1] to any other;

(ii) money at call placed with money brokers and gilt-edged jobbers in the Stock Exchange, and secured on gilt-edged stocks, Treasury bills, local authority bills and eligible bank bills.

6 ELs will be calculated in uniform fashion for all reporting institutions[2] except:

(i) members of the London Discount Market Association (LDMA), whose ELs will be calculated as the total of sterling deposits other than from institutions within the monetary sector and from money-brokers and gilt-edged jobbers in the Stock Exchange.

(ii) certain banks with money trading departments, who will be allowed to omit from their ELs secured money at call placed by other banks with these departments, up to a limit set by the Bank.[3]

---

[1] See paragraph 16 below.

[2] The present arrangements for those finance houses which have observed a 10% reserve asset ratio since 1971 will lapse accordingly.

[3] The banks concerned are: Algemene Bank Nederland, Banque Belge, Charterhouse Japhet, Leopold Joseph and Samuel Montagu. Hitherto, funds placed on this basis, up to a limit set by the Bank, have counted as reserve assets.

Undertakings by eligible banks

11 From 20 August 1981, each eligible bank undertakes to maintain secured money with members of the LDMA and/or secured call money with money brokers and gilt-edged jobbers[1] - all at market rates appropriate to the nature of the lending - such that:

(i) the total funds so held normally average 6% of that bank's ELs (as defined in paragraph 5);

(ii) the amount held in the form of secured money with members of the LDMA does not normally fall below 4% of ELs (as defined in paragraph 5) on any day.

12 In relation to the above undertaking, each eligible bank will

(i) aim to meet the daily average ratio over either six or twelve month periods (having first notified the Bank of its choice of period), the ratio on any particular day in a banking month being calculated as a proportion of ELs at the last but one make-up day.[2]

and

(ii) to provide monthly returns of its daily figures, which the Bank will use to assess the bank's performance relative to its long-term commitment.

A bank will go below the minimum only in exceptional circumstances and will be ready to explain such action to the Bank when the relevant monthly return is made.

13 The Bank will be prepared to review these undertakings, in consultation with eligible banks and the LDMA, when sufficient experience of the operation of the arrangements has been gained, covering at least a year. The Bank will also be prepared to discuss particular difficulties, as they arise, with any party to the arrangements.

---

[1] The Bank's concern with the adequate availability of funds for the efficient functioning of the gilt-edged market was noted in "Monetary control: next steps". There are six recognised money-brokers - James Capel & Co, Cazenove & Co, Hoare Govett (Moneybroking) Limited, Laurie Milbank & Co, Rowe & Pitman Money Broking and Sheppards and Chase. Secured call money with these firms has hitherto counted as a reserve asset. The amount of such money which these firms can take will continue to be limited by the Bank.

[2] For example, the relevant ELs figure for each day in banking September will be those as at make-up day in banking July.

Prudential considerations

14 The Bank has received the assurances required in its paper of 12 March "The liquidity of banks", and mentioned in the Chancellor's Budget Speech, that those institutions in the United Kingdom to whom the reserve asset ratio has applied will discuss with the Bank, in advance, changes in their policies for the management of their liquidity and its composition. The Bank is resuming discussions with the banks on the measurement of liquidity as the basis for continuing supervision.

Statistical changes

15 The present banking sector, as defined for the purposes of calculating the monetary aggregates, contains those institutions included in the statistical list of banks and the list of discount market institutions. These lists were drawn up prior to the Banking Act and are no longer appropriate to current circumstances. They exclude a number of recognised banks, many LDTs, and also the trustee savings banks[1] (who will become subject to cash ratio and Special Deposit requirements when they are authorised under the Banking Act).

16 A new monetary sector will therefore be defined, to include

(i) all recognised banks and LDTs;

(ii) National Girobank;

(iii) those banks in the Channel Islands and the Isle of Man which opt to join the cash ratio scheme described earlier in this paper;

(iv) the trustee savings banks (TSBs);

(v) the Banking Department of the Bank.

17 Although the population of the monetary sector will be considerably larger than that of the "statistical list", the statistical effect will be comparatively modest since the present business of many of the new contributors is relatively small. In total, the

---

[1] The Central Trustee Savings Bank (CTSB) is a recognised bank.

initial once-for-all adjustment to the stock of the main monetary aggregate, £M3, will probably be of the order of £8 billion (13%), of which the TSBs account for around £6 billion (9 1/2%).

18 Institutions in the monetary sector having either eligible liabilities totalling £10 million or more, or a balance sheet of £100 million or more, will be asked to supply the full range of statistics (comprising both the monthly and other returns); other institutions will be asked to report only at end-calendar quarters.[1]

The timetable for change and the transitional arrangements

19 The essential features of the new arrangements can be brought rapidly into effect. This section sets out the sequence of developments.

20 On 20 August 1981:

(i) the Reserve Asset Ratio will be abolished;

(ii) the acceptances of all banks in the first list (attached) of eligible banks will become eligible for discount at the Bank;

(iii) all the banks covered in (ii) above will begin to observe the undertakings set out in paragraph 11 above;

(iv) the agreement with the London clearing banks, whereby they keep an average of 1 1/2% of their ELs at the Bank, will lapse;

(v) the Bank will receive the first deposits under the cash ratio requirement.

21 On this date, the first cash deposits will be placed by institutions on the present statistical list of banks and by members of the LDMA; the statistics necessary to include other institutions are not yet available. These initial deposits will relate to the average of institutions' ELs on the monthly make-up days in the period January-June 1981 inclusive, ELs being defined on a transitional basis: ie calculated for 'statistical banks' as at present except that offsets will be allowed in respect of all lending to the discount market and all secured money

[1] The TSBs will continue, for the time being, to make returns on the existing consolidated basis.

at call placed with money-brokers and gilt-edged jobbers and money-trading banks.[1] These initial deposits will remain unchanged until sufficient figures using the new definition of ELs are available (see paragraph 22 below). Thereafter, these deposits will be adjusted every six months. The undertakings by eligible banks as set out in paragraph 11 will take effect on 20 August 1981, based on the transitional definition of ELs and in respect of their level as at 15 July.

22 As soon as possible thereafter, (probably in respect of the make-up day in banking November) currently reporting institutions will be asked to produce figures for one reporting date both on the basis used hitherto and on the basis of the enlarged list of institutions comprising the new monetary sector. At the same time, those seventy or so institutions which are not currently on the statistical list of banks and which are above the cut-off points for full statistical reporting will join the full reporting network. They will be asked to place cash deposits with the Bank when two months' figures have been obtained, if their ELs are £10 million or more on average.

23 Monetary aggregates will be calculated on both bases for this one reporting date; thereafter statistics will only be collected on the basis of the new monetary sector.

24 The remaining institutions not currently reporting and below the cut-off points set out in paragraph 18 will be brought into the reporting network only when the current review of banking statistics has been completed (which is unlikely to be before the second half of 1982).

---

[1] The Bank can calculate these offsets for listed banks from statistics already provided. The ELs of members of the LDMA will be calculated as set out in paragraph 6 above, except that no allowance will be possible in this transitional period for deposits by money-brokers and gilt-edged jobbers in the Stock Exchange.

SUBJECT
cc. Master

CONFIDENTIAL

cc BE
AW
Econ Pol

10 DOWNING STREET

From the Private Secretary

3 August, 1981.

Dear John,

The Prime Minister held a seminar on monetary control here on Friday afternoon. The following were present: Chancellor of the Exchequer, Financial Secretary, Governor and Deputy Governor of the Bank of England, Sir Robert Armstrong, Sir Douglas Wass, and Messrs. Burns, Middleton, Monck , Britton, Fforde, George, Coleby and Walters. They had before them the papers circulated by Mr. Middleton on 24 July.

The seminar first discussed the new arrangements for improved monetary control due to come into operation on 20 August. Mr. Middleton said that they were agreed between the Bank, the Treasury, and Mr. Walters, including the suspension of MLR. The Govenor confirmed that this was the case. On the question of MLR, the Bank's view was that a continuous posted lending rate would be inconsistent with the other elements in the new system. At the same time, there would still be some occasions - for example, at the time of major economic policy change or pressure on the exchange rate - when the authorities might want to signal the minimum rate at which they would be prepared to lend to the market. The suspension of MLR would mean that the authorities would have less control over interest rates generally; for example, in current market conditions it would make an early increase in base rates rather more likely. In addition, the market would - at least initially - be unhappy with the greater uncertainty that the suspension of MLR would entail. It would be looking even more closely than ever at the authorities' actions for evidence of their intentions.

The Chancellor said that the Treasury had no difficulty with the proposition that, in certain special circumstances, the authorities would need to give an advance signal to the market on the rate at which they would lend. In response to a comment from the Prime Minister tha it might have been desirable to have retained a greater measure of influence over base rates, the Financial Secretary said that one of the purposes of suspending MLR was precisely to reduce the influence of the authorities, and increase that of the market, over the determination of interest rates. In future, there should be less biased delay in the movement of interest rates, and this should make monetary control easier. Sir Douglas Wass added that it would be vital in future, if the market was to play a bigger role, for Ministers to refuse to answer specific questions about interest rates.

/ The

CONFIDENTIAL

The Prime Minister said she accepted it was worth losing influence over interest rates if that would mean an improvement in monetary control. But in that case, with a rise in base rates now more likely, it was important to ensure that the resultant higher bank profits would also be reflected in a higher tax take. The Financial Secretary commented that the banks were already paying a special tax in 1981/82; the question of their future taxation would be covered in the Green Paper on Corporation Tax.

The Prime Minister noted that it was intended to announce the new arrangements on 5 August in separate statements from the Treasury and the Bank. She asked whether Parliament might not resent the announcement immediately after the start of the recess. The Chancellor said that all of the arrangements had been foreshadowed by statements he had already made in the House. He did not believe there would be any criticism.

The discussion then turned to the question of how the interest rate band should be set. There were two main options: <u>either</u> to set the band on the basis set out in the Budget - i.e., with regard to both the movement of £M3 compared with its annual target and to other factors such as the movement of the narrower monetary aggregates and other indicators of inflationary conditions; <u>or</u> to set the band with regard to M_1 or the wide monetary base, M_o.

It was argued that, although the M_3 figures were heavily distorted by the civil service strike, it would be a mistake to shift from the formula set out in the Budget. M_3 had been chosen as the target variable for good policy reasons. A shift to reliance on M_1 (which would itself be preferable on merits to M_o) would involve a more restrictive policy stance if the 6-10% target for 1981/82 were to remain unchanged, because M_1 was now rising faster than M_3. Furthermore, any change would cause confusion in the market. On the other hand, it was argued that the current distortionsin both the M_3 and M_1 figures were so large that it would be sensible to have greater regard for M_o. Against this, it was pointed out that the authorities were relying on adjusted M_3 figures which took into account the estimated effects of the strike, and the distortions were likely to have disappeared by the end of 1981/82.

Summing up, the Prime Minister said that the new arrangements, including the suspension of MLR, should be introduced on 20 August as proposed, and announced on 5 August. The question of whether to move in due course to a system of monetary base control should be kept open. Of the two options for setting the interest rate band, they were agreed that it should be done on the basis set out in the Budget. While the current and prospective trend of £M3 (for the time being in adjusted form) would be the primary determinant, other factors - including M_1, M_o, the exchange rate, the real level of interest rates, and general inflationary conditions - should be taken into account. In making the announcement on 5 August, attention should be given to ensuring that it was understood

/ both

both by the experts and by the public generally: it was particularly important that the latter properly understood why MLR was being suspended. Finally, the Treasury should keep under review the taxation of bank profits so as to ensure that the Exchequer obtained an adequate increase in tax take if bank profits increased again in response to rising interest rates.

I am sending a copy of this letter to Tim Allen (Governor's Office) and David Wright (Cabinet Office).

Yours ever,

Tim Lankester

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

c.c. Master
Ops

CONFIDENTIAL

10 DOWNING STREET

cc: Mr Walters
Mr Wolfson
Mr Duguid
Mr Ingham

THE PRIME MINISTER

Personal Minute

No. M 8/81

CHANCELLOR OF THE EXCHEQUER

MONETARY CONTROL

It is now more than six months since the new measures for monetary control were announced in the November 1980 statement. The last progress report was in January. I understand that, since then, considerable progress has been made; but my impression is that it has not been quite as rapid as you had originally envisaged.

For example, in the first place, it seems that the Reserve Asset Requirement still remains in place. It was envisaged in the progress report that it would be abolished by the Budget.

Secondly, I understand that the Bank still have not been able to abolish the 1½ per cent cash ratio and introduce the new ½ per cent reserve requirement which was announced at the time of the Budget.

Thirdly, it was envisaged in the progress report that the various changes in money market management and in the Bank's role as lender of last resort (including, I thought, the abolition of MLR) could be implemented at Budget time. I understand that progress has been made in that the Bank has

CONFIDENTIAL

substantially reduced its discount window lending and is now operating primarily through open market operations; but the interest rate band apparently still remains to be put into effect, and MLR is still with us.

Fourthly, possible new funding techniques were being studied by a Treasury/Bank committee. I am not clear what has emerged from this work.

I am told that you now envisage making the new measures fully operational by August. I understand that we would then be in a position to move to Monetary Base Control if we so wished. I can only say that I very much hope that the programme does not slip any further. Although I know you have misgivings about a [illegible] move to MBC, I am more than ever convinced - especially after my conversations with Dr. Zijlstra - that we must change over to some such system of quantitative control and sooner rather than later. I believe MBC could be introduced and implemented provided it includes a suitable discretionary element.

I would like to hold a stock-taking seminar before the Recess, and my office will be in touch with yours to arrange thi[s].

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

Margaret Thatcher

4 June, 1981

2.

O1Ro.

Secretary of State for Industry

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

CF

31 July 1981

Mike Pattison Esq
Private Secretary to the
Prime Minister
10 Downing Street
London SW1

Prime Minister

MAP 31/VII

Dear Mike

PROFESSOR ROSE

As you know, my Secretary of State has gone into hospital but before he went he asked me to ensure that the Prime Minister's attention is drawn to the attached article which Professor Harold Rose, who acts as Sir Keith's occasional economic adviser, has submitted to the Times. The Times have apparently "lost" the original copy of the article which was submitted to them but Professor Rose is continuing to press for publication.

I am copying this letter to Professor Walters, to Peter Jenkins (Treasury) and to David Hayhoe (CDL).

Yours ever

Ian

I K C ELLISON
Private Secretary

BARCLAYS

PROFESSOR H. B. ROSE
GROUP ECONOMIC ADVISER

BARCLAYS BANK LIMITED
54 Lombard Street London, EC3P 3AH
Telephone: 01-626 1567

27 July 1981

Sir Keith Joseph
Secretary of State for Industry
Department of Industry
Ashdown House
123 Victoria Street
LONDON SW1E 6RB

Dear Secretary of State,

The Times apparently lost the article that I was asked to write, and I do not know whether it will ever see the light of day. However, you asked for a copy, which I am enclosing. It says nothing new.

A further - political - point that might be worth making is that, whatever the merits of the case for incomes policy, and they are few, the proposed change in the Labour Party's method of electing its Leader, which gives the trade unions more ~~powers~~ power, makes it most unlikely that the Labour Party would ever dare to restrain the trade unions for long. Perhaps the Party, and especially Mr Healey, could be challenged by reference to this aspect of the Labour Party's coy statement and to Mr Healey's evasiveness, in particular, on incomes policy.

I note that today's Telegraph (Economic Commentary - page 14) contains yet another reference to work by reputable economists on the responsibility of real-wage resistance for the growth in unemployment.

Good luck.

Yours ever,

Harold

Cc to Hans Liesner

THE DEATH OF MONETARISM?

David Blake, The Times' Economics Editor, alleges that "monetarism" has failed in Britain, that other countries have rejected the policy and that the 1980's will see the theory "pushed back in to the economic history section of the world's textbooks" (The Times, 15 July). These two last contentions are contradicted by the statement accepted by Ministers attending the June OECD meeting that: "In all countries monetary and fiscal policies need to remain steadfastly non-accommodating, conducted with a medium-term focus and in a complementary fashion so as to avoid financial market pressures".

No better summary could be made of the basic monetarist prescription. Indeed, it reads like an advertisment for the Government's Medium-Term Financial Strategy; and if the OECD communique is representative, far from Mr. Blake being right, "we are all monetarists now", if by monetarism is meant merely a belief in the need for sustained monetary restraint.

In Britain "monetarism" and "anti-monetarism" have become associated with political conflict. In other countries this is not so, and there the existence of a link between money supply growth and future inflation is in less dispute. Of course there is professional disagreement over the timing and predictability of that link and over the pace at which money supply growth should be reduced; but this is equally true of other policy instruments. Exaggerated claims tend to be made for all policies.

The most controversial question remains the extent to which the effect of monetary restriction falls on output and employment in the short- run as well on prices and wages. This question turns on the so-called flexibility of the latter, "so-called" because what is at issue today is the extent to which the rate of increase of prices and wages can be reduced, and not, as in the interwar Keynesian debate, their absolute level. Monetarists are usually well in the van of those calling for supplementary policies to make labour and other markets more competitive and flexible, as the letter by Lord Harris (23 July) makes plain. The now-familiar contention that "monetarism is not enough" does not mean that "monetarism is unnecessary". The real criticism that should be levelled at the Government's policy, apart from its mistaken tactics in 1979, is that it has moved too slowly in the direction of union law reform and of the removal of other obstacles to a competitive labour market. It is this, rather than an excessively tight monetary policy, that has made unemployment unnecessarily high.

Indeed, after allowing for the effects of the "corset", no significant deceleration is discernible at all in the wider monetary aggregates during 1979 and 1980. The control of the money supply has undoubtedly proved more difficult than many had expected. Those who believe that policy was tighter than the statistics suggest argue that the rise in interest rates in 1979-80 itself led investors to want to hold more interest-bearing deposits, which account for over 50 per cent of sterling M3. If more attention had been directed at the margin between deposit rates and yields on competing assets, the argument runs, the absolute level of rates as a whole need not have been so high.

This may be so, but in real terms short-term rates did not become positive at all until the spring of 1980 and remained high for only a matter of months. Moreover, monetarists would argue that interest rates also rose to high levels because of the Government's failure to reduce its 'discretionary' expenditure. The link between government borrowing and interest rates may be denied by anti-monetarists but is not by OECD Ministers, judging by the statements made both at the June meeting in Paris and, more recently, at Ottawa.

Mr Blake's contention that "monetarism" has failed is presumably not directed at our inflation rate, which until the drop in the exchange rate had fallen faster than had been widely predicted. Moreover, one should note the contrast between the price increase of some 20 per cent still prevailing in the public sector and the figure of about 7 per cent for private sector goods and services. Even allowing for the impact of special factors such as energy prices, the contrast is indicative of where the most important obstacles to wage and price adjustments really lie.

The allegation that "monetarism" bears the major responsibility for Britain's appallingly high unemployment looks misplaced in the light of the moderate degree of monetary restriction actually achieved. Today's unemployment is partly the result of a long history of indifferent management, union restrictive practices and structural decline, culminating in a long overdue reduction of excess manning. The exchange rate floated upwards on North Sea oil, and the world recession is now delaying economic recovery. The main direct cause, however, was the 22 per cent increase in wages in the 1979-80 pay round. This not only confronted the Government, like its predecessor, with the need to pursue restrictive policies but also brought about a fall in industrial profitability from a level that was already low. The most important avoidable cause of the increase in Britain's unemployment - which rose by 750,000 even with relatively little demanning under the last Government - has been the excessive rise in <u>real</u> wages following the oil price shocks of 1973 and 1979.

According to OECD, a fall in real pre-tax wages of 5-6 per cent, relative to labour productivity, is needed in Britain merely to return the share of profits in national income to its low level at the beginning of 1978. No policy that fails to do this will reduce unemployment for long. The crucial role of real wages is probably accepted by most anti-monetarist economists, but they are doing a dis-service to the unemployed by not declaring openly that it is union wage pressure rather than monetary restraint as such that is at bottom responsible for the plight of the unemployed.

Instead, anti-monetarist economists and journalists seem content to assume the implementation of effective incomes policies - which are merely one way of checking union power - without saying how they can be sustained (and by means that do not reduce productivity as well). It is sometimes argued that unions will agree to an incomes policy to avoid a mutually frustrating wage race; but this is not so. The TUC-Labour Party statement on reflationary policy calls for price controls but is significantly evasive regarding wage restraint, a combination that could only aggravate the problem of profitability and unemployment. It is to this quarter that The Times should be directing its funeral oration.

Harold Rose
London Business School

2

MR MIDDLETON

cc Chancellor
Financial Secretary
Sir Douglas Wass
Mr Burns
Mr Ryrie
Mr Kemp
Mr Monck
Mr Britton
Mr Turnbull
Mr Shields
Mr H Davies
Mr Lankester - No 10

Prime Minister
Confirmation that M3 grew by 2.2% in banking July.
MS

JULY MONEY SUPPLY FIGURES

TL 31/7

I attach the provisional money supply figures for banking July and the Bank's draft press announcement.

2. Sterling M3 is estimated to have increased by 2.2 per cent, in line with the 'first guess' and our forecast. The Bank's press notice makes two points:

(i) that the figure was again distorted by the strike, with the CGBR being increased rather more than in previous months;

(ii) nevertheless, underlying growth in £M3 still appears to be within the target range.

Tim Lennon.

T LENNON
31 July 1981

PROVISIONAL MONETARY AGGREGATES FOR JULY

£ millions, seasonally adjusted

As usual at this stage all figures are subject to revision, particularly those affected by overseas holdings of gilts and others shown in brackets in the attached table.

1 Sterling M3 is provisionally estimated to have risen by 1,580 (2.2%), in line with both the first estimate based on weekly banks' figures and the forecast. The cumulative growth in the first five months of the target period is 17.6% at an annual rate. This figure has been distorted by the Civil Servants' dispute which is estimated to have inflated the CGBR by approximately 1,600 in July and by about 5¼ billion cumulatively to date; for growth to have been within the 6-10% target range it would be necessary for between 2 and 3 billion of this to have increased bank deposits (ie between 37% and 57%).

2 The wide monetary base showed virtually no change in July continuing a run of very low figures. It has grown at an annual rate of under 2% since February and at only 6½% over the past year. M1, which may be liable to large (and unpredictable) strike distortions, increased very sharply by 3.2% in July after falling by ½% in June. Some 390 of 1,000 increase was in interest bearing sight deposits so NIBM1 growth of 2.3% was somewhat smaller. Since mid-February NIBM1 has grown at 17.9% pa. The wider sterling liquidity aggregates also rose sharply, PSL1 by 2.2% and PSL2 by 1.6%. Growth in PSL2 over the past five months has been 16.0% pa.

3 Foreign currency deposits of UK residents, on a transactions basis showed a slight fall (-10) - the first this year. The 550 rise in the outstanding level of these deposits was due entirely to valuation. Total M3 rose by 2.6% and has risen at 26.4% pa since February.

4 The counterparts to the rise in sterling M3 are broadly similar to the pattern indicated by the weekly figures. The CGBR was 2,290, about 70% of it due to strike distortions. The direct contribution of the rest of the public sector, at -490, was heavily and surprisingly negative (almost 600 less than forecast after allowing for differences in forecast on-lending by central government). This indicates that, allowing for the strike, the underlying PSBR was low in July; although an accurate figure cannot be calculated it is hard to see how it could have been more than 4-500. Net purchases of central government debt were also relatively low at 630, but nevertheless the underlying PSBR was overfunded by some 4 or 500.

5 Sterling lending to the private sector increased by 400 nearly 200 more than forecast (no details yet available). External and foreign currency items indicate a modest inflow of 140 - lending in sterling to overseas was large (570) but largely matched by higher overseas sterling deposits (440). (Allowing for a net repayment of 60 foreign currency lending to the private sector the balance on current and capital account may have been a surplus of some 200).

Conclusion

The large increase in sterling M3 this month appears to be due mainly to:

(a) an above average strike distortion to the CGBR (some 1.6 billion compared to an average 1.2 billion in the previous 3 months);

(b) a low level of gilt-edged purchases by the non-bank private sector - only 150 compared with a monthly average of 780 over the previous eleven months (even though the underlying PSBR was substantially overfunded in July);

(c) a slight up-turn in bank lending. This may reflect a changing pattern of strike distortions - as overdrafts are paid off less of the strike effect will reduce lending and more will tend to increase deposits - but it is equally consistent with an increase in the underlying trend; there is no way of knowing which explanation is correct.

In addition, there was no movement into foreign currency deposits this month - over the previous six months they have increased by an average of 400 a month (transactions basis).

Financial Statistics and Economics Divisions (HO-4)
30 July 1981

DJR

D J Reid (4764)/W A Allen (4315)

£ millions
seasonally adjusted

PROVISIONAL DCE, STERLING M3 ETC IN BANKING JULY 1981

	Preliminary$^{\phi}$		Forecast*	
CGBR: own account	+2,091		+2,218	
on-lending to LAs	- 101		- 118	
on-lending to PCs	+ 302		+ 120	
		+2,292		+2,220
Net purchases of CG debt by non-bank private sector: (inc. -)				
Gilts	- 153		- 415	
Treasury bills	- 22		- 25	
National Savings	- 249		- 150	
TSB claim on FBS	- 1		-	
Certificates of tax deposit etc.	- 207		- 190	
		- 632		- 780
Other public sector: Local authorities	- 194		+ 140	
Public corporations	- 298		+ 160	
		- 492		+ 300
Sterling lending to the private sector:				
Bank lending to private sector	+ 586			
Issue Department commercial bills	- 183		+ 215	
		+ 403		+ 215
Sterling lending to the overseas sector:				
Bank lending to overseas sector	+ 575		+ 250	
		+ 575		+ 250
External and foreign currency finance:				
Increase in reserves (inc. +)	- 521		- 367	
Official borrowing (inc. -)	+ 259		+ 267	
Overseas purchases (-) of: gilts	(- 97)		)- 80	
treasury bills	(- 51)		)- 40	
LA debt	(+ 1)		)- 10	
Overseas sterling deposits (inc -)	- 438		- 310	
Banks' net currency deposits (inc -)	+ 283		- 100	
Seasonal adjustment	+ 125		+ 125	
		- 439		- 515
Non-deposit liabilities (inc. -)		- 131		- 125
Sterling M3		+1,576		+1,565
		+ 2.2%		+ 2.2%
DCE		+2,146		+2,205

$^{\phi}$Figures in brackets are more uncertain than other figures.
*As circulated in the Monetary Review of 15 July 1981.

2/3(a) B4

SECRET

MR TURNBULL - We discussed this. If you have any further comments I would be grateful for them by lunchtime on Monday.

D.L.
31/7

DRAFT PRESS ANNOUNCEMENT

PROVISIONAL MONEY SUPPLY AND ELIGIBLE LIABILITIES: 15 JULY 1981

Preliminary information suggests that, during the four weeks to 15 July, sterling M3 may have grown by about 2½ per cent, after seasonal adjustment. This figure was again distorted by the Civil Servants' dispute (now ended) which is thought to have increased the CGBR by rather more in July than in previous months - probably by more than £1½ billion. It is increasingly difficult to estimate how much of this added to bank deposits but during the current target period the underlying growth of sterling M3 is not thought to have been outside the 6 per cent to 10 per cent range. The preliminary figure may of course need to be revised in the light of subsequent information.

Eligible liabilities of banks in the UK rose during the month by £2,290 million (3.2%) to stand at £74,549 million. Reserve assets fell by £55 million to £8,231 million and the reserve ratio fell from 11.5 per cent to 11.0 per cent.

Bank of England
4 August 1981

CHANCELLOR

cc Financial Secretary
Sir Douglas Wass -
Mr Middleton
Mr Monck
Mr Britton
Mr Turnbull
Mrs Gilmore

MINIMUM LENDING RATE

You will have seen the piece on the front page of today's Times suggesting that you announced the abolition of MLR to the House yesterday. We have not yet discovered why the story appeared in this way. The story was also carried, though in less dramatic fashion, in the Telegraph and FT.

2. Reports of MLR's death are, of course, much exaggerated. We have been careful not to prejudge the outcome of today's seminar, and have considered carefully the terms of an announcement thereafter, covering particularly the circumstances in which we might still want to announce in advance the rate at which the Bank will deal. We have therefore today been correcting the mistaken impression given in the Times, and have rested on the wording in the PQ you answered, and on what was said in the Financial Secretary's speech yesterday in Oxford (copies attached).

3. There is a further complication of which you should be aware, though there is no reason for it to be raised at today's seminar. MLR appears as a reference interest rate in many contracts and in some legislation. The legislative problems are not great and we are in discussion with Departments about them. But the Law Society and the City Capital Markets Committee have made representations to the Bank about the need for some guidance on an alternative rate to use, if we are not to see what might be a considerable amount of litigation about the interpretation of existing contracts. The Bank have invited the Law Society to propose an alternative rate, which they might find it helpful for the Bank to validate in some way through retrospective publication in the Quarterly Bulletin.

It has been made clear, however, that we shall not be willing to publish an official rate in any way which might affect the achievement of the objectives we have in mind for the new system.

Howard Davies

H J DAVIES
31 July 1981

MR COLEBY - BY MUFAX.

ORAL

THURSDAY 30 JULY 1981

TREASURY

LA/CO - HARLOW

* 19 MR STANLEY NEWENS: TO ASK MR CHANCELLOR OF THE EXCHEQUER, IF HE WILL MAKE A STATEMENT ON THE PRESENT LEVEL OF INTEREST RATES.

SIR GEOFFREY HOWE

BOTH SHORT AND LONG TERM INTEREST RATES HAVE RISEN IN THE LAST MONTH. BUT THERE HAVE BEEN SOME SIGNS OF EASING THIS WEEK AND UK RATES REMAIN LOWER THAN THOSE PREVAILING IN THE ECONOMIES OF MANY OF OUR PRINCIPAL COMPETITORS. THE HOUSE WILL RECALL THAT MY BUDGET SPEECH FORESHADOWED A NUMBER OF CHANGES IN OUR SYSTEM OF MONETARY CONTROL, THE PRINCIPAL OBJECTIVE BEING TO ALLOW THE MARKET A GREATER ROLE IN DETERMINING THE STRUCTURE OF SHORT-TERM INTEREST RATES. RECENT DEVELOPMENTS HAVE BEGUN TO SHOW THE WAY IN WHICH THESE ARRANGEMENTS WILL OPERATE IN PRACTICE. I EXPECT THE FULL SYSTEM TO COME INTO OPERATION ON 20 AUGUST, THE FIRST DAY OF BANKING SEPTEMBER.

Extract from Financial Secretary's Speech on 30 July

"The principal objective of the new system, which will come into operation later in the summer, is to allow the market a greater role in the determination of the structure of short-term interest rates. What this means in practice is that in its day-to-day operations with the discount market the Bank will not announce in advance the rates at which it proposes to deal, but will respond to offers of bills from the discount houses.

This means, of course, that the existing MLR will lose its operational significance - indeed it has already to a large extent done so - and, as the Chancellor said, before very long it may be suspended altogether."

Chancellor's Oral Reply on 2 July

"As I explained in my Budget Statement, it is our intention to enable market forces to play a greater role in determining interest rates. Discussions on further improvements in monetary control are well advanced. The Bank has issued the final draft of the detailed provisions. When these are put into effect we shall aim to keep short-term interest rates within an unpublished band. It may then be appropriate to suspend the practice of publishing the MLR."

10 DOWNING STREET

Prime Minister

Here is the promised brief from Alan Walters.

I think it should be sufficient for you to read this and the covering note from the Treasury at Flag B.

TL.

30/7

PRIME MINISTER

Notes for the Monetary Seminar: 31 July 1981

The ultimate objective is to switch from a system of control through interest rates to a system whereby interest rates are determined by market forces and the Bank controls the money supply quantitatively using open market operations.

The medium term objective was to have "new arrangements" which allow markets to have greater influence in determining short interest rates within a moving band. The movement of the band would be determined basically, but not solely, by quantitative money supply targets. The new arrangements envisaged in the November seminar and reaffirmed in the March budget are now substantially in place.

You may feel it right to congratulate the Bank and the Treasury on getting the basic "new arrangements" working so efficiently.

- the discount window is now used only very infrequently
- interest rates (up to 14 days) have moved with market pressures within the band (2 percentage points wide)
- MLR is now otiose
- the cash ratio and RAR have been reformed

These changes have been achieved in very difficult market situations (with the fall of sterling and record high US interest rates) yet with the money supply apparently remaining under control. All the interim objectives, which you set out in the November seminar and reiterated in your minute of 4 June to the Chancellor have been achieved.

/ Although

Although the Bank was rather reluctant to give up their "signal" of the MLR (at least until the strike is over) there is now full agreement that MLR be abolished on 20 August. This move is widely expected by the markets and should cause no problems. The Bank wishes to retain some power to lead money markets by announcing the rate at which it will supply cash. Again there is agreement that, although such occasions should be rare, the Bank ought to have such residual powers.

There is no agreement, however, about the criteria which should be used for moving the unpublished interest rate bands. The Bank is not happy with the use of quantity-of-money targets, whether M3 or M1. The Bank would clearly like maximum discretion to determine the band in accordance with its view about credit conditions and sterling, etc. For the most part, the Treasury (especially Peter Middleton) would like to move the band so that it is consistent with a quantity target - and I suspect that Middleton and his group would prefer M1 as the target.

Although there is apparently inconsistency between the Bank and Treasury views, there is a possibility of reconciliation. For the quantitative targets the stress is that they be achieved in the long run (i.e. over more than a 12 month period). Within this period, in the day to day, month to month, or quarter to quarter management of the bands, there could be considerable discretion. The Bank could respond to transitory credit demands, "shortages", and to erratic movements in sterling, provided that it delivered the appropriate quantitative targets over the long period. The combination of short period discretion with long period targetting is entirely consistent with the Government's strategy.

This still leaves the issue whether primacy be accorded to M3 or M1 as the long run target for movements of the band. At present, and for at least six months ahead, this is not a live issue.

/ The

The M3 and M1 figures have been obscured by the strike. And even if the strike is settled in August, it will take some 5-6 months to unwind the effects. Meanwhile, only the monetary base is known with certainty. This shows a modest expansion of about 5% and is again consistent with the MTFS. Thus as far as we know interest rates over the past 6 months or so have been appropriate for domestic purposes. Monetary expansion seems to have been contained.

Choosing £M3 for a primary long run target would be attractive mainly in so far as it can be represented as directly consistent with the MTFS. But in view of the policy on MLR from November 1980 onwards, it is doubtful if such a policy announcement would carry much conviction. And the structural changes in credit markets (such as for example the recent incursion of banks into housing mortgages) suggest that £M3 may again provide, as during 1980, only a rather biased guide to monetary conditions.

Choosing M1 as a primary target would be better in the sense that short term interest rates have more influence on M1 than on £M3. Thus, a statement that interest rates are to be determined largely by reference to the trend in M1 would carry some conviction. (It would be very similar to the United States M1B criterion.) (But there would be the risk that £M3 and M1 would follow markedly different paths for a while, as in 1980, and this would require close monitoring and appropriate interpretation. Using M1 as a target for the band would also be a step nearer to a form of MBC. (My preference is for a long run primary target for M1. However, since all aggregate other than M_o are likely to be very obscure until the end of the year, I believe that we should watch closely M_o the wide monetary base - the only monetary aggregate on which we can rely.)

/ The

The ultimate transition to MBC can be achieved by widening the bands and relying on operations in money markets to control the base. In the Treasury papers there is no recommendation for a timetable for widening the bands nor for a decision for proceeding to MBC. It should be possible and useful to review the "new arrangements", and in particular the width of the bands later in the year (November, say). I believe that by February, 1982, the banking system will have had time to adapt their reserve policies and we shall have sufficient experience of the new arrangements, so that we can take a firm view of the next steps. Decisions should then be made on a timetable for the adoption of MBC or some clear alternative policy. The Bank may not find this palatable, but will probably agree that it is feasible provided that it has considerable short term discretion.

ALAN WALTERS

30 July, 1981

SECRET

Reference ....

MR MIDDLETON

cc. Mr Monck
Mr Britton
Mr Turnbull
Mr Davies

MONEY GROWTH RATES ETC., INCLUDING JULY FIRST GUESS

You asked to see the attached material, which incorporates the 'First Guess' figures for July.

Clive Cook

C. CROOK
30 July 1981.

CODE 18-77

832/7

SECRET

GROWTH RATES AND CHARTS INCLUDING JULY 'FIRST GUESS'.

Reference

TABLE: GROWTH IN £M3 AND OTHER AGGREGATES

CHARTS:

1. Real £M3 and Trend
2. Real M1 and Trend
3. Real M0 and Trend
4. Real PSL2 and Trend

5. 12 mth % change in M1 and M0
6. " " " " " M1 and £M3
7. 6 " " " " " " "
8. 3 " " " " " " "
9. 12 " " " " PSL2 and £M3
10. 6 " " " " " " "
11. 3 " " " " " " "

CODE 18-77

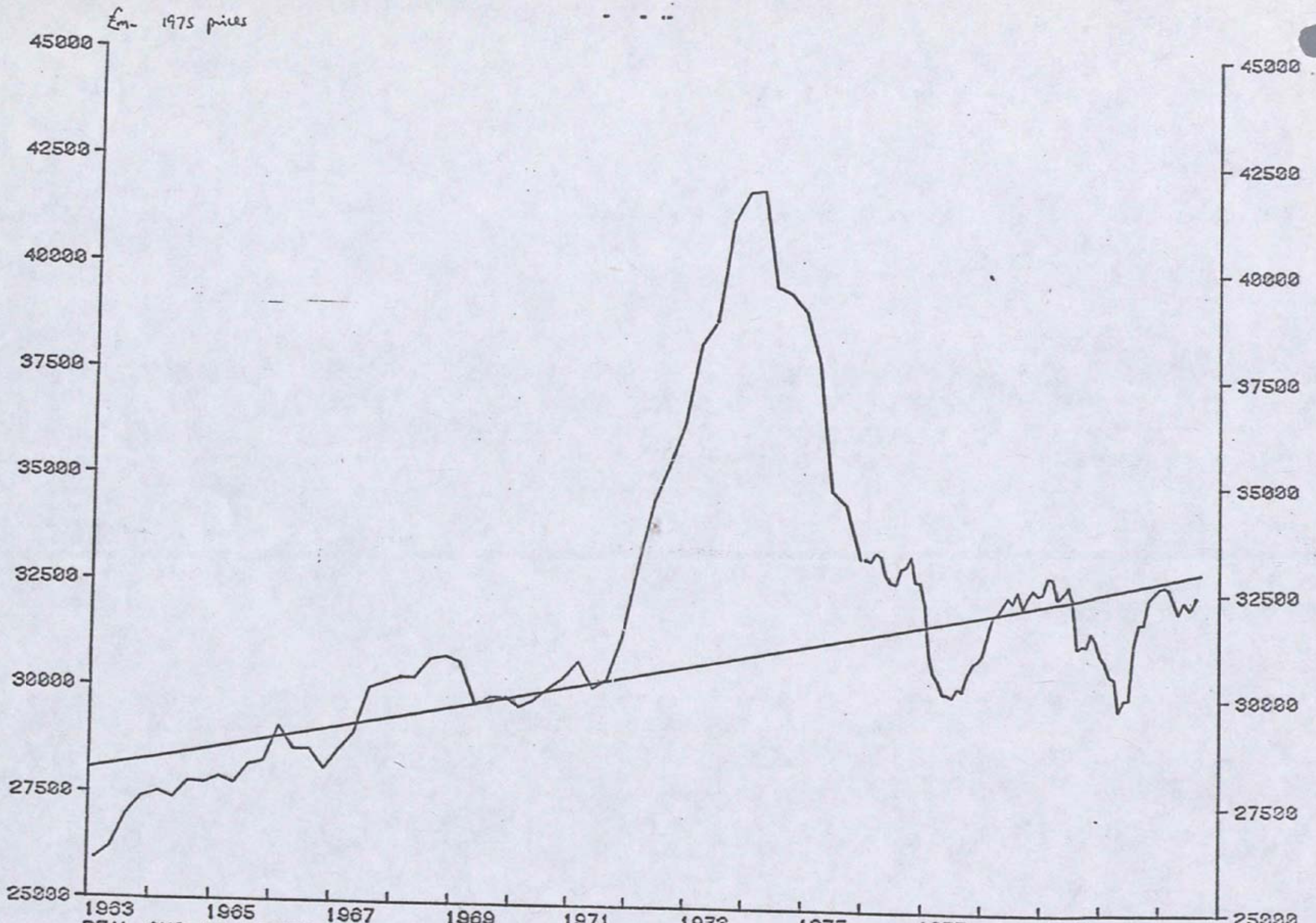
SECRET (AND PERSONAL UNTIL

TABLE : £M3 AND OTHER AGGREGATES (% CHANGE: S.A. DATA)

FIGURES REVISED TO SHOW 'FIRST GUESS' FOR JULY.

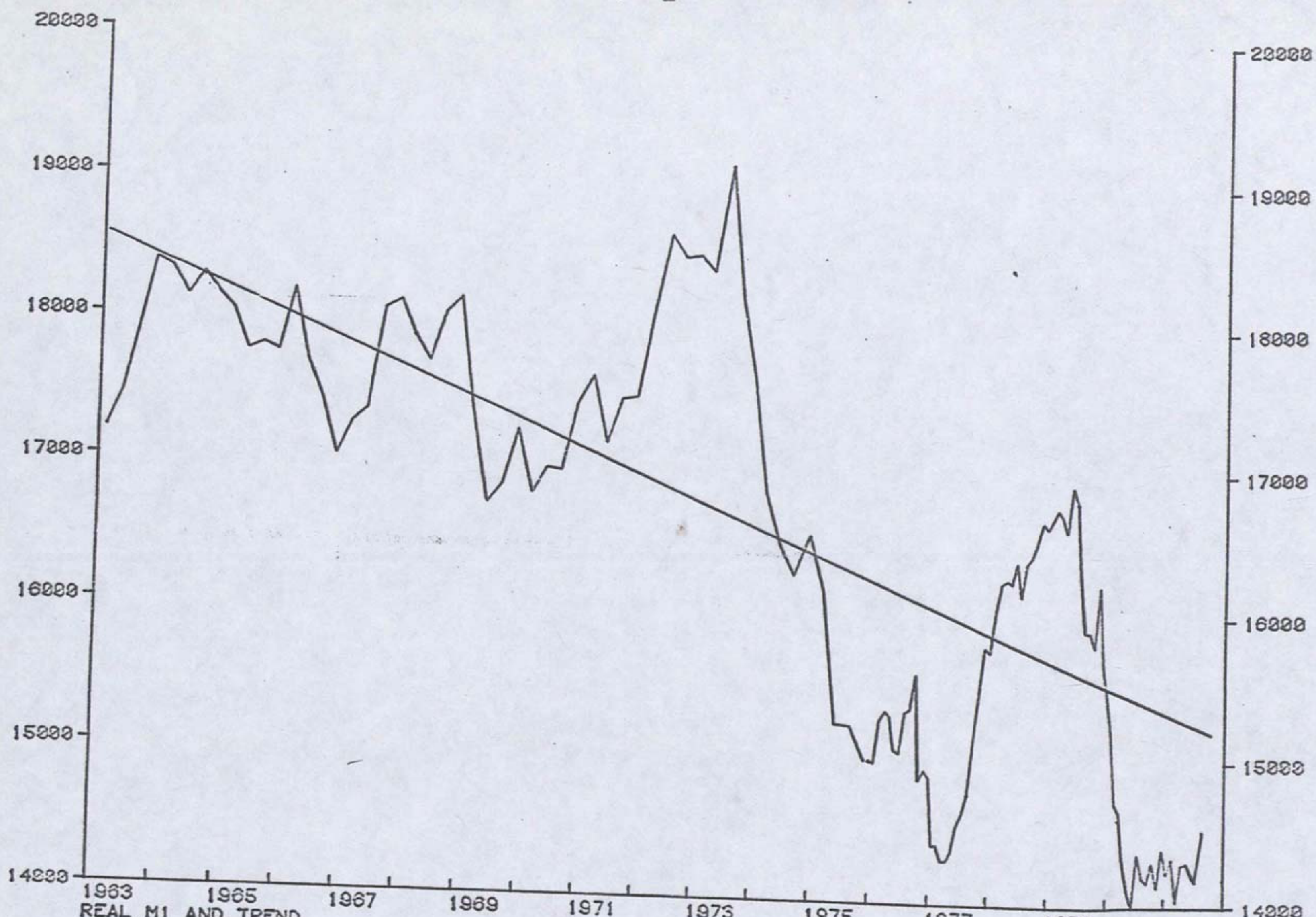
Banking month	Wide monetary base (s.a.)	Non-interest Bearing M1	M1	£M3	£M3 adjusted for effects of corset and strike	M3	PSL1	PSL2
Cutturns								
December	0.2	1.8	2.3	0.8	0.8	0.8	1.0	0.6
January	-0.1	-0.6	-0.7	0.5	0.5	1.4	-0.1	0.6
February	2.3	1.7	1.3	0.2	0.2	1.1	0.1	0.8
March	-0.1	-0.4	-0.5	0.6	0.4	1.2	0.2	0.9
April	1.1	4.2	4.9	2.2	0.9	2.5	2.7	2.0
May	-0.9	0.4	0.6	1.5	0.9	2.3	1.4	1.1
June	0.5	0.4	-0.5	0.2	-0.5	1.2	0.2	0.4
to June: Last 6 months (a r)	5.9	11.8	10.6	10.8	4.9	21.2	9.4	12.4
to June: Last 12 months	5.6	8.8	11.9	18.3	9.5	22.2	13.5	13.3
to June: Last 4 months (target period a r)	1.9	14.5	14.3	14.3	5.3	23.9	14.4	14.2
July	–	N/A	3.0	2.2	1.3	N/A	2.2	1.8
to July: Last 6 months (ar)	6.0	N/A	18.9	14.7	6.9	N/A	14.6	15.0
to July: Last 12 months	6.4	N/A	14.7	15.0	8.9	N/A	13.2	13.4
to July: Last 5 months (target period a.r.)	1.6	N/A	19.4	17.3	7.8	N/A	17.3	16.1
Forecast *								
(i) % change in month								
August				2.0	1.1		2.0	
September				2.2	1.7		1.9	
(ii) % change since Feb 1980 (a.r.)								
August				18.8	13.6		17.3	
September				19.4	14.1		17.7	
(iii) % change since Feb 1981 (a.r.)								
August				18.9	8.9		19.3	
September				20.5	10.7		20.1	

* The first guess figures have not led us to revise the forecasts for August and September.

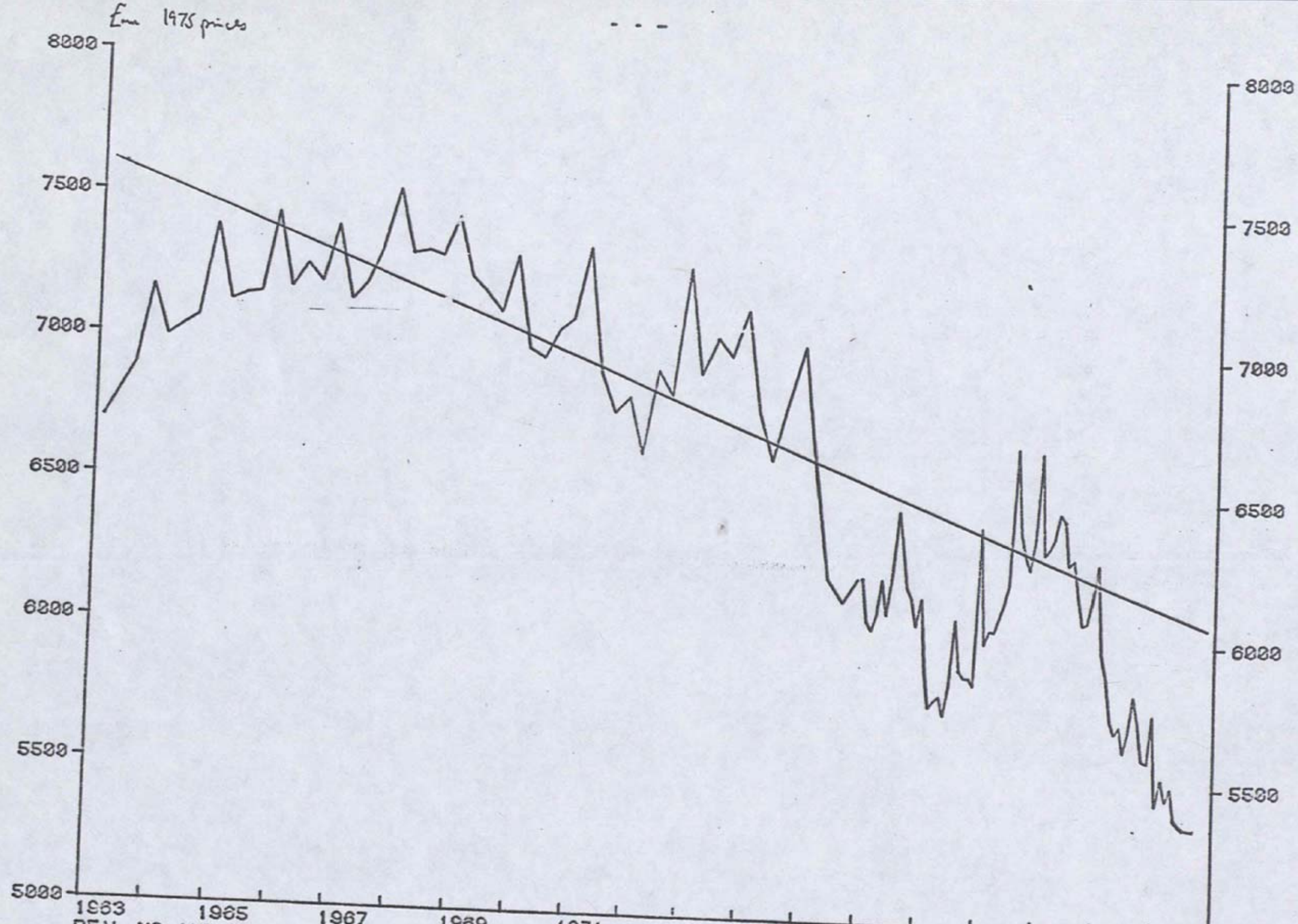


REAL $M3 AND TREND

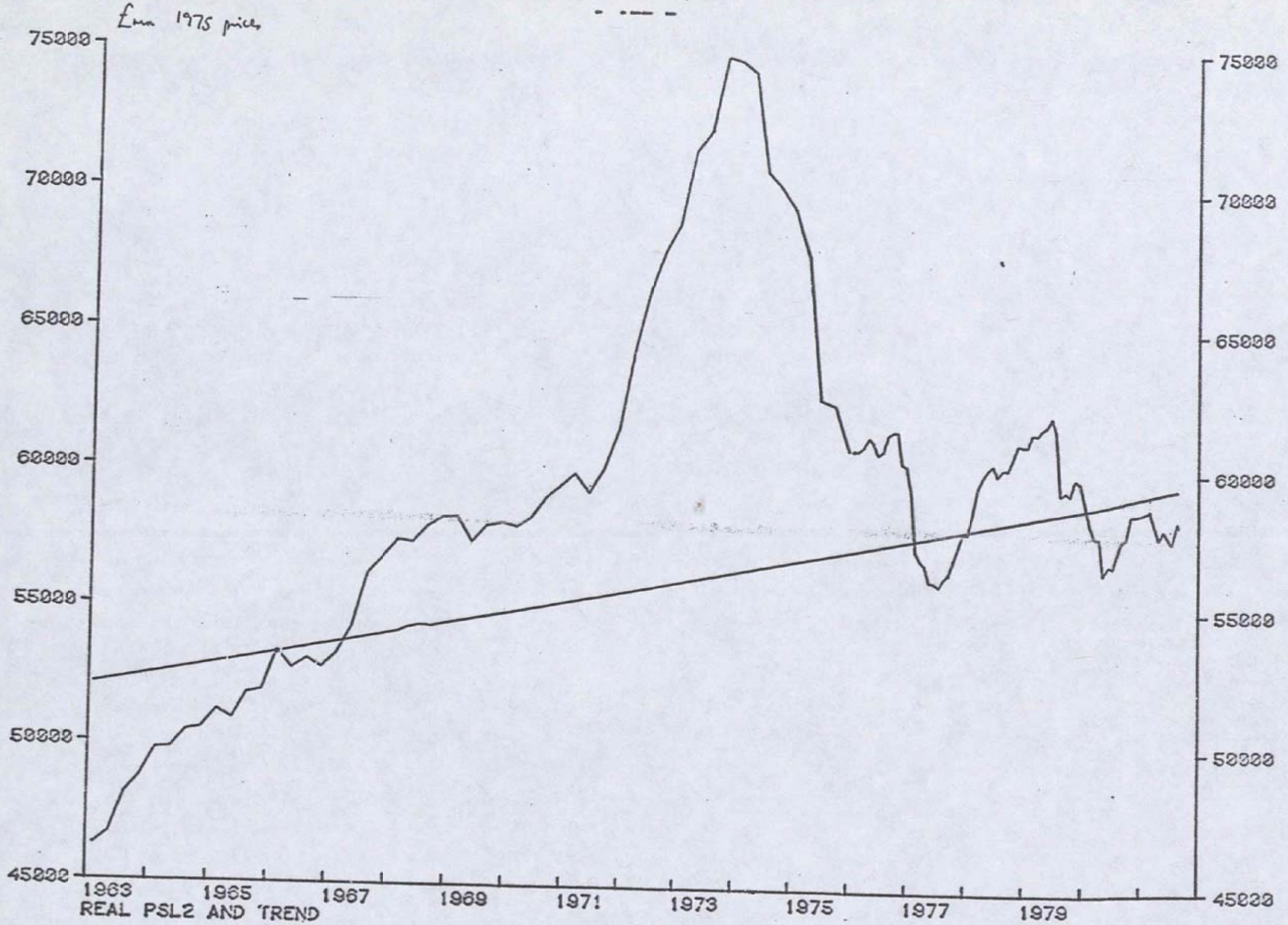
£m 1975 prices

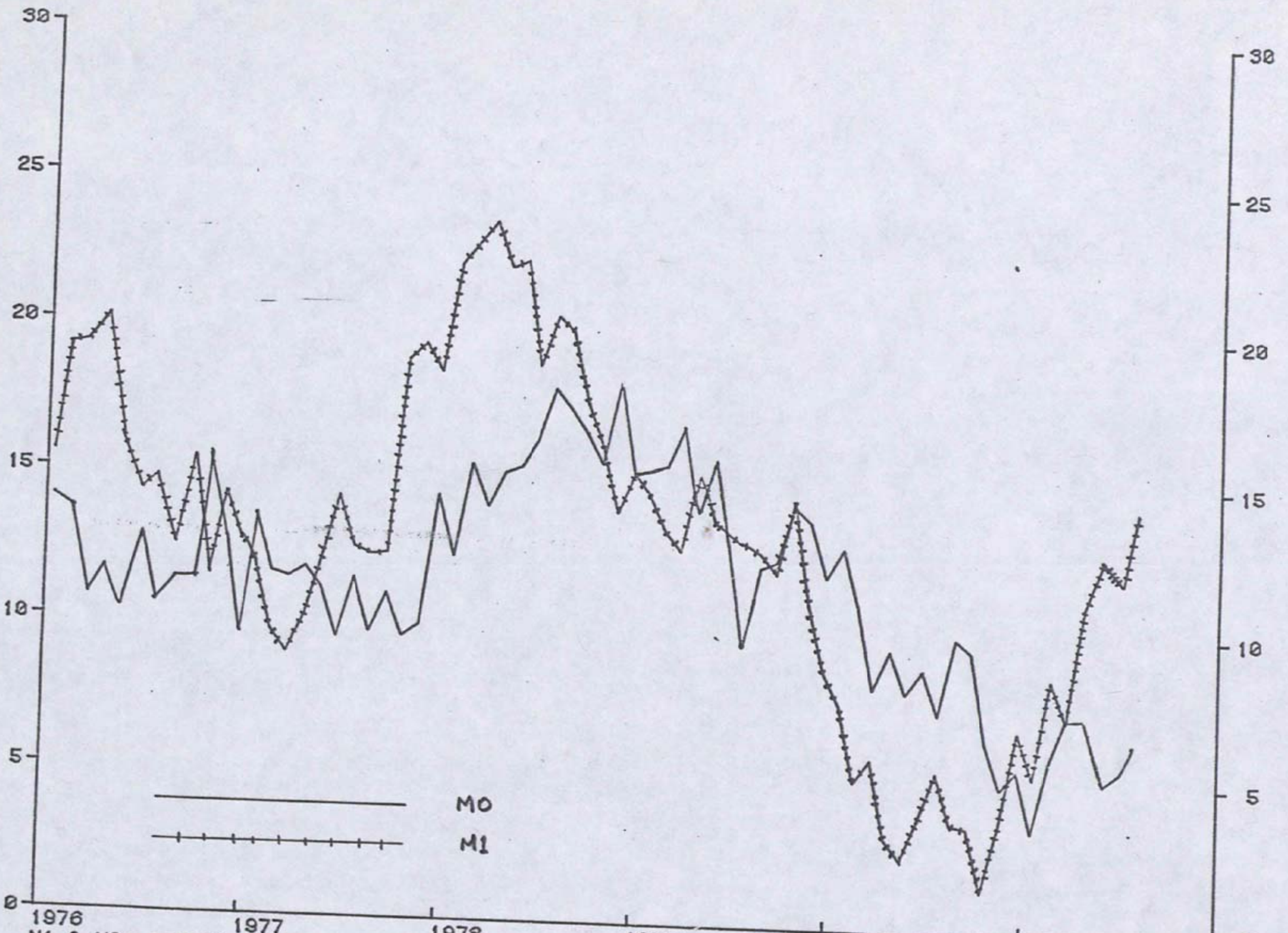


REAL M1 AND TREND

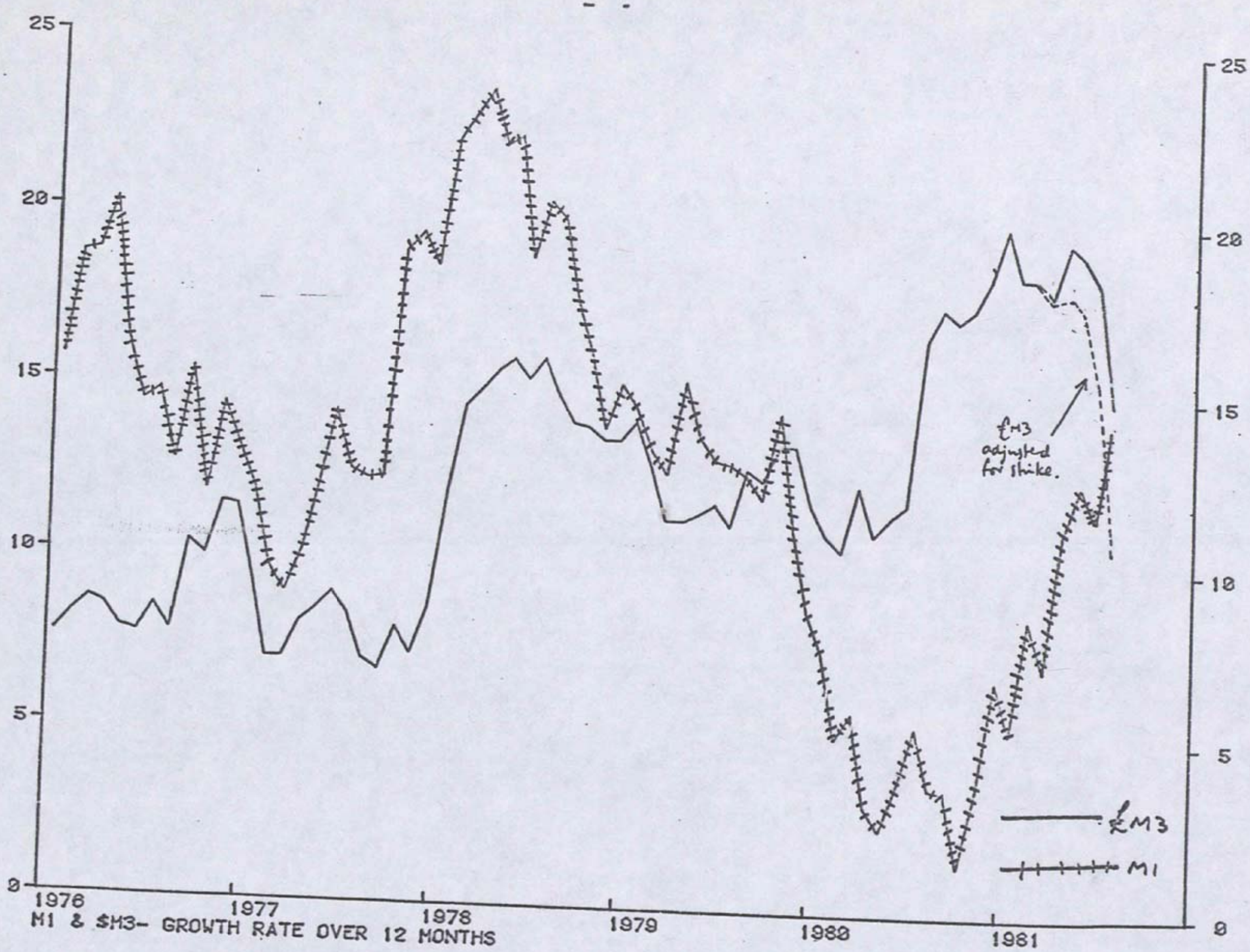


REAL M0 AND TREND

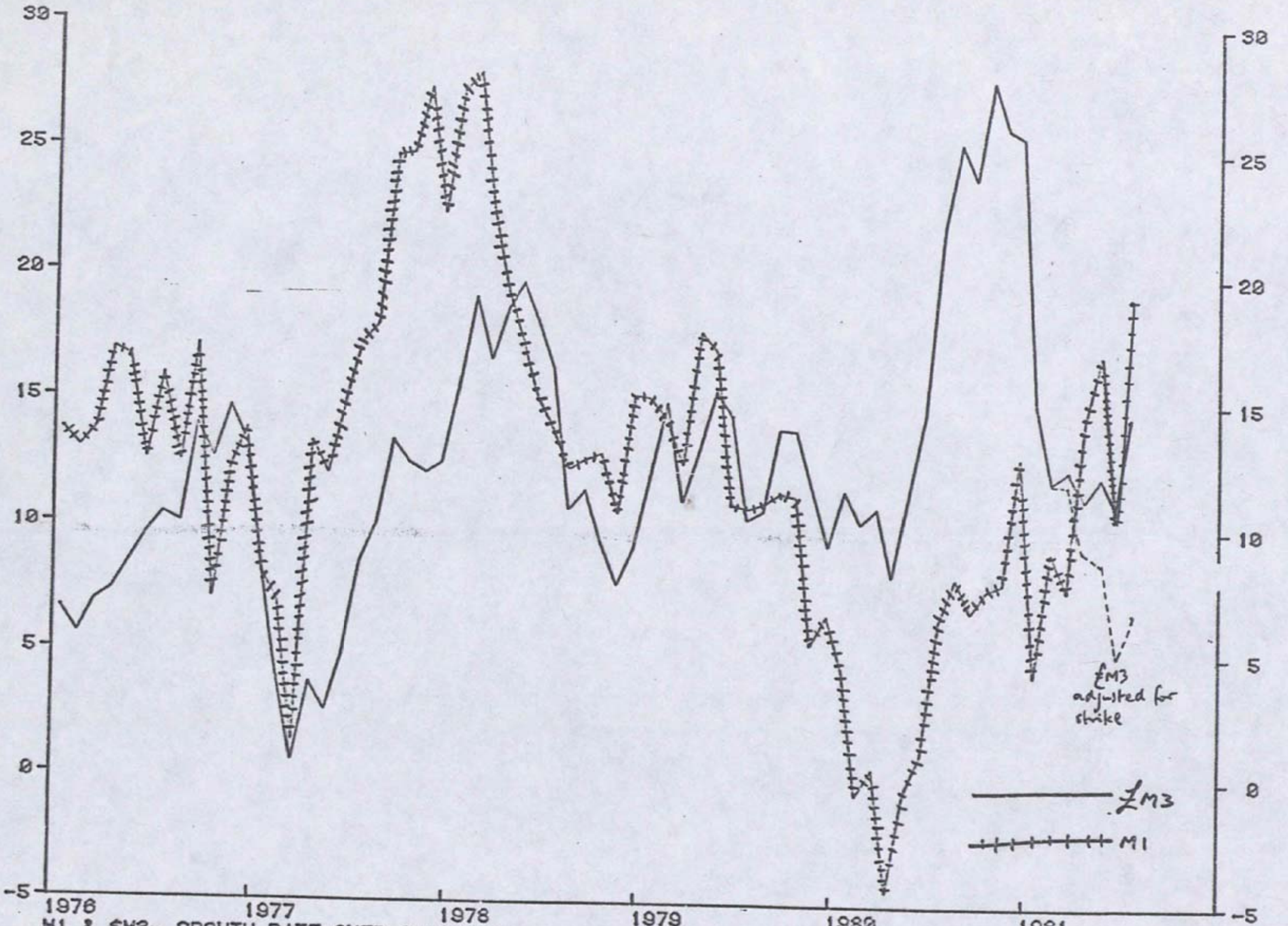

£mn 1975 prices
75000
70000
65000
60000
55000
50000
45000
1963
1965
1967
1969
1971
1973
1975
1977
1979
REAL PSL2 AND TREND



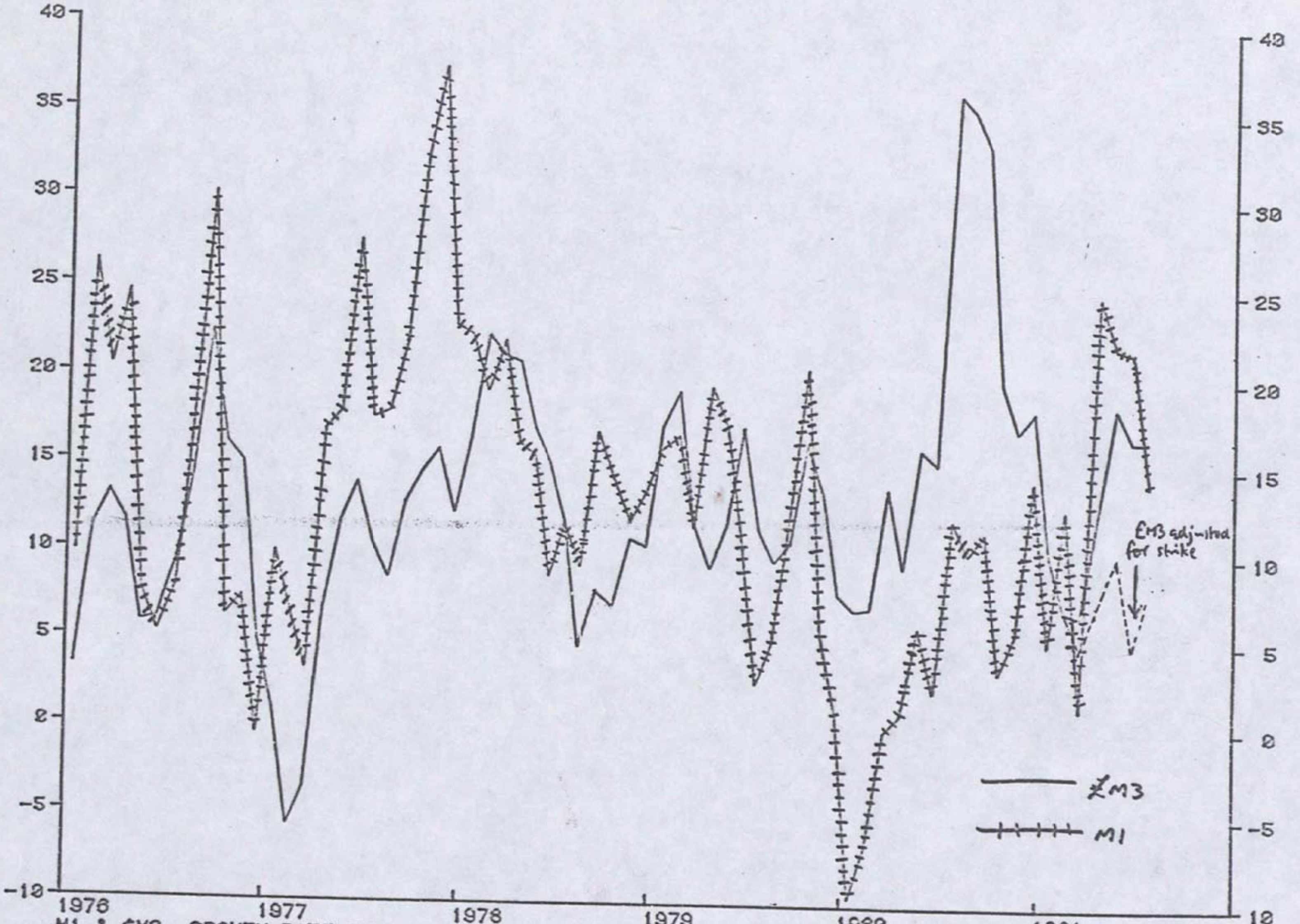
M1 & M0- GROWTH RATE OVER 12 MONTHS



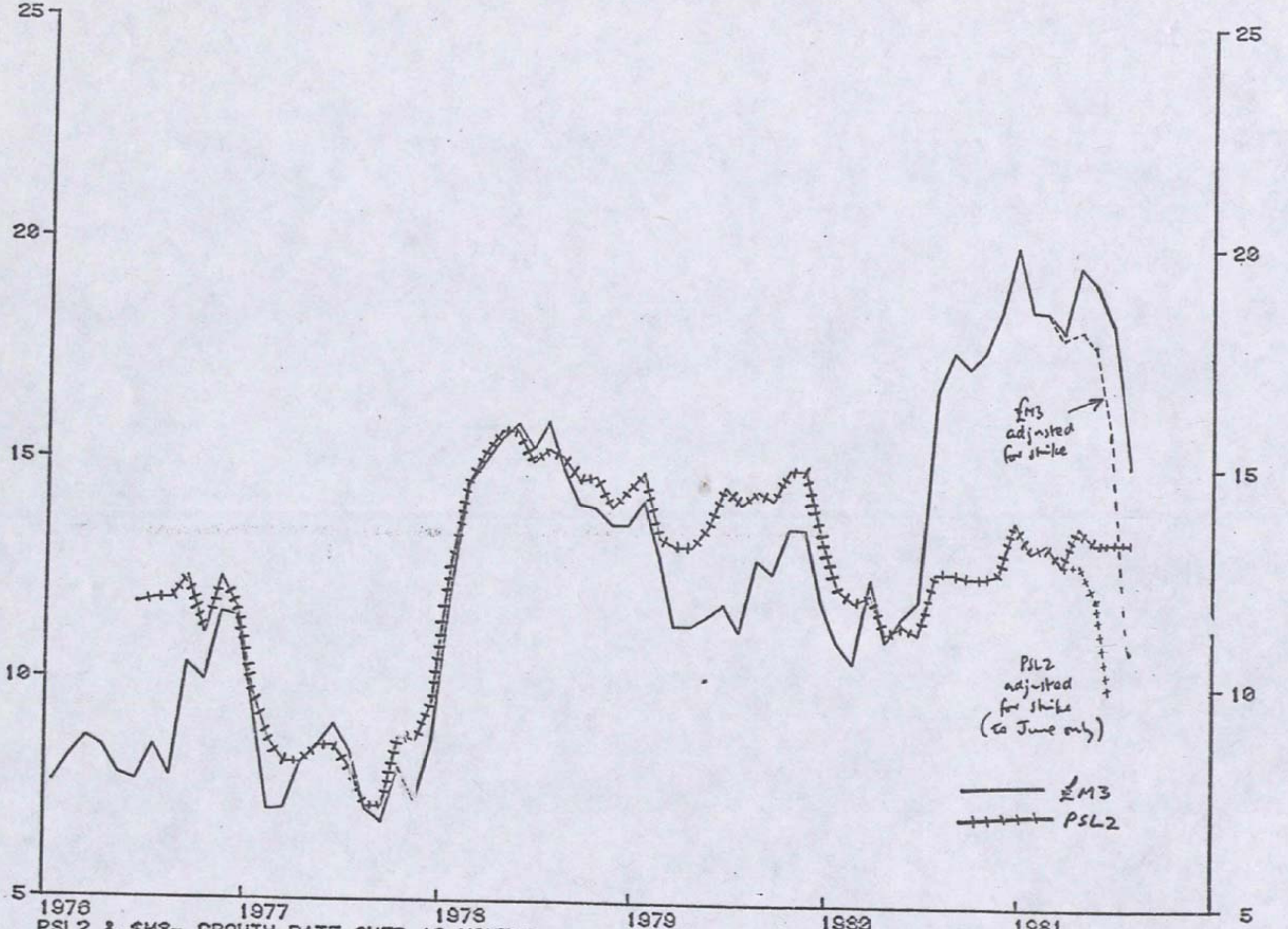
M1 & $M3- GROWTH RATE OVER 12 MONTHS



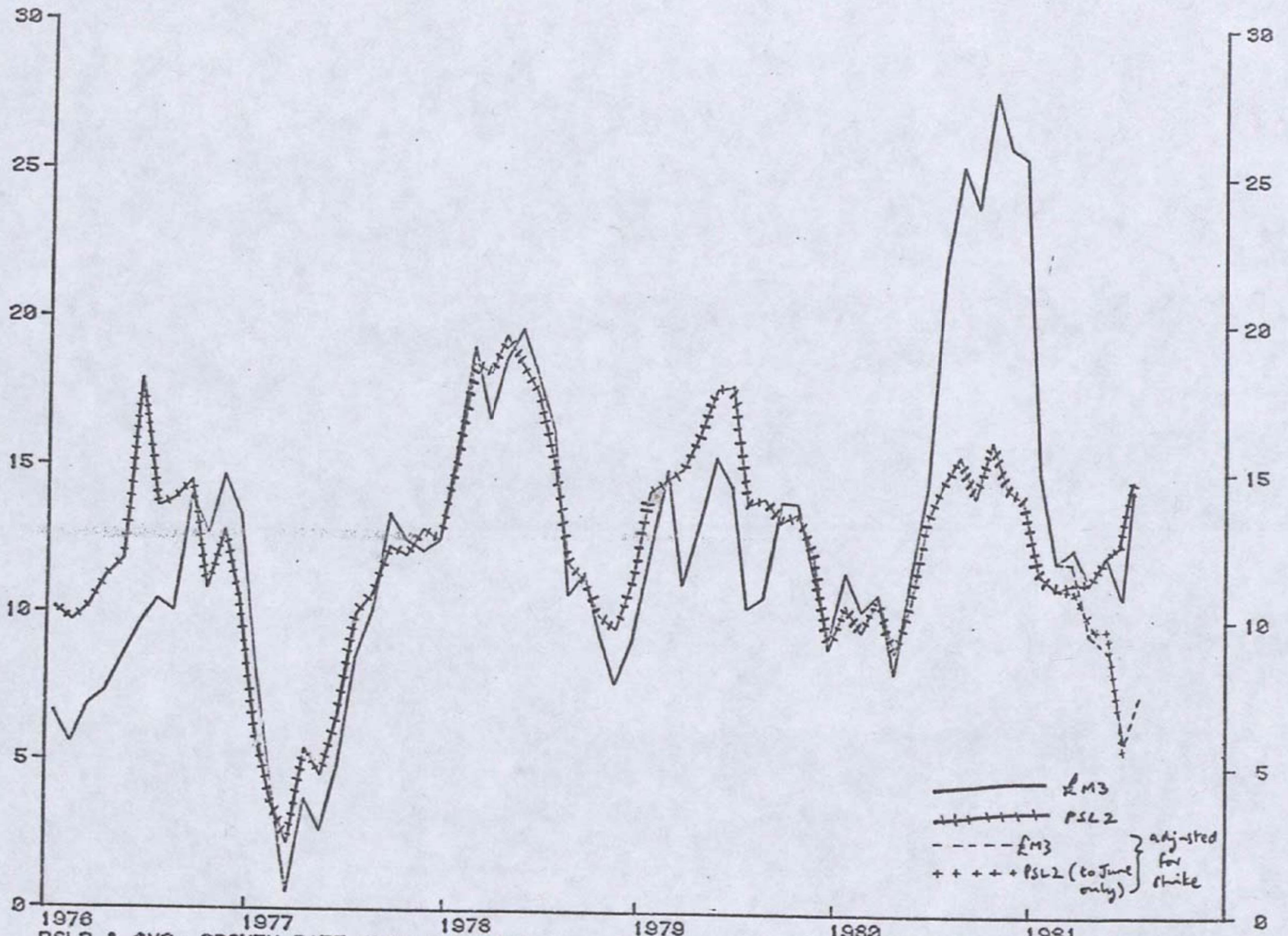
M1 & $M3- GROWTH RATE OVER 6 MONTHS



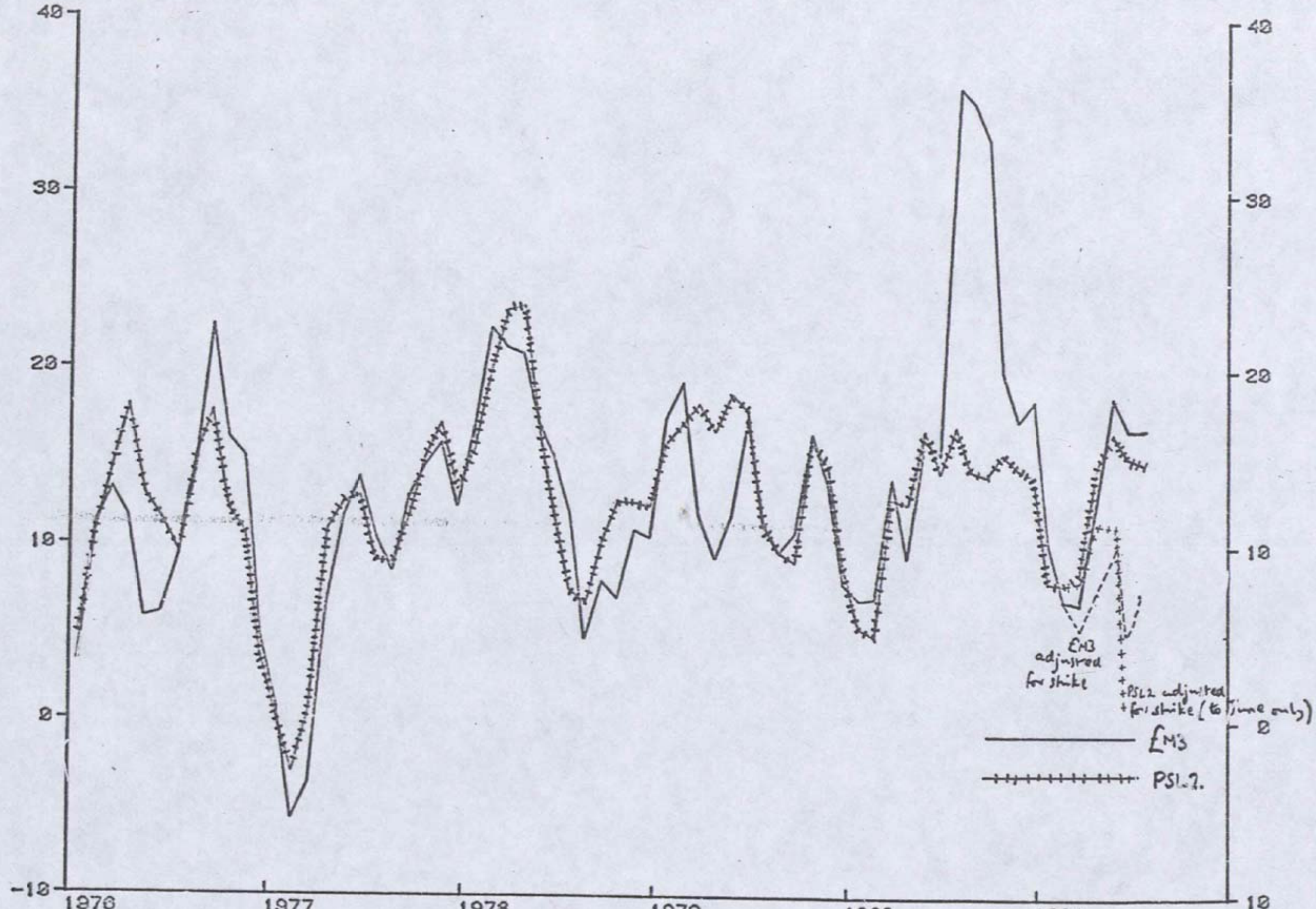
M1 & $M3- GROWTH RATE OVER 3 MONTHS



PSL2 & $M3- GROWTH RATE OVER 12 MONTHS



PSL2 & $M3- GROWTH RATE OVER 6 MONTHS



PSL2 & $M3- GROWTH RATE OVER 3 MONTHS (A.R.)

CONFIDENTIAL

Chancellor of the Exchequer

cc Financial Secretary
Sir Douglas Wass
Mr Burns
Sir Kenneth Couzens
Mr Monck
Mr Britton
Mr Lavelle
Mrs Lomax
Mr Peretz
Mr H Davies
Mr Pirie
Mr Ridley
Mrs Gilmore

Governor)
Deputy Governor)
Mr Fforde) B/Eng
Mr Coleby)
Mr George)

MONETARY CONTROL: DRAFT STATEMENT

1. I attach a possible statement which would need to be issued by 5 August. The draft incorporates comments from the Financial Secretary, from the Bank and from within the Treasury. There are two points to which I might draw your attention:

a. There are two possible forms of words to describe the circumstances in which we should wish to bring back something akin to MLR. The Bank prefer the former; we rather incline to the latter.

b. There is a general preference for spelling out a little the considerations to be taken into account in setting interest rates on the lines of page 3 of the statement. These were deliberately left rather obscure in the Budget Speech which has to be read with great diligence to come up with this list. There is an argument for being clearer about the criteria assuming that we reach agreement at the seminar. On the other hand, as the Financial Secretary has pointed out, it does not add a great deal to what was said in the Budget Statement and could raise more questions than it answers.

2. The statement assumes the outcome of the discussion with the Prime Minister. If it goes the way we hope, there should not be much difficulty in resolving the two points referred to above.

E P Clarke

PP P E MIDDLETON
30 July 1981

Enc

CONFIDENTIAL

Mu

13

DRAFT 30.7.81

B

1. The Chancellor of the Exchequer said in the Budget Speech that a number of improvements in monetary control would come into effect later in the financial year. The Bank of England has now completed its discussions with the financial institutions; and the agreed detailed arrangements are set out in a note issued by the Bank today. They will come into effect on 20 August - the first day of banking September.

The Reserve Asset Ratio

2. Among the changes to come into effect on that day is the abolition of the requirement that the banks should maintain a minimum reserve asset ratio. The institutions to which it has been applied will discuss in advance with the Bank, as part of normal prudential supervision, any changes in their policies on liquidity management.

The Cash Requirement

3. The previous requirement on the London clearing banks to hold 1½% of their eligible liabilities with the Bank in non-interest bearing form will also be abolished. Instead there will be a uniform requirement on all banks and licensed deposit-takers to hold ½% of their eligible liabilities with the Bank. The fulcrum for the Bank's money market operations will in future be the balances - over and above the ½% requirement - which the clearing banks hold voluntarily with the Bank for clearing purposes.

Money Market Operations

4. Besides these changes, 20 August will mark a stage in a period of transition which we have been going through since last November. The Bank now relies mainly on open market operations - buying and selling bills - rather than on direct lending to the money markets. Dealing rates are no longer quoted; the Bank responds to bids and offers from the market, making public the rate at which it has done business. In future, the Bank will aim to keep interest rates at the very short end of the market within an undisclosed band which will be moved from time to time.

5. The new arrangments are intended to reduce the "bias to delay" in changing interest rates - in both directions - which was identified in the Green Paper on Monetary Control. And the market will have a greater role in determining the term structure of short interest rates. Market pressure will show itself mainly in movements in rates at the longer maturities which the Bank does not influence so directly - and this experience of market conditions will be one of the factors taken into account in deciding on the position of the interest rate band.

Minimum Lending Rate

6. A continuous posted Minimum Lending Rate would be inconsistent with the objective of the new arrangements to give the market more influence over the structure of interest rates. MLR will be suspended from 20 August. The option will, however, be retained /should circumstances warrant/ /for use in

special circumstances7 of announcing in advance the minimum rate which, for a short period ahead, the Bank would apply to any lending to the market.

Changes in the Interest Rate Band

7. The undisclosed interest rate band will be changed by the Bank with the agreement of the Chancellor of the Exchequer primarily in response to the requirements of the annual monetary targets together with the range of factors referred to in the Budget Speech. The principal indicators which will be taken into account are thus:

- the current and prospective trend of £M3;
- movements of other monetary aggregates, in particular, M1 and the wide monetary base;
- the growth of nominal incomes, as measured by the value of gross domestic product at current prices;
- movements in the exchange rate and costs as indicators of underlying monetary and inflationary conditions.

24.7.81

MONETARY CONTROL - PROVISIONS

Introduction

1 On 24 November 1980, the Bank published a Background Note describing a number of improvements to be made to the existing framework of monetary control. On 12 March this year, in a paper entitled "Monetary control: next steps", more detailed proposals on a number of the subjects covered in the Background Note were sent to all recognised banks and licensed deposit-takers (LDTs). The present paper sets out the provisions resulting from discussions since then with the various associations, as well as with a number of individual institutions.

The cash ratio

2 A substantial part of the Bank's resources and income in recent years has been provided by the average of 1 1/2% of Eligible Liabilities (ELs) maintained by the London clearing banks in non-interest-bearing accounts at the Bank. This sum has also served as a fulcrum for money market management. The Bank's paper in March proposed that this latter purpose should in future be served by the volume of operational funds which the London clearing banks would retain voluntarily at the Bank for clearing purposes, while the Bank's resources and income should additionally be secured primarily by a uniform requirement on all banks and LDTs to hold non-operational, non-interest-bearing deposits with the Bank. The provisions set out in this section have accordingly been designed to provide, in aggregate, broadly the same amount of non-interest-bearing funds initially as did the previous arrangements with the London clearing banks alone.

3 This non-operational requirement will be 1/2% of an institution's ELs and will apply to institutions covered in paragraph 16(i)-(iii) below having ELs which average £10 million or more in the latest period over which the requirement is calculated. The level of an institution's non-operational balance will be set twice a year in relation to its average ELs in the previous six months[1].

---

[1] A deposit calculated in, say, May would relate to the monthly average of ELs from November to April inclusive.

6/9/1

4 For institutions not on the present statistical list of banks and whose business mainly comprises the provision of fixed rate finance for periods in excess of one year, the Bank accepts that the introduction of the 1/2% cash ratio may present a special transitional problem. The Bank will be prepared to consider individual representations from such institutions for some temporary alleviation of the requirement. In addition, in recognition of the special conditions in Northern Ireland, the Bank has reduced to 1/4% the cash ratio to be observed by institutions for which Northern Ireland is the principal place of business in the United Kingdom. This concession will apply in respect only of the ELs of their Northern Ireland offices and will run for two years, when it will be reviewed.

5 ELs are to be redefined to reflect the changes set out in this paper. In future, offsets will be allowed in the calculation of ELs in respect of:

(i) funds (other than cash ratio deposits or Special Deposits placed with the Bank) lent by one institution in the newly defined monetary sector [1] to any other;

(ii) money at call placed with money brokers and gilt-edged jobbers in the Stock Exchange, and secured on gilt-edged stocks, Treasury bills, local authority bills and eligible bank bills.

6 ELs will be calculated in uniform fashion for all reporting institutions[2] except:

(i) members of the London Discount Market Association (LDMA), whose ELs will be calculated as the total of sterling deposits other than from institutions within the monetary sector and from money-brokers and gilt-edged jobbers in the Stock Exchange.

(ii) certain banks with money trading departments, who will be allowed to omit from their ELs secured money at call placed by other banks with these departments, up to a limit set by the Bank.[3]

---

[1] See paragraph 16 below.

[2] The present arrangements for those finance houses which have observed a 10% reserve asset ratio since 1971 will lapse accordingly.

[3] The banks concerned are: Algemene Bank Nederland, Banque Belge, Charterhouse Japhet, Leopold Joseph and Samuel Montagu. Hitherto, funds placed on this basis, up to a limit set by the Bank, have counted as reserve assets.

7 It would be contrary to the objective of these agreed arrangements for any institution to reduce its ELs deliberately or artificially on reporting dates. The Bank accordingly reserves the right to make a spot check on the level of an institution's ELs on days when it would not normally report.

Special Deposits

8 The Special Deposits scheme remains in place and will apply to all institutions with ELs of £10 million or more at the latest make-up day for which figures are available[1]. As hitherto, calls will be set as a percentage of ELs. The scheme for Differential Special Deposits[2] has lapsed.

Eligibility

9 As set out in its March paper the Bank has judged applications, by recognised banks wishing their acceptances to become eligible for discount at the Bank, according to the following criteria:

(i) whether the applicant has and maintains a broadly based and substantial acceptance business in the United Kingdom;

(ii) whether its acceptances command the finest rates in the market for ineligible bills;

(iii) whether, in the case of foreign-owned banks, British banks enjoy reciprocal opportunities in the foreign owners' domestic market.

A first list of eligible banks is attached.

10 A bank may apply for eligibility at any time. An eligible bank which wishes to renounce its eligibility is free to do so on giving notice to the Bank.

---

(1) Hitherto only banks on the statistical list and finance houses observing a reserve asset ratio have been subject to Special Deposits.

(2) Details can be found in the Bank's Quarterly Bulletin for March 1973.

Undertakings by eligible banks

11 From 20 August 1981, each eligible bank undertakes to maintain secured money with members of the LDMA and/or secured call money with money brokers and gilt-edged jobbers[1] - all at market rates appropriate to the nature of the lending - such that:

(i) the total funds so held normally average 6% of that bank's ELs (as defined in paragraph 5);

(ii) the amount held in the form of secured money with members of the LDMA does not normally fall below 4% of ELs (as defined in paragraph 5) on any day.

12 In relation to the above undertaking, each eligible bank will

(i) aim to meet the daily average ratio over either six or twelve month periods (having first notified the Bank of its choice of period), the ratio on any particular day in a banking month being calculated as a proportion of ELs at the last but one make-up day.[2]

and

(ii) to provide monthly returns of its daily figures, which the Bank will use to assess the bank's performance relative to its long-term commitment.

A bank will go below the minimum only in exceptional circumstances and will be ready to explain such action to the Bank when the relevant monthly return is made.

13 The Bank will be prepared to review these undertakings, in consultation with eligible banks and the LDMA, when sufficient experience of the operation of the arrangements has been gained, covering at least a year. The Bank will also be prepared to discuss particular difficulties, as they arise, with any party to the arrangements.

---

(1) The Bank's concern with the adequate availability of funds for the efficient functioning of the gilt-edged market was noted in "Monetary control: next steps". There are six recognised money-brokers - James Capel & Co, Cazenove & Co, Hoare Govett (Moneybroking) Limited, Laurie Milbank & Co, Rowe & Pitman Money Broking and Sheppards and Chase. Secured call money with these firms has hitherto counted as a reserve asset. The amount of such money which these firms can take will continue to be limited by the Bank.

(2) For example, the relevant ELs figure for each day in banking September will be those as at make-up day in banking July.

Prudential considerations

14 The Bank has received the assurances mentioned in the Chancellor's Budget Speech, and in its paper of 12 March "The liquidity of banks", that those institutions in the United Kingdom to whom the reserve asset ratio has applied will discuss with the Bank in advance, in the course of the normal process of prudential supervision by the Bank, changes in their policies for the management of their liquidity and its composition. The Bank is resuming discussions with the banks on a new prudential regime, on the basis of a new paper on liquidity measurement.

Statistical changes

15 The present banking sector, as defined for the purposes of calculating the monetary aggregates, contains those institutions included in the statistical list of banks and the list of discount market institutions. These lists were drawn up prior to the Banking Act and are no longer appropriate to current circumstances. They exclude a number of recognised banks, many LDTs, and also the trustee savings banks[1] (who are evolving towards banking status and who will become subject to cash ratio and Special Deposit requirements when they cease to be exempt institutions under the Banking Act).

16 A new monetary sector will therefore be defined, to include

(i) all recognised banks and LDTs;

(ii) National Girobank;

(iii) those banks in the Channel Islands and the Isle of Man which opt to join the cash ratio scheme described earlier in this paper;

(iv) the trustee savings banks (TSBs);

(v) the Banking Department of the Bank.

17 Although the population of the monetary sector will be considerably larger than that of the "statistical list", the statistical effect will be comparatively modest since the present business of many of the new contributors is relatively small. In total, the

---

[1] The Central Trustee Savings Bank (CTSB) is a recognised bank.

initial once-for-all adjustment to the stock of the main monetary aggregate, £M3, will probably be of the order of £8 billion (13%), of which the TSBs account for around £6 billion (9 1/2%).

18 Institutions in the monetary sector having either eligible liabilities totalling £10 million or more, or a balance sheet of £100 million or more, will be asked to supply the full range of statistics (comprising both the monthly and other returns); other institutions will be asked to report only at end-calendar quarters.[1]

The timetable for change and the transitional arrangements

19 The essential features of the new arrangements can be brought rapidly into effect. This section sets out the sequence of developments.

20 On 20 August 1981:

(i) the Reserve Asset Ratio will be abolished;

(ii) the acceptances of all banks in the first list (attached) of eligible banks will become eligible for discount at the Bank;

(iii) all the banks covered in (ii) above will begin to observe the undertakings set out in paragraph 11 above;

(iv) the agreement with the London clearing banks, whereby they keep an average of 1 1/2% of their ELs at the Bank, will lapse;

(v) the Bank will receive the first deposits under the cash ratio requirement.

21 On this date, the first cash deposits will be placed by institutions on the present statistical list of banks and by members of the LDMA; the statistics necessary to include other institutions are not yet available. These initial deposits will relate to the average of institutions' ELs on the monthly make-up days in the period January-June 1981 inclusive, ELs being defined on a transitional basis: ie calculated for 'statistical banks' as at present except that offsets will be allowed in respect of all lending to the discount market and all secured money

---

[1] The TSBs will continue, for the time being, to make returns on the existing consolidated basis.

at call placed with money-brokers and gilt-edged jobbers and money-trading banks.[1] These initial deposits will remain unchanged until sufficient figures using the new definition of ELs are available (see paragraph 22 below). Thereafter, these deposits will be adjusted every six months. The undertakings by eligible banks as set out in paragraph 11 will take effect on 20 August 1981, also on the transitional definition of ELs and in respect of their level as at 15 July.

22 As soon as possible thereafter, (probably in respect of the make-up day in banking November) currently reporting institutions will be asked to produce figures for one reporting date both on the basis used hitherto and on the basis of the enlarged list of institutions comprising the new monetary sector. At the same time, those seventy or so institutions which are not currently on the statistical list of banks and which are above the cut-off points for full statistical reporting will join the full reporting network. They will be asked to place cash deposits with the Bank when two months' figures have been obtained, if their ELs are £10 million or more on average.

23 Monetary aggregates will be calculated on both bases for this one reporting date; thereafter statistics will only be collected on the basis of the new monetary sector.

24 The remaining institutions not currently reporting and below the cut-off points set out in paragraph 18 will be brought into the reporting network only when the current review of banking statistics has been completed (which is unlikely to be before the second half of 1982).

---

[1] The Bank can calculate these offsets for listed banks from statistics already provided. The ELs of members of the LDMA will be calculated as set out in paragraph 6 above, except that no allowance will be possible in this transitional period for deposits by money-brokers and gilt-edged jobbers in the Stock Exchange.

SECRET AND PERSONAL UNTIL 2.30PM ON AUGUST 13

MR MIDDLETON

cc Chancellor
Financial Secretary
Sir D Wass
Mr Burns
Mr Monck
Mr Britton
Mr Turnbull o.r.
Mr H Davies
Mr Shields
Mr Lankester - No 10.

Prime Minister

Bad figures, though the civil service strike has inflated them.

MONEY SUPPLY IN JULY: FIRST GUESS

I attach a note by the Bank giving a first estimate of monetary growth in banking July. £M3 is estimated to have increased by 2.2%, much in line with our forecast. After the surge in April, followed by a flat two months, M1 has again risen sharply by 3%. We will be investigating these figures further and reporting next week.

T LENNON
24 July 1981

MONTHLY AGGREGATES IN BANKING JULY - A FIRST ESTIMATE

£ millions, seasonally adjusted

Estimates based on the figures provided by the weekly reporting banks show a rise in £M3 of 1,570 (2.2%) in banking July. This increase is exactly in line with the rise predicted at the monthly forecast. If confirmed by the full banking figures next week it would indicate an annual rate of growth since February 1981 of 17.3%.

M1 is estimated to have risen by 920 (3.0%). The monetary base was flat this month and has risen at an annual rate of only 1.6% since February. Tentative figures for PSL1 and PSL2 show rises of 2.2% and 1.8% respectively.

The attached table compares changes in the counterparts and £M3 with the forecast. The CGBR at 2,280 was much in line with the forecast (HMT are estimating the strike effect at between 1,500 and 1,750, slightly higher than forecast). However, within the CGBR, on-lending was markedly different from the MRC forecast with 460 extra borrowing by the rest of the public sector, mainly by public corporations. Underlying own-account borrowing appears to have been significantly less than expected. The higher on-lending is more than offset in the other public sector's direct contribution, which was contractionary by around 560 compared with the expansionary +300 that was forecast. Thus on the face of it the underlying PSBR seems to have been much lower than forecast. Net purchases of CG debt by the non-bank private sector, at 680, were 100 less than forecast. Within this, gilts raised 180 (240 less than forecast, but banks and discount houses appear to have bought heavily in the last week), National Savings raised 230 and there were sales of CTDs of 210.

Sterling lending to the private sector rose by 330, a little more than the forecast rise of 220; within the total, Issue Department sold 180 commercial bills. (The bill leak is estimated to have risen by 45.) Lending in sterling to overseas rose very sharply, by 490. Overseas sterling deposits also rose sharply, by 300, so this may reflect a further expansion of offshore inter-bank type transactions. The residual between DCE and £M3 was -290. Identified external items excluding switching by banks, account for -540 which suggests the residual may include a reversal of last month's erratic increase in NNDLs.

Financial Statistics Division
Money and Banking Aggregates Group HO-4
24 July 1981

A S Watson (4757)

SECRET 24. 7.81

£ millions
seasonally adjusted

		First Estimate (a)		Forecast	
CGBR			+2,280		+2,220
CG Debt:	Gilts	-175		-415	
	Treasury Bills	- 65		- 25	
	National Savings	-230		-150	
	CTDs etc	-205		-190	
			- 675		- 780
Other public sector:	LA	..		+140	
	PC	..		+160	
			- 560		+ 300
Bank lending to:					
private sector (inc Issue bills)			+ 325		+ 215
overseas			+ 485		+ 250
DOMESTIC CREDIT EXPANSION			+1,855		+2,205
External and foreign currency finance)					- 515
Non-deposits liabilities)			- 290		- 125
			+1,565 (+2.2%)		+1,565 (+2.2%)
Notes and coin			- 45		
Private sector sight deposits			+ 965		
M1			+ 920 (+3.0%)		

(a) Including some transactions which could not be attributed to individual weeks in Table 3W/1.

CONFIDENTIAL

H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-233 3000
Direct Dialling 01-233 5627

P E Middleton
Deputy Secretary

24 July 1981

T Lankester Esq
10 Downing Street
WHITEHALL

Dear Tim,

Seminar on Monetary Control: 31 July

I attach a set of papers prepared for the Prime Minister's seminar. The covering paper is intended to serve as a steering brief for the discussion.

I am copying this letter to Sir Robert Armstrong.

Yours ever,
Peter

P E MIDDLETON

Encs

CONFIDENTIAL

B

SEMINAR WITH THE PRIME MINISTER: NOTE BY OFFICIALS

1. In his Budget Statement the Chancellor said:

"Discussions are now to take place with the financial institutions about these and other changes, including the future of the cash ratio. When they are complete, the Bank will aim to keep very short-term interest rates within an unpublished band, and in due course suspend altogether the practice of having an announced MLR, which would by then have lost its operational significance."

2. The purpose of the seminar is:

a. to take note of the new arrangements. Some elements are in place already; a further set of changes will come into effect on 20 August.

b. to consider how the unpublished bands should be determined.

3. There are 3 papers which:

I. Describe the new arrangements and explain how they work.

II. Discuss the role which the narrow aggregates could play in monetary policy decisions.

III. Explain how the considerations set out in the Budget Speech might be brought together in taking interest rate decisions.

The papers have been prepared by a Working Group of officials from the Treasury and the Bank. Mr Walters (No 10) was a member of the Group.

The Arrangements (Paper I)

4. The arrangements follow from decisions taken at the Prime Minister's seminar last November. They were first described in the Chancellor's November 1980 statement and were carried forward in the 1981 Budget. They reflect extensive discussions with the financial institutions culminating in the Draft Provisions issued by the Bank in June (and shown to the Prime Minister by the Chancellor on 19 June). The Draft Provisions are attached for the sake of completeness, but all the relevant points are covered in

the paper.

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

6. The Prime Minister particularly asked about the timing of the suspension of Minimum Lending Rate. Giving the market more of a role means giving the authorities less. Putting MLR into suspense is part of the new approach. We therefore recommend that MLR should be suspended on 20 August. This would gain the maximum presentational and operational advantage from the new arrangements. The Authorities' role in influencing some of the more politically sensitive rates, would become less direct and obvious.

7. But when this has been done the Authorities will be unable to give such clear signals about their immediate interest rate intentions. In particular they will have considerably less direct influence over base rates and mortgage rates.

8. There may however be occasions when the Authorities will wish to signal changes in interest rates before a change in the Bank's market operations can become fully effective. The most obvious circumstances would be in response to sharp fluctuations in the foreign exchange markets. These occasions will be exceptional. But, in presenting the new arrangements, it will need to be made clear the Authorities will retain the capacity, on occasion, to signal in advance the rate at which they will provide cash to the market.

This issue is considered in paras 35-38 of Paper I.

Setting Short Term Interest Rates

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

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

11. The Government also restated its annual targets in terms of £M3 in the Budget, while recognising that other factors needed to be taken into account in determining short-term interest rates.

12. The Prime Minister in her minute of 4 June to the Chancellor of the Exchequer said that she believed that we must switch to a system of quantitative control sooner rather than later. So the group has concentrated on those changes which seem to be practical possibilities for immediate implementation.

13. The new arrangements are consistent with a widening of the interest rate bands and moving to monetary base control. But none of us is advocating an immediate move to a monetary base regime which would exclusively determine short-term interest rates. The changes we have considered are those which to quote the Budget Speech are:

> "Desirable in their own right and consistent with a gradual evolution to monetary base control."

14. The immediate issue, as we see it, concerns the determination of the band for short-term interest rates. Broadly speaking there are two options:

a. Make this decision depend primarily on one or other of narrow aggregates - essentially the choice is between M1 and the wide monetary base. This would mean abandoning the annual £M3 target. We do not regard the option of dual targets - eg for M1 and £M3 - as viable.

b. Retain an annual target for £M3 and set the interest rate band on the basis set out in the Budget Speech. This said:

> "Decisions about short-term interest rates will continue to take account of the whole range of monetary indicators referred to earlier and other factors that affect the significance of the numbers, especially the progress of inflation."

The other factors included: the narrow aggregates, the exchange rate and the real cost of borrowing.

We all agree that whichever option is adopted it would be necessary to retain some discretion to depart from the set criteria, in special circumstances.

The Narrow Aggregates (Paper II)

15. The paper sets out the implications of moving to the narrower aggregates:

a. the narrow aggregates are not demonstrably inferior to £M3 in predicting long run trends in inflation. Like all aggregates, however, they show large and erratic short-run variations which are not closely associated with movements in nominal incomes.

b. M1 would be easier to influence by changes in the level of short term interest rates than £M3. But it does not have the same obvious links with expenditure and tax policy. And the response of M1 to interest rates is still subject to a margin of error.

c. M_0, the monetary base, would be more difficult to control by changing the level of interest rates than M1 (and possibly than £M3).

d. It would be possible (subject to the qualification in b above) to relate interest rate decisions to a quantitative objective for the growth of M1 over 6-9 month periods.

e. An immediate move to M1 would mean either adopting figures which seem high both in relation to the £M3 targets and to nominal incomes, or accepting high real interest rates.

f. Such an objective for M1 would make it difficult and sometimes impossible to meet, at the same time, an annual target for £M3. There might also be some conflict with the medium term £M3 targets; these would cease to have much day to day operational significance though they would remain very important at Budget time.

g. In the event of a narrow aggregate deviating from target, the presumption would be - much more clearly than with £M3 -

that the initial response should be to change the level of short-term interest rates. This instrument would not, therefore, be available to meet other objectives, without adverse implications for achieving the target for the narrow aggregate.

£M3 Plus Other Factors (Paper III)

16. The paper explains the implications of retaining the annual £M3 target and the associated considerations set out in the Budget Speech:

a. It follows directly from the Budget Speech, and is more obviously consistent with the MTFS. It would not need a new announcement, though we might wish to give more explanation of how the various factors were to be taken into account.

b. It provides a less clear guide to changes in the interest rate bands. £M3 responds to the structure of interest rates as well as the general level of interest rates. It can be unpredictable in the short term, and can take a long time to respond.

c. The additional factors to be taken into account are difficult to quantify.

d. Decisions would be taken with a longer forward timescale in mind, and in practice are likely to be taken less frequently.

e. It appears to be more flexible because it gives the authorities greater discretion, whereas an M1 approach might look more rigid. This flexibility will however be seen as a disadvantage by those who want to give maximum weight to preventing shocks coming through on to the money supply.

17. In one way or another a range of factors will be taken into account in arriving at decisions on interest rates; this has been stated repeatedly by Ministers since the Green Paper on Monetary Control. The choice between the two approaches is one of emphasis in determining the bands - primacy to M1 or primacy to £M3.

Presentation

18. If interest rates are to fluctuate more, changes in the interest rate bands should be seen as a natural response to the criteria by which interest rates are set. We need to do everything we can to ensure that changes, whether up or down, are not seen as overt political acts. So far as possible Ministers need to stick to the line taken by the Prime Minister in Ottawa and avoid commenting on particular actions by the Authorities in the money markets or on changes in particular interest rates.

PEM
24 July 1981

Paper I

MONETARY CONTROL: THE NEW ARRANGEMENTS

I. Introduction

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

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

   (ii) how they will function;

   (iii) what they are seeking to achieve.

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

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

3. This paper will discuss:

   (I) The characteristics of the new arrangements

   - (a) The interest rate band
   - (b) Operations in bills
   - (c) Discount window lending
   - (d) Bankers' balances
   - (e) Special deposits
   - (f) Reserve asset ratio, prudential norms.

   (II) Suspending minimum lending rate.

   (III) Presentation

   (IV) Procedures.

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

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

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

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

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

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

II Characteristics of the New Arrangements

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

(i) Interest rate band

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

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

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

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

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

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

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

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

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

(ii) <u>Operations in bills</u>

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

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

(b) In contrast with the sum of over £4 billion currently held by all banks on a daily basis with the discount houses under the reserve asset ratio, eligible banks will undertake to maintain a minimum of secured money with the discount market - initially around £2 billion - and to aim at a daily average of some £3 billion. Included in the calculation of the latter will be secured call money with money brokers and gilt edged jobbers.

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

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

(i) 1-14 days,

(ii) 15-33 days,

(iii) 34-64 days,

(iv) 64-91 days.

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

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

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

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

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

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

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

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

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

---

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

(ii) Discount window lending

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

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

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

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

(iv) Bankers' balances

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

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

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

(v) Special Deposits

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

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

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

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

(iv) Reserve asset ratio and prudential supervision

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

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

II. Suspending Minimum Lending Rate

35. It was announced in the Budget that the Government's intention was "in due course to suspend altogether the practice of having an announced MLR, which would by then have lost its operational significance".

36. Retention of an MLR would not fit well within the new arrangements as it would present a clear signal of the authorities' views about interest rates beyond the very short rates which the authorities will keep within the band. This would limit the expression of a market view. It would also retain the high political profile of administered changes.

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

38. There may be occasions when a substantial change in short-term interest rates is either required immediately or needs to be timed to coincide with policy action in other fields. The Bank of England's open market operations could not be relied on to ensure that such changes would occur to the right extent and at the right time. In such exceptional circumstances, when the Authorities consider that an immediate signal about such a move is necessary, it will still be possible to give one by announcing in advance the rate at which the Bank will provide cash on the next available occasion. Thereafter the normal arrangements, under which no advance announcements about rates would be made, would be resumed.

III Presentation

39. The new arrangements are attempting to:

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

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

40. In principle control of a quantity - money - should imply freedom for the price - interest rates - to vary. In practice, however, it will be difficult to achieve public acceptance of this proposition. Although the monetary target is a quantity rule, the links between money and interest rates are not very direct or precise nor have we committed ourselves to being guided only by one monetary aggregate. What we do not have is a quantity rule at the point at which monetary policy is operated i.e in the money markets. This contrasts with the position on the exchange rate where the objective of achieving no net intervention rule is directly operational or with monetary policy in the US where the Fed sets a path for the supply of non-borrowed reserves. Only if we were operating a policy of controlling the supply of monetary base month by month (targetting the wide base over 6 months would be little different from targetting other aggregates) would there be a sufficiently precise quantity rule.

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

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

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

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

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

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

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

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

Finally, it will be necessary to consider the terms in which the Bank's operations in the money markets are described e.g in the Quarterly Bulletin. Paragraph 9 above indicated that we will not want to reveal the width or location of the band. The description, therefore, will have to be carefully constructed so as to give the public an adequate account of developments without undermining the authorities' freedom of action.

IV Procedure

44. The procedure for reviewing monetary developments and prospects and for deciding on the interest rate band will represent a development of current practice. Shortly after the publication of the provisional money figures for one month, an exercise is undertaken to assess the prospects for the current plus the following two months. This, together with a report by the Bank on recent money market operations,(2) and a note relating the monetary prospects to developments in the economy more generally, is then discussed at a Treasury/Bank meeting chaired by Mr Ryrie - the Bank team is led by the Deputy Governor.

---

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

2

The meeting will attempt to form a view about interest rates and in particular whether changes in the interest rate band are required. It will also consider the prospects for funding and what our objectives should be over the coming months.

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

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

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

H F 3 Division
July 1981

THE ROLE OF THE NARROW AGGREGATES

Paper II

SUMMARY AND CONCLUSIONS

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

Targets

2. The alternatives are:-

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

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

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

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

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

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

Indicators

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

Outlook for 1981/82 and 1982/83

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

THE ROLE OF THE NARROW AGGREGATES

Introduction

This paper summarises and updates some of the work done before the Budget on the choice of target aggregate and considers whether there is a role for one of the narrower aggregates (M1 or some measure of the monetary base) either as a target in its own right or as a less formal yardstick for taking short term interest rate decisions. The Budget reaffirmed the Government's commitment to £M3 as the target aggregate both for medium term (MTFS) and annual purposes. The paper discusses how far a role for one of the narrower aggregates would be compatible with this position. It concludes by reviewing the prospects for the different monetary aggregates in the next two years as implied by the Budget forecast, and by the latest internal forecasts and describing how we might set about choosing a numerical target for a narrow aggregate, should we want to adopt one.

I. The Monetary Aggregates

(a) M1

2. UK statistics currently identify three measures of money: £M3, M3 (which differs from £M3 only by including residents foreign currency deposits) and M1. The most obvious function of money is to act as a means of payment and the aggregate which most closely corresponds to money in this sense is M1, which consists of notes and coins and £ sight deposits. Most of these deposits do not carry an explicit rate of interest,* but there is a small, though quite rapidly growing, interest bearing component, including accounts which are clearly not primarily a means of payment, but provide a temporary home for funds eventually destined for the gilt edged market. But M1 does not include all the assets which can be effectively used to make payments and

*though current accounts do bear an implicit rate of interest because of the way offsets to bank charges are calculated.

financial innovations of the sort recently introduced in the USA are likely to make it even more difficult to unambiguously identify a set of assets which performs this role. There are also statistical problems with M1; for example, the seasonal adjustments are prone to much larger revisions (in percentage terms) than are the adjustments to £M3 and short term movements in the series do tend to be rather erratic.

(b) £M3

3. Sterling M3 includes all the assets that are in M1, plus a large interest bearing component (£ time deposits and CD's) which fulfill another, wider function of 'money'-to act as a store of value; But there are a wide range of other short term financial assets which serve the same purpose - LA deposits, Treasury bills and deposits with finance houses. The main feature which distinguishes time deposits from these other assets is that they are capital certain. Like other short term financial assets, however, they become more attractive when the level of short term interest rates is expected to rise, relative to longer term rates. The fact that 60% of £M3 is interest bearing is the reason why £M3 is primarily responsive to relative rates of return rather than, like M1, to the level of short rates alone. While a rise in short rates will unambiguously depress M1, it may or may not reduce long term rates, and the expected capital gains to be made from holding gilts.

(c) M2

4. The Bank are now in the process of constructing a new monetary aggregate, M2, to fill the gap between M1 and £M3. Unlike these other measures of money, which are based on subsets of the deposits distinguished in the banks' own balance sheets, M2 is an attempt to give statistical content to a purely economic concept - money balances which are primarily used to finance transactions. It will include interest bearing accounts below a certain size, as well as current accounts, and may include deposits outside the banking system which can be used to make payments. It will be sometime before the usefullness of the new series can be properly assessed. The first data should be available by the end

of the year, but it will be a matter of years before we have enough understanding of its seasonal and other properties to use it as the basis for taking monetary policy decisions.

(d) The Monetary Base (Mo)

5. Other measures of money can be derived from the published statistics, though they are not identified as monetary aggregates in their own right. One of the narrowest measures is base money* (designated Mo for the purposes of this paper) which include notes and coins held by the public - 85% of the total - and bank cash and bankers' balances at the Bank of England. From a theoretical standpoint, it is an interesting concept because it measures the money which is created directly by the monetary authorities (sometimes called 'high powered money'). Money assets which are the liabilities of the banking system (bank deposits) are excluded altogether. Looked at another way, base money is equal to that part of the Central Government's borrowing requirement, including its net acquisition of foreign assets (via EEA), which is not funded by selling non-money assets to either the banks or the non-bank private sector. Unlike other measures of money, information on the monetary base is available on a daily basis.

(e) Growth of the Different Aggregates

6. Over long periods of time, the various aggregates tend to move broadly in line with one another: between 1964 and mid-1980 for example the trend growth of Mo was 8½% of M1 8¼%, while £M3 grew by about 10¾%. If the years 1972-75 are excluded in calculating the trend (on the grounds that £M3 was distorted by the aftermath of Competition and Credit Control, round tripping etc.) the correspondence is even closer, with a trend growth of £M3 of 8½% a year. But the year by year growth rates in broad and narrow aggregates have often diverged very sharply - indeed, over the 1970's,

*The monetary base can be defined in a number of ways. The definition used here is the wide base including notes and coins and bankers' balances at the Bank of England, but not other deposits at the Bank (eg. by Bank staff, and overseas customers). Different definitions of base money were discussed in an article in the March 1981 BEQB.

there appears to have been a slight inverse relationship between the annual growth rates of M1 and £M3. There are three striking recent examples. Between 1971 and 1975, £M3 first grew at three times the rate of M1 (1972/73) and then rose much more slowly than M1 over the period 1974/75. In 1977, M1 growth was much higher than £M3, while in 1980, £M3 grew more than twice as fast as M1. On each occasion Mo behaved like M1 rather than £M3. The last two episodes reflected dramatic changes in short term rates (down in 1977, up in 1979/80) which were not matched at the long end of the market, leading to sharp changes in the attractiveness of all short term financial assets (including time deposits) relative to longer term ones.

II. Choice of Target Aggregate

7. A satisfactory target aggregate needs to meet two conditions:- it must be causally related to the final objectives of policy - nominal incomes and inflation - and the authorities should be capable of controlling it, at least over the target period (ie. within a year, in the case of an annual target).

(a) Relationship with Inflation

8. There does not seem to be much to choose between the different aggregates as predictors of inflation. Over the last fifteen years or so, the correlation between prices and £M3 has been no better or worse than between prices and M1. Until about 1978, it is true, £M3 did seem to have the edge over M1. But this rested heavily on a single episode - the inflationary explosion of 1975 which was preceded in 1972/3 by a much more dramatic upturn in the broad than the narrow aggregates. One view is that an excessive growth in broad money led, two years later, to a price explosion. An alternative view is that £M3 was heavily influenced by special factors in 1972/73 and that the rise in UK inflation in 1975 was largely caused by developments in the rest of the world, the 1974 oil price rise and the upsurge in manufactured export prices. This is not to say that the 1975 inflation

was non-monetary in origin: the increase in world export prices in 1973-5 was preceded by a sharp rise in world monetary growth in 1971/72, echoes of which can be seen in the UK for both the broad and narrow aggregates.

9. This explanation does not resolve all the problems about the monetary origins of the 1975 inflation, but it casts doubt on the popular view that the behaviour of £M3 and M1 in the early '70's proves conclusively that, for the UK, broad aggregates are more economically significant than the narrow ones. The period 1972-75 aside, M1 has been slightly better than £M3 in predicting the rate of inflation and since 1978, M1 has been distinctly better, with £M3 showing a marked tendency to under-forecast the rise in prices that occurred.

10. The more important point, however, is that simple relationships between money (and money alone) and prices are not very good at tracking movements in inflation over periods as short as 2-5 years, though they may be adequate for explaining long run trends. Inflationary shocks of various sorts - stemming from movements in world oil prices changes in tax policies, income policies and their aftermath etc. - may significantly affect the speed with which prices respond to movements in the money supply. Even though these fluctuations may be ironed out in the long term, they can be very important in determining prices in the short to medium term. But over the long term, as noted above, the various monetary aggregates tend to move fairly closely together.

11. This suggests that it is not possible to discriminate adequately between the different monetary aggregates on the basis of their relationship with prices. Restraining the rate of inflation by controlling the money supply is a fairly long run policy and, over this time horizon, one aggregate will broadly do as well as another.

(b) Control Issues

12. On the second issue - controllability - the differences between the various aggregates are more pronounced. The instruments available to the authorities are variations in the level of short term interest rates and fiscal policy. They may also, on occasion, be able to influence relative interest rates, through operations in the gilt-edged market, though-in our present state of knowledge - not reliably and possibly not to any great extent. Changes in short term rates may often have powerful effects on £M3 by changing expectations about future interest rates and encouraging asset holders to switch between money and gilts. But the net effect on £M3 depends on how long rates move as well, and this is not easy to predict. Short term interest rates also directly influence the growth in gross wealth, which includes bank lending- though this effect takes a year or two to build up. In general, therefore, the relationship between £M3 and the level of short term interest rates is neither very reliable nor very well understood certainly over periods as short as a year. The authorities cannot, therefore, depend on controlling £M3 by manipulating short term interest rates alone. A supportive fiscal policy is necessary. But since fiscal policy is cumbersome to change, relatively slow acting, and its effects are specific to the precise measures taken, this makes control of £M3 over periods of less than a year a distinctly chancy business.

M1

13. By contrast the narrower aggregates are less likely to be affected by fiscal policy changes and to be more responsive to changes in the level of short term interest rates. The link with fiscal policy is a matter of degree. The demand for M1, like the demand for broad money, seems to be related to gross financial wealth as well as income, and it too is likely to be influenced by fiscal policy - though to a rather smaller extent than the demand for £M3. The relationship between M1 and the level of short term interest rates seems to be reasonably well defined and stable. Recent work suggests that the direct effect of a 1 percent

point rise in short rates is to depress the demand for M1 by about $1\frac{1}{2}\%$ after one year, and about 2% in the longer term. Indirect effects through the impact of higher interest rates on income and wealth tend to increase the effect, especially in the longer term. These effects are not instantaneous, of course, and they are subject to a margin of error so they cannot guarantee very precise control. They may still mean that unacceptable fluctuations in interest rates are needed to control M1, especially over relatively short periods when, for other reasons, the demand for M1 is growing strongly relative to its desired path. But they provide some basis for thinking that M1 might be relatively easier to control, on an annual basis, than £M3.

The Monetary Base (Mo)

14. The wide monetary base (Mo) would probably be more difficult to control than M1. Even though base money consists only of the monetary liabilities of the monetary authorities, controlling the base is no different in principle from controlling M1, whether the Bank's operating instructions are set in terms of interest rates or quantities. This is because 85% of base money consists of notes and coins in the hands of the public. Quantitative rationing of the physical supply of notes and coins is not a serious option - the main effect would probably be to distort monetary conditions, rather than control them.

15. The Bank can only act directly on the banking system's holdings of cash through its money market operations. But these are tiny compared with the public's holdings. It will often not be practical to offset shifts in the public's demand for notes and coins by contracting or expanding the supply of cash to the banking extent by a matching amount. Nor would this be necessary if control of the base were only sought over a period of about 6-12 months. In practice, the Bank would have to react to a rise in the public's demand for notes and coins by driving up interest rates far enough to reduce the public's demand for cash to the extent needed to bring Mo back on track within the target period - ie. several months later. Control of Mo would therefore be based on judgements about private sector behaviour and would raise similar issues to those raised by control of M1 or £M3.

16. The problem is that the relationship between the wide base (M.o) and interest rates seems to be considerably weaker, less stable andmore poorly determined than that between M1 and interest rates. We have found no relationships capable of explaining past, very volatile movements in bankers' balances at the Bank of England, nor would past experience necessarily be a good guide to future behaviour, given the changes to money market tactics and the cash ratio now in prospect. Banks holdings of notes and coins (about 10% of the total) do seem to be (rather poorly) related to bank deposits and short term interest rates. The most important component of the base - notes and coins held by the public - are supplied on demand and, not surprisingly they seem to be well related to consumer prices and real personal disposable incomes. Evidence drawn from the fifteen years prior to about 1978 suggests that they are not much influenced by the level of short term interest rates. However, one explanation for the very low growth in the base in 1979 and 1980 is that notes and coins were more responsive to interest rate levels than past relationships would have suggested.

17. Estimates of the interest rate sensitivity of the demand for notes and coins therefore depend on how much weight is attached to very recent experience. This implies that the response to interest rates is unstable. On the basis of the last 15 years' experience including 1979 and 1980 one might guess that a 1 percentage point rise in short rates would reduce the demand for cash by about ½%, within a year. But ignoring 1979 and 1980, experience since 1965 is consistent with a very small response indeed - less than ¼% in a year. Both these estimates are subject to disturbingly large margins of error, relative to their size.

18. In our present state of knowledge, we could not hope to control Mo with any reasonable degree of precision within a year by manipulating the level of short term interest rates - and, conversely, movements in Mo could not provide as good a guide for setting interest rates as M1.

Since we are so uncertain about the size of the short term response to interest rates, it would be extremely difficult to know how much to move interest rates if Mo was growing either too fast or too slowly. The small size of even the largest estimates strongly implies that very large movements in interest rates would be needed to correct over or under-shoots within a period as short as 6-12 months. So, on the evidence now available, Mo looks decidedly inferior to M1, on control grounds.

(c) Why £M3?

19. If M1 is easier to control over relatively short time periods than £M3, and is not demonstrably inferior to it in terms of economic significance, why was it decided to re-affirm the commitment to £M3 as an annual target at the time of the Budget? One important argument was continuity: the need to demonstrate that, following a serious overshoot of the 1980/81 target, the policy of controlling the money supply had not been abandoned or diluted. Equally important was the desire to avoid - and be seen to avoid - achieving monetary control solely by means of unduly high interest rates. This route can put a disproportionate share of the burden of adjusting to lower inflation on the company sector leaving the public sector relative unscathed. Fiscal restraint must play a full part (though of course the net effect on industry depends on how this is achieved).

20. A target for a narrow aggregate which can, at least in principle, be controlled by manipulating short term interest rates offers no assurance that fiscal policy will play a supporting role. In practice, however, interest rates might not have been very different, on average, in recent years, if we had been operating an M1 target. Moreover, the fact of very high interest rates, if they prove to be necessary, may itself force a change in fiscal policy. The US, where policy is largely focussed on narrow money, provides one illustration of these problems. Despite the difficulties of achieving short term control, therefore, the fact that £M3 can only be controlled if fiscal policy is consistent is sometimes considered a positive virtue, if one of the objectives of policy is to meet money targets without undue reliance on interest rates.

III Targetting a Narrow Aggregate: the Options

21. These arguments do not rule out some shorter term role for M1, or even Mo, in taking decisions about interest rates providing it can be assumed that fiscal policy is in fact consistent with the MTFS. The possibilities are:-

(i) a single target for a narrow aggregate in place of the existing targets for £M3, annual and medium term - possibly (though not necessarily) alongside some objective for the PSBR; this option was discussed in the preceding section;

(ii) a short term (6-12 month) operational target for one of the narrow aggregates, with £M3 as the medium term (MTFS) target;

(iii) a short term target for a narrow aggregate as an adjunct to the annual and medium term targets for £M3.

(iv) using the narrow aggregates to interpret or predict monetary conditions alongside £M3, without adopting a formal target for them.

(a) Multiple Targets: options (ii) and (iii)

22. The objection to options (ii) and (iii) is that measures taken to control the narrow aggregate may jeopardise the already difficult task of achieving the target for £M3. This has most force if there are annual targets for both £M3 and one of the narrow aggregates, but it may be serious even if the £M3 target is only a medium term one. The problem arises because both broad and narrow money are responsive to interest rates and fiscal policy instruments, though to different degrees. If we knew, with some precision and confidence, exactly how each instrument affected each of the different aggregates, and fiscal policy could be manipulated as flexibly as interest rates, it should,

in principle at least, be possible to offset the unwanted consequences for £M3 of interest rate changes made primarily with an eye on the narrow aggregate by altering fiscal policy. Even if this were not feasible, it might still be possible to vary gilts sales so as to smooth the path of £M3, before the necessary fiscal changes were implemented and took effect. In other words, two (and possibly three) policy instruments should in theory allow the authorities to hit two intermediate targets at more or less the same time.

23. But whether there is, even in theory, scope for multiple targets is debatable. Even though the relationship between short term rates and the level of £M3 is unreliable, the authorities may need to use them to control bank lending, if they are to control £M3 over a run of years without distorting banks' balance sheets in a way which may sooner or later prove destabilising. If so, they may have less room for manoeuvre on interest rates than the simple "two instruments two targets" proposition suggests. If bank lending is growing strongly for example, control of £M3 will involve overfunding the PSBR, unless and until bank lending is reduced. This will tighten money market conditions and the authorities will be confronted with a choice between allowing short term interest rates to rise and providing possibly substantial amounts of money market assistance eg. by buying commercial bills, or forward swaps. If short rates are allowed to rise, the growth in bank lending should in time be corrected, and a more balanced pattern of bank lending to public and private sector will be re-established. But if short term rates are held down - because they are determined by other considerations - banks will find themselves increasingly short of public sector assets.

P.E.M (i) (ii) (iii)

24. It is difficult to know how banks would react in such a situation. If they are indifferent as between commercial bills and public sector assets, there may be no real problem. But they may not be. Cutting lending is likely to be a last resort. In the short run, banks could respond by bidding liquid assets

away from non-banks, driving down their yields and encouraging the non-bank private sector to switch into money. Whether, in this situation, the authorities would be right to allow a rise in the money supply rather than put up interest rates, depends on why bank lending is growing so fast. If it represents a structural shift away from other non-bank forms of borrowing for example, it may be appropriate to accommodate at least some of the increase in the money supply. But it if reflects a sharp rise in activity, it would probably be preferable to increase interest rates.

25. If the theoretical case for multiple targets is not clearcut, the presentational and practical difficulties are obvious. Multiple targets may reduce the credibility of monetary policy. Commentators will be tempted to focus on the aggregate which is performing worst relative to target, as the authorities will usually want to point to the one which is most nearly on track. Even if one target is de-emphasised and called a medium term target, both markets and the authorities would find it almost impossible in practice to ignore short term developments. This is not unreasonable, since even short term fluctuations may contain some information about longer term trends among the inevitable "noise".

---

26. There can be no guarantee that both targets would in practice be met, certainly on a year by year basis. Our knowledge of the effects of different policy instruments is inevitably imprecise, and the fact that policy takes time both to change and to take effect adds to the problem. In recent years it has proved difficult to meet even one target, with all the instruments at the authorities disposal. Two would certainly add to the problems to put it no higher.

27. It would be difficult to make £M3 a purely medium term target in the current financial year, without risking a serious loss of credibility in the overall strategy. The fact that last year's target was so seriously overshot makes it particularly important to achieve the 1981/82 target if at all possible. Adopting an additional annual target for M1 or Mo could jeopardise the £M3 target, without significantly adding anything to the credibility of policy. This risk would still be present if there were a move to multiple targets after the end of the current target period- say in the 1982 Budget.

(b) Narrow Aggregates as Indicators: option (iv)

28. A less formal way of giving a role to the narrow aggregates would be to treat them as early warning devices, rather than explicit targets. This would be worth doing if there was reason to think that movements in the narrow aggregates systematically 'led' developments in £M3 or other broad money aggregates. But in fact this does not seem to have been the case, on average, over the last decade or so, judging by the statistical relationships between M1 and £M3. On the other hand, one can certainly point to individual episodes where, with the benefit of hindsight, the narrow aggregates seemed to be giving an earlier - or more accurate - signal about monetary conditions than £M3.

1977/78

29. The clearest example is 1977. In the first half of 1977, MLR was reduced by stages from 15% to 5%, as the authorities tried to hold the exchange rate down. This was reflected in an acceleration in the growth of M1 from 0.6% in 1976 Q4, to 5% in 1977 Q2 and 7.2% in the third quarter. Despite heavy intervention, £M3 growth never exceeded 3% even in 1977 Q3. This dramatic fall in interest rates did however fuel the growth in bank lending in 1978, which was largely responsible for the target overshoot in that year. If the authorities had taken more

account of the narrow aggregates in early '77 - as some commentators advocated at the time - they might have abandoned the policy of trying to reconcile incompatible exchange rates and monetary objectives sooner, thereby increasing their chances of meeting the £M3 target in both 1977 and 1978.

<u>1980</u>

30. Last year provides an example of a case where the narrow aggregates may have been giving a more accurate picture of underlying monetary conditions than £M3. On our own analysis the rise in £M3 reflected a rise in financial wealth, as consumers reacted to the inflationary shocks of 1979/80 by saving more, relative to their income, in order to rebuild the real value of their holdings of money-fixed assets. Since the rise in financial wealth represented a move back to some preferred position, not a temporary switch which will be reversed, the increase in £M3 to which it gave rise is likely to be held, not spent. It was a response to <u>past</u> inflation, in other words, and is unlikely to fuel a future rise in the price level. The narrow aggregates, which are less responsive to financial wealth, were more affected by the sharp rise in interest rates in both nominal and real terms. The effect of interest rates on activity is uncertain, but it is difficult not to believe that they were a factor in the savage destocking that took place last year, and, indirectly, in the deceleration in inflation that occurred.

31. While there is therefore some reason to think that the narrow aggregates may have been a better indicator of monetary conditions last year than £M3, the evidence is not conclusive. We cannot be sure, at this stage, that the growth in broad money will not fuel future inflation. Our analysis rests on the assumption that there is a stable demand for wealth relative to income. If the rise in financial wealth was not planned, or is only temporary, the associated rise in £M3 could still find its way into extra spending, and finance future inflation. In fact, however, little is known directly about the demand for gross financial wealth. The evidence is indirect and largely based on the behaviour of the personal sector saving ratio in the 1970's.

32. Secondly, £M3 was only a misleading indicator, even on our analysis, if the Government's concern is about the future rate of inflation, rather than the price level itself. If the worry is the price level itself accommodating past inflation is not acceptable: the appropriate response to the £M3 overshoot was not to ignore it, but to claw it back in future year to correct for the inflationary shocks that took place in 1979/80 which were unwittingly accommodated by the expansion of broad money in 1980/81.

1972-74

33. There is one notable episode when, it is often asserted, the narrow aggregates provided a misleading indicator of underlying monetary conditions and future inflation - the period 1972-4. Over this period, the authorities justified their failure to tighten policy in the face of an explosive growth in £M3 partly by reference to the more moderate growth in M1. Some of the difficulties in interpreting this episode have already been mentioned. £M3 was known to be heavily distorted by the aftermath of Competition and Credit Control and in 73/74 by round tripping, and there were good grounds for looking at other monetary indicators. (though there were also fears that M1 was distorted too, to a lesser extent). Moreover, the decision not to adopt a more restrictive stance on fiscal policy as well as interest rates was in part a deliberate one, not just a by-product of inadequate information. As the charts show, both real Mo and real M1 rose sharply relative to past trends between 1972 and mid-1973. Yet fiscal policy remained very lax until late 1973 and the authorities did not push MLR above 9% until July 1973. Thereafter the growth in the narrow - though not the broad - aggregates did decelerate sharply as interest rates were raised in stages, to 13% by November.

34. The simple view that the narrow aggregates always lead movements in broad money does not stand up. But M1 and Mo have sometimes contained useful information about underlying monetary conditions and future trends which are

obscurred in the broad aggregates, for structural or other reasons. It would be unwise to ignore sharp divergences in the growth of broad and narrow aggregates. But equally, there seems no case for relying on either Mo or M1 entirely, to the exclusion of other factors (including broad money) in taking decisions about interest rates. The moral seems to be that no rule can remove the need for the authorities to form their own interpretation of events before changing policy instruments.

IV. Outlook for the Monetary Aggregates in 1981/82 and 1982/83

35. In 1980/81, £M3 grew twice as fast as M1 and Mo. The forecast underlying the MTFS suggested that this position may be broadly reversed over the next three years, if the assumptions on which it was made are correct: £M3 growth was assumed to fall from nearly 18% in 1980/81, to 8% in 1981/82 and then to decline steadily by a percentage point each year to reach 6% in 1983/4. With the PSBR falling relative to GDP, this was consistent with a gradually declining path for interest rates. The narrower aggregates were expected to grow relatively rapidly, however, at around 14-15% a year, principally in response to the decline in interest rates and some recovery in activity.

36. The latest forecast shows a somewhat different picture. Higher and rising short term interest rates are now thought to be necessary if the £M3 target is to be met; the average level of short term rates is put at nearly 14% in both 81/82 and 82/83. As a result, the forecast growth of the narrow aggregates is rather lower than in the MTFS, though still above the assumed growth in £M3. M1 is expected to grow by about 11% in both financial years, while Mo may grow by about 10½% this year, falling to about 8% next.

V. Setting Targets for the Narrow Aggregates

37. While the forecasts are subject to a wide margin of error, the broad conclusion they point to is plausible: namely that a target for M1 or Mo which is in single figures will require higher real interest rates than would otherwise

be needed to meet the MTFS targets for £M3. This reflects a general problem with targetting a narrow aggregate when the rate of inflation is changing. The demand for M1 depends, inter alia on the price level and the level of nominal interest rates. If nominal rates are constant as inflation comes down, the demand for M1 will grow broadly in line with nominal incomes, though the deceleration in the rate of inflation will itself cause real interest rates to rise. If, on the other hand nominal interest rates fall in line with inflation to keep real interest rates constant, the demand for M1 will tend to grow faster than nominal incomes. In other words, the fact that the demand for M1 is sensitive to the level of nominal interest rates means that velocity is likely to vary with the rate of inflation. This makes it difficult to reconcile a smooth growth in M1 with stable real interest rates during periods when the rate of inflation is changing.

38. There have been pronounced changes in M1 velocity over the past decade, as the rate of inflation has varied. M1 velocity rose steeply between 1972-75 when the rate of inflation accelerated, although real interest rates fell. When inflation decelerated from 1976 to 1978, M1 velocity fell sharply, although real interest rates became less negative. Between 1978 and 1980 inflation accelerated again, and M1 velocity again rose sharply, while real interest rates tended to fall until the end of 1979. The increase in M1 velocity as inflation decelerated through 1980 was, associated with a marked rise in real interest rates.

39. Over the next few years, a target for M1 which would avoid the need for high real interest rates would probably have to be above the growth in nominal incomes - that is, the target would have to be set to accommodate some fall in velocity as inflation comes down. That would mean choosing rather high numbers - certainly above the current £M3 target

and probably in excess of 10% for both 1981/82 and 1982/83. If the target were a public one, this would be presentationally very difficult, though it would be consistent with using M1 as an indicator, for internal purposes, in the sense discussed in section III(b) above, to interpret movements in £M3.

FEU
7 July 1981

CHARTS

Chart 1 Velocity

A: Mo
B: M1
C: £M3

Chart II Money and Prices (% changes)

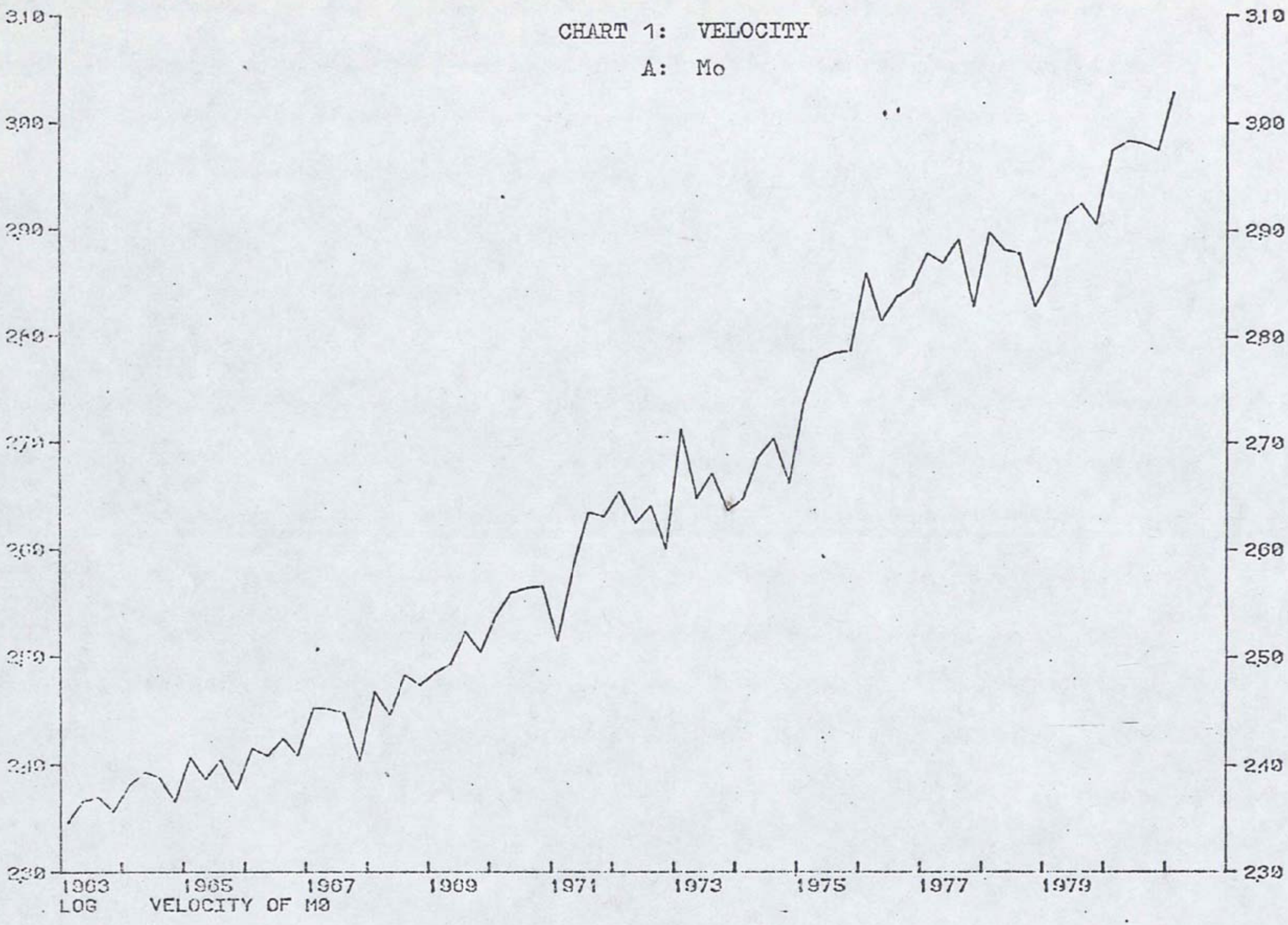
A: Mo
B: M1
C: £M3

Chart III Real Money Supply and Real GDP

A: Mo
B: M1
C: £M3

CHART 1: VELOCITY

A: Mo



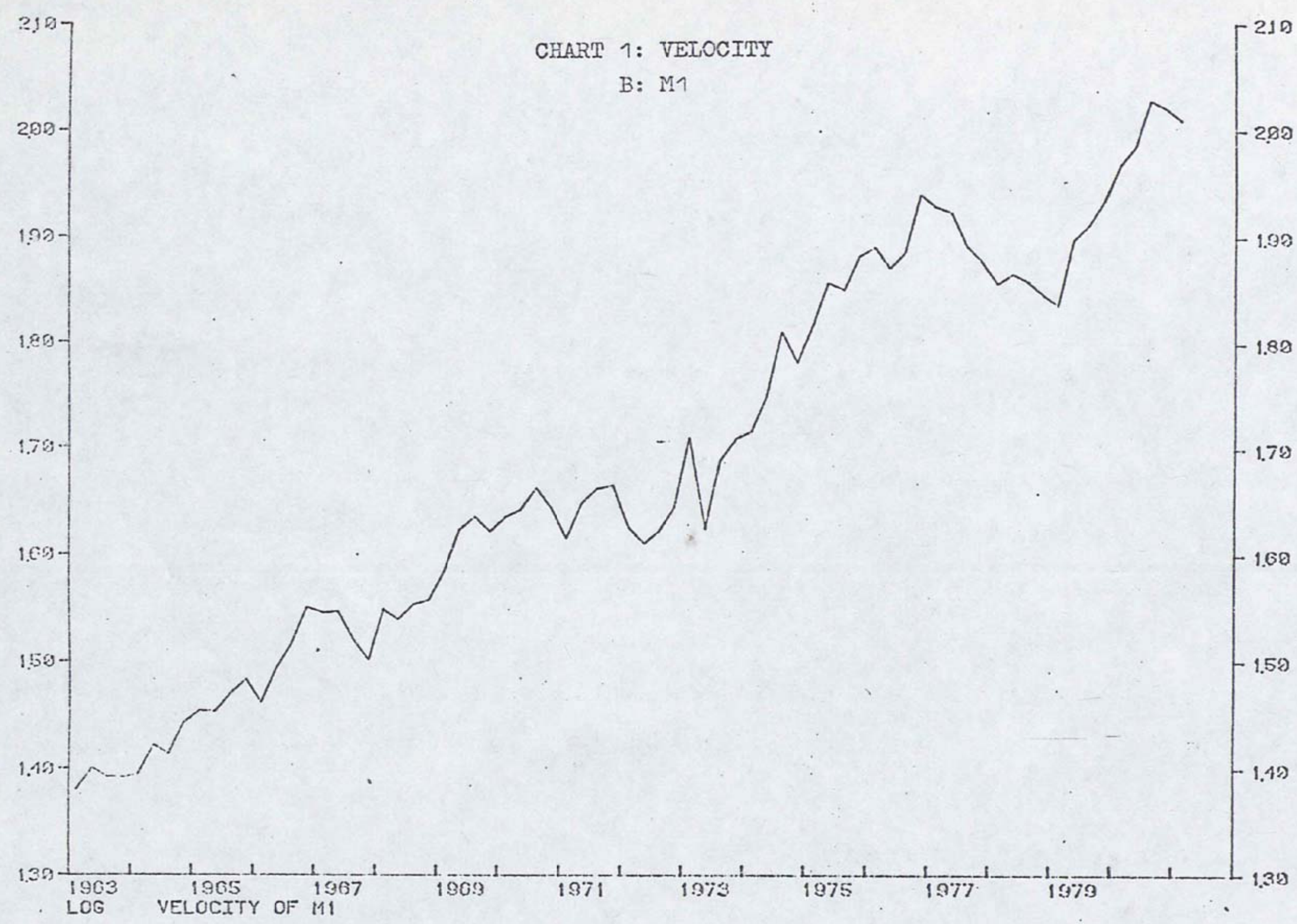


CHART 1: VELOCITY
B: M1
2.10
2.00
1.90
1.80
1.70
1.60
1.50
1.40
1.30
1963
1965
1967
1969
1971
1973
1975
1977
1979
LOG VELOCITY OF M1

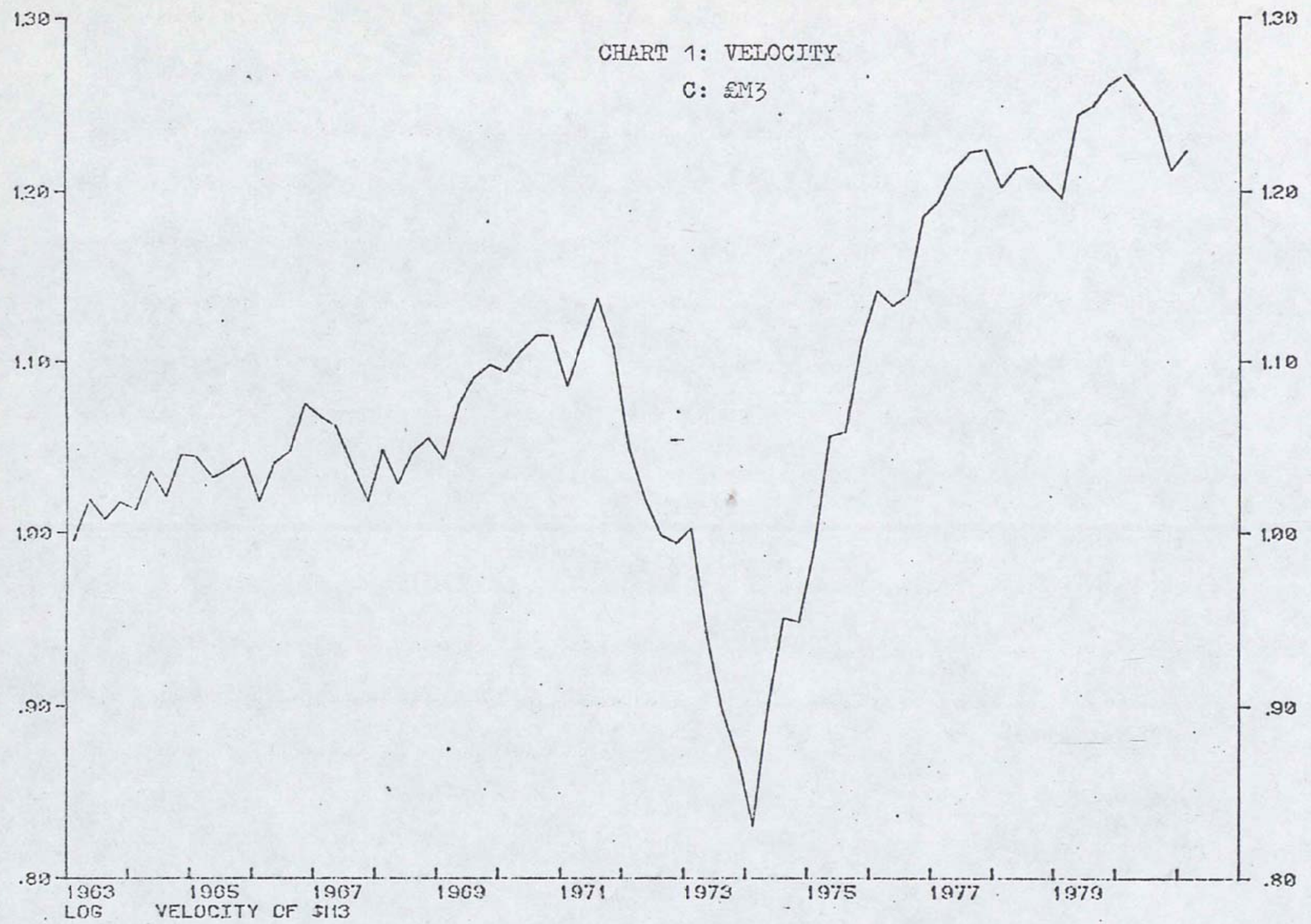
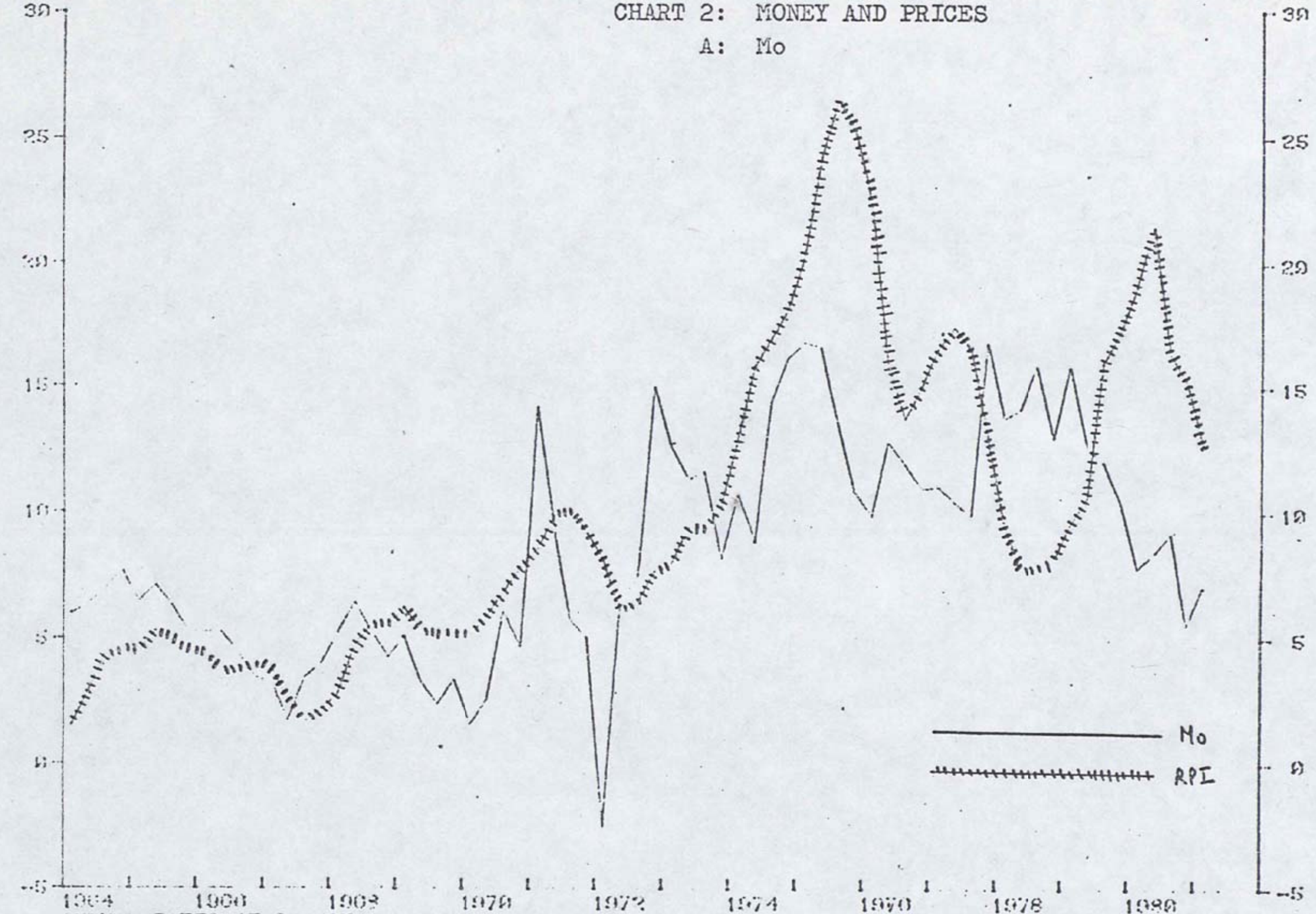


CHART 1: VELOCITY
C: £M3
1.30
1.20
1.10
1.00
.90
.80
1963
1965
1967
1969
1971
1973
1975
1977
1979
LOG VELOCITY OF £M3

CHART 2: MONEY AND PRICES

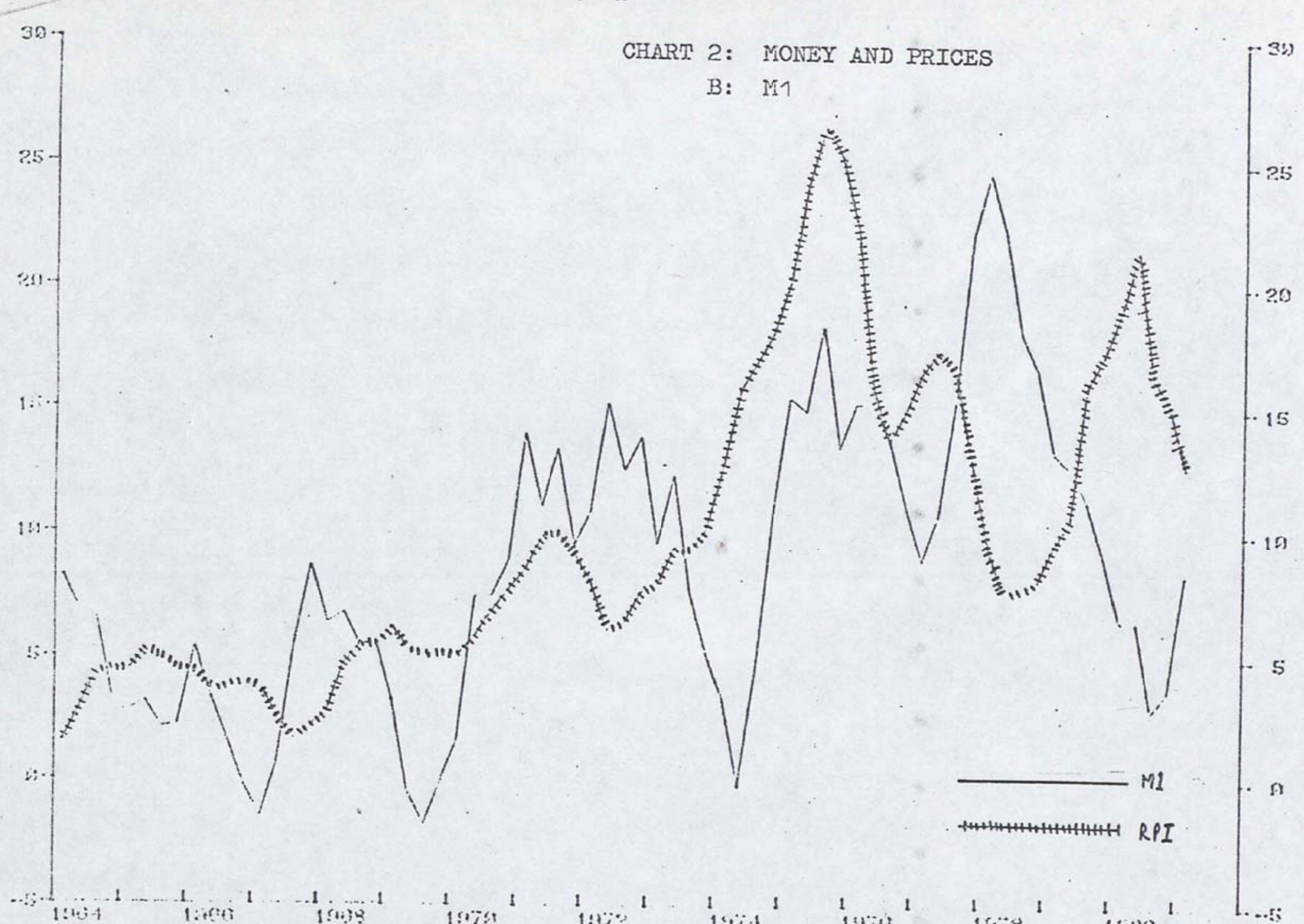
A: Mo



ANNUAL RATES OF CHANGE OF M0 AND RPI

CHART 2: MONEY AND PRICES

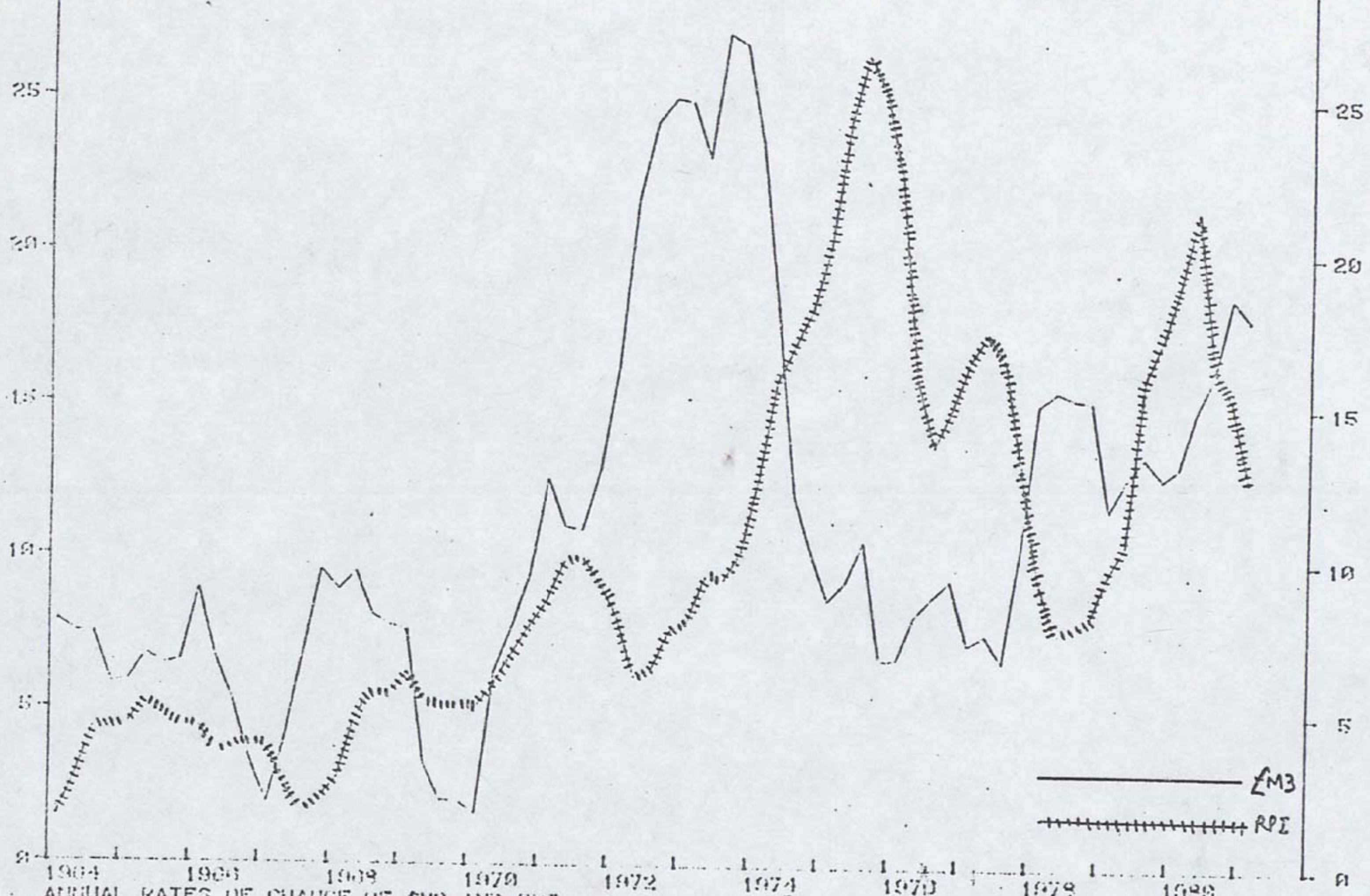
B: M1



ANNUAL RATES OF CHANGE OF M1 AND RPI

CHART 2: MONEY AND PRICES

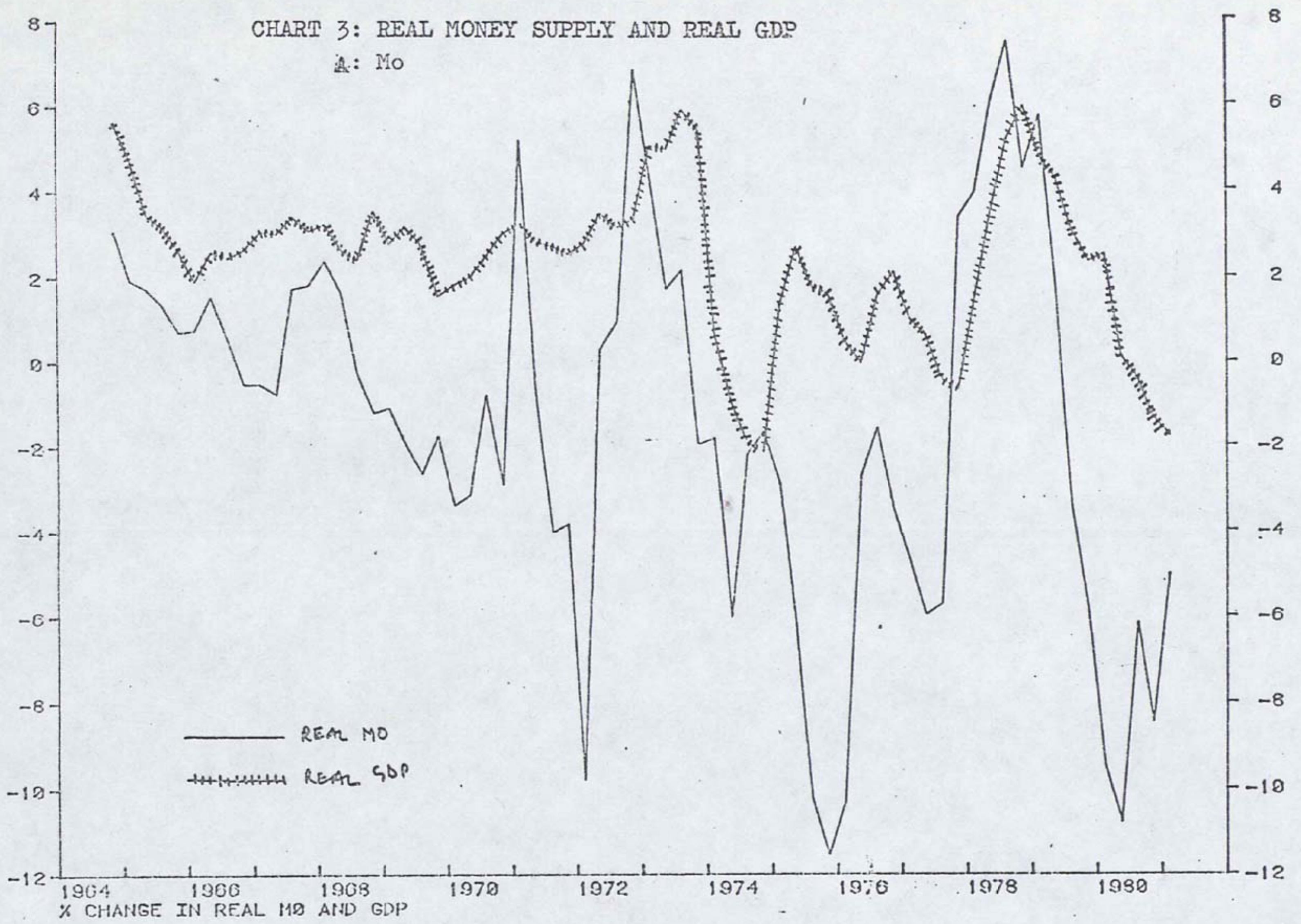
C: £M3



ANNUAL RATES OF CHANGE OF £M3 AND RPI

CHART 3: REAL MONEY SUPPLY AND REAL GDP

A: Mo



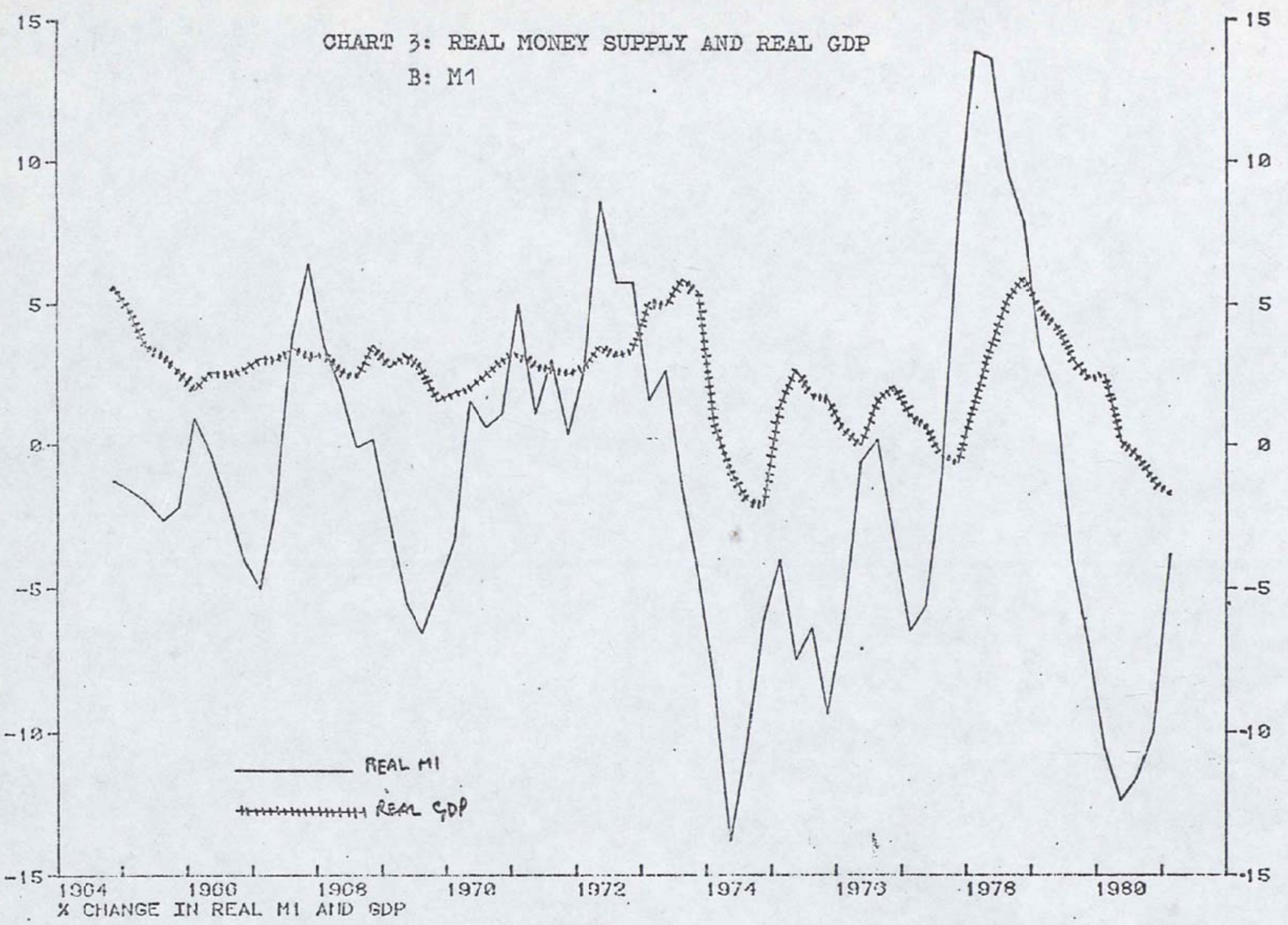


CHART 3: REAL MONEY SUPPLY AND REAL GDP
B: M1
15
10
5
0
-5
-10
-15
REAL M1
REAL GDP
1964
1966
1968
1970
1972
1974
1976
1978
1980
% CHANGE IN REAL M1 AND GDP

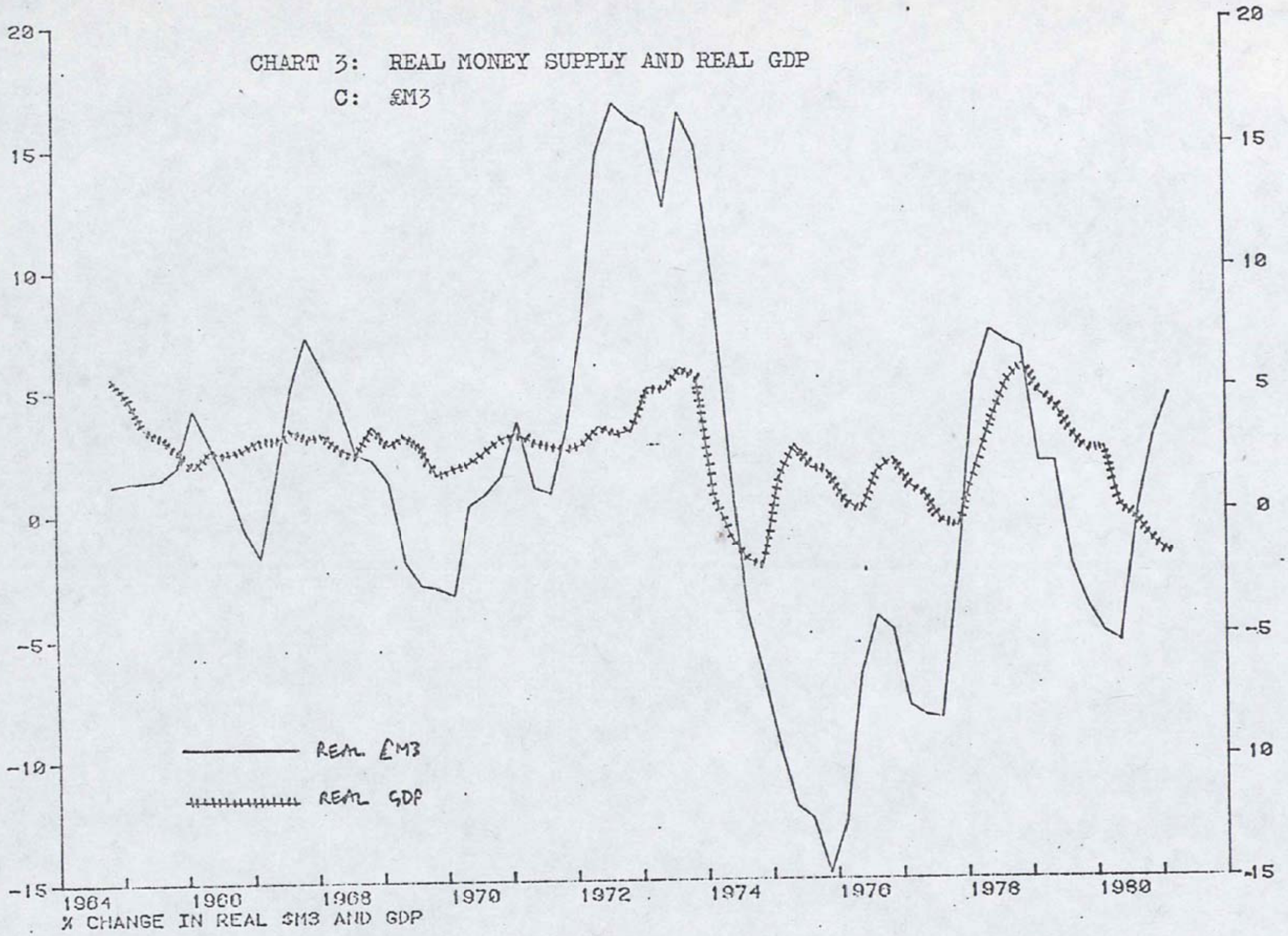


CHART 3: REAL MONEY SUPPLY AND REAL GDP
C: £M3
20
15
10
5
0
-5
-10
-15
REAL £M3
REAL GDP
1964
1966
1968
1970
1972
1974
1976
1978
1980
% CHANGE IN REAL £M3 AND GDP

CONFIDENTIAL

PAPER III

SETTING SHORT-TERM INTEREST RATES: £M3 AND OTHER INDICATORS

The new arrangements are intended to reduce the visibility of the guiding hand of the authorities and also to let the market play some part in the determination of interest rates of differing maturities. The system is described in the first paper prepared for the seminar: "Monetary Control: The New Arrangements".

2. It has also been established that the movement of £M3 relative to the target range is not the only factor to be taken into account in deciding the level of the interest rate band. The purpose of this paper is to describe the factors to which we should give attention and the circumstances in which an increase or reduction in the level of the band might be considered appropriate. We are not seeking a simple formula which will provide the correct response to all conceivable circumstances, but neither do we want to re-think our position each month from first principles.

3. We shall be operating within the framework of the medium-term strategy. This was designed with the intention that the deceleration of monetary growth should be achieved without relying on an excessive level of interest rates. In that sense, but only in that sense, we have an objective for the level of short-term interest rates themselves. This has been an important consideration in fiscal policy decisions, most notably in this year's budget. It cannot, however, be given much weight in setting short-term interest rates, month by month, unless it can be demonstrated that such a move is consistent with the overall strategy, and with a reduction in the growth rate of money and prices.

4. The new arrangements are designed, amongst other things, to remove a perceived bias towards delay in an administered MLR system. We shall not, therefore, wish to build any such bias into the new system, and should, indeed, consider a decision to keep the level of the band unchanged as needing just as much justification as a decision to raise or lower it.

5. The interest rate band will be relatively narrow, and its main purpose will be simply to allow for the imprecision of control. The instructions to the market operators will be to keep rates within the band. This does not mean, however, that we cannot, or should not, respond to market pressures. These will show up not only as movements within the band, but also as movements in rates at longer maturities which the authorities do not influence so directly. Thus, the first of the factors to be considered when setting rates is the experience of market conditions in the preceding period.

Market conditions

6. The authorities cannot be wholely passive in the market, since there would then be no reason why the outcome for any of the monetary aggregates should accord with our intentions. If, however, we make our intentions clear to the market, then we may find that market sentiment is useful as an indicator to us of future developments in the factors which govern our decisions. Thus, if the market believes that the rate of monetary growth or inflation is likely to accelerate, there will be upward pressure on interest rates - so long as the market believes that these are amongst the factors which influence the authorities in setting interest rates. If the market expects monetary growth or inflation to accelerate, and we have no reason to believe that view is incorrect, then we may well decide to make a move in interest rates immediately rather than wait for the monetary growth or inflation to manifest itself in fact. The situation has parallels in the management of an exchange rate: sometimes the market can see the "fundamentals " more clearly than the monetary authorities.

7. Money market conditions, especially in the longer maturities, will reflect such expectations, but more "technical" factors such as the flow of funds day-by-day into and out of the exchequer will also be important, especially at the very short end. Thus, last summer there was sustained and strong upward pressure on rates during periods when the PSBR was being overfunded. The system will work rather differently after the reserve assets requirement is abolished, but conditions of the same general kind can recur (for example, in the aftermath of the Civil Service dispute). Such "technical"

pressures are not, in general, likely to signal new information which is relevant to the achievement of targets for the monetary aggregates, or the economy more generally. Typically, we will want to resist such pressure, whether up or down, to the extent necessary to keep interest rates within the band.

8. Market conditions more generally, including the foreign exchange market and the gilts market as well as money markets, may also on occasion influence the timing of interest rate changes. If these markets are unsettled for any reason, there will remain a strong inhibition against the authorities initiating a movement of interest rates, particularly a movement in an unexpected direction. It would be particularly difficult to lower interest rates at a time when the exchange rate was falling.

Sterling £M3

9. The Budget Speech confirmed that the targets for £M3 will continue as the centrepiece of the economic strategy. The emphasis is on meeting the target for the year as a whole, rather than month-by-month. It should be possible to keep the confidence of the markets in the face of short-term fluctuations in £M3, provided that assurance can be given of a consistent underlying trend. Moreover we do not have the instruments to achieve very precise control if we wished it. This must influence the way in which we monitor movements in the target aggregate and respond to divergences in either direction.

10. The first stage of analysis must be, as always, to estimate the effects of known distortions to the outturn figures. Last year the after-effects of the corset scheme were important; this year it is the Civil Service dispute; round-tripping has also been a recurrent problem. The next stage is to look at identifiable factors influencing the short-term outlook. The result is a view of the current trend, based on the movement over the past six months together with the prospect for the next three months.

11. The assessment also needs to look further ahead than the next three months. The short-term response of £M3 to changes in interest rates seems, typically, to be quite small relative to the response in the longer-term. In these circumstances, there is clearly a danger

of over-correction in response to deviations from the target path if the authorities attempt control over too short a period. We have never believed that it was possible to correct all deviations within a period as short as three months. A more realistic horizon would be about six to twelve months - in other words we should, even in the early months of the target year, direct our assessment towards the measures necessary to deliver the right level of £M3 at the end of the year and beyond. This suggests a need for a forecast which focuses on conditions nine months hence.

12. Unfortunately monetary forecasting is a particularly hazardous occupation. Typically the error margin for a forecast of £M3 twelve months ahead is about 4%. Nevertheless we will want to take account of all the relevant information we now have that has clear implications for future monetary growth. If such information was ignored there would be occasions when interest rates were moved up or down to correct divergences which were believed to be transitory. This would tend to increase the volatility of the money supply as well as interest rates. It would also mean turning a blind eye to early warnings that conditions were likely to become too tight or too slack.

13. If interest rate decisions are to be based on forecasts of £M3 as well as outturns, it is important that the reasoning behind these forecasts is clear and convincing. Sometimes we can point to particular events in the future which can be predicted with reasonable confidence - the receipt of our EEC refund last year was a good example. Sometimes we can point to events in the recent past which will undoubtedly have implications for the future - a recent change in interest rates or the exchange rate would be a good example. We must also take account of the prospects for economic activity generally and for inflation, insofar as they are relevant to monetary developments, to the PSBR for example, and to bank lending - although, again, uncertainty must reduce the weight given to such forecasts.

14. Having assessed the underlying trend in £M3, and considered what information there is about the prospects nine months ahead, the next step in principle should be to calculate the scale of interest rate change that would bring the target aggregate back to the centre of the

range within the nine-month forecast period. A calculation of this kind cannot, in practice, be made with any certainty or precision. A wide aggregate like £M3 responds not only to the level of interest rates, but also to the structure of relative interest rates in ways which are complicated and not at all well understood. Indeed the possibility of a perverse reaction in the short run, £M3 increasing as a result of higher short-term interest rates, cannot be ruled out.

15. The effects of short-term interest rates on £M3 include:

(a) higher interest rates will reduce bank lending, but this effect seems slow acting;

(b) higher interest rates will increase the incomes of some individuals and institutions, but on the other hand, some will suffer capital losses; on balance, this should reduce the demand for money, but again it will take time to work;

(c) higher interest rates will make interest-bearing bank deposits <u>more</u> attractive, but on the other hand if the rise is thought to be temporary, gilts will be even more attractive; on balance this could produce a substantial reduction in £M3 almost immediately, but the effect is difficult to predict;

(d) higher interest rates will reduce economic activity and inflation, especially if the exchange rate is strengthened; this will reduce the demand both for bank lending and for bank deposits.

The latest estimates suggest that a rise in short-term interest rates of one percentage point will, on average, reduce £M3 after nine months by 1 to 2 percentage points. But these estimates keep changing; and the effects also depend on tactical decisions of the authorities in the gilt-edged market. There is no satisfactory way of replacing the process of forecasting and policy assessment by a purely mechanical procedure.

Last year, faced with a serious over-run on £M3, we decided that an interest rate increase was not an appropriate response. Instead, some quite stringent fiscal measures were taken in this year's Budget. This instrument was chosen partly because the monetary problem was associated with an over-run on the PSBR, and partly because interest rates were already at a high level. This illustrates the general point that an increase in interest rates will not always be the appropriate response to excessive monetary growth. Sometimes a fiscal policy solution will be preferred, or else a change in the funding programme.

<u>The Other Monetary Aggregates</u>

17. A separate paper, "The Role of the Narrow Aggregates", discusses M1 and M0 either as alternatives to a £M3 target or as elements in a system of multiple targets. The analysis of various periods in the past suggests that the narrow aggregates do contain information which should be taken into account in interpreting the movements of £M3 and in interest rate decisions. We need to establish as routine an appropriate procedure for making use of this information.

18. Each year a target is set for £M3. It would be possible at the same time to estimate the growth of M1 which was compatible, according to the information then available, with the achievement of the £M3 target. This would reflect medium-term trends in the velocity of circulation of the two aggregates, recent and prospective movements in interest rates and no doubt a variety of "special factors". The result of this calculation could then form the basis for a guideline relating to the movements in M1 in the following twelve months. During the year we would then monitor the outturn and prospect for M1 over the same time span as we apply to £M3. Unexpected movements in M1, irrespective of what was happening to £M3, would be considered an important element in the interest rate decision.

19. At present we do not publish even a forecast of M1, although a qualitative indication was given in this year's Budget Speech. If the procedure of setting guidelines for M1 came to play a more important part in interest rate decisions, we would need to consider whether it would be advantageous to make a more explicit public reference to it.

20. At a later stage a similar procedure might be applied to MO, but in the coming year its movements are likely to be distorted by the change in the cash ratio. The narrow aggregates should be espcially valuable when £M3 is believed to be subject to serious distortion. Currently, for example, the growth of MO is of particular interest as it is relatively undistorted by the Civil Service dispute.

21. Last year we also made frequent reference to the wider aggregates, especially PSL1, since they were likely to be less distorted than £M3 by the ending of the corset. The growth of more vigorous competition between banks and building societies suggests a rather similar role for PSL2 in the future. This year we have also seen a remarkably rapid increase in residents' foreign currency deposits, made possible by the abolition of exchange control. This suggests an enhanced role for M3, which had attracted little attention in previous years.

22. Recent analysis of money supply movements over a long period of time suggests that a useful relationship may exist between £M3 and the total of all financial assets held by the private sector. This total, the gross financial wealth of the sector, is potentially the widest wide aggregate of all. Quarterly data is now available, and even monthly movements can be estimated approximately. We expect to make more use of this data in interpreting monetary conditions in the future.

<u>External Considerations</u>

23. Over the past year, intervention in the foreign exchange markets has been confined to short-term smoothing and it is assumed that this policy will continue, irrespective of whether the rate is rising or falling. It is appropriate, however, that external considerations should be given some weight in se t ting short-term interest rates. This does not mean that the Government has or should have an objective for the exchange rate. On the other hand, the exchange rate will influence our judgments through its effects on inflation and the growth of nominal incomes in the domestic economy.

24. Forecasts of the exchange rate have been unreliable and the way it is influenced by relative interest rates remains very uncertain.

Nevertheless, movement in overseas rates are relevant information when we are considering interest rate movements in the UK, since differentials do have some effect on the exchange rate and the exchange rate does have an effect on prices. As mentioned above, conditions in the exchange market may also on occasion be important to the timing of interest rate moves, especially when such a move could be misinterpreted as a change in the nature of our policy either towards the monetary targets or towards the exchange rate itself.

Nominal Incomes

25. The purpose of the monetary targets is to control nominal incomes and ultimately the price level. In interpreting movements in the monetary aggregates, it is always necessary to set them in that context. Last year it was partly the relatively slow growth of nominal incomes which led to the decision to permit some over-shooting of the target for £M3. That decision is potentially reversible if the growth of nominal incomes were for any reason to speed up again.

26. We have made use on several occasions recently of the idea of a national cash limit. Within the framework of the monetary strategy there is, in effect, a constraint on gross domestic product as current prices, although no explicit target, or even forecast, has ever been announced for this total. The idea, without quantification, has been used in setting out the implications of public sector spending for the private sector, and the implications of pay settlements for employment. It is also relevant to the setting of short-term interest rates.

27. Quarterly figures for current price gdp are only available several months in arrears. There is normally however sufficient information in the monthly indicators to build up quite a good estimate for the movement of nominal incomes on a reasonably up-to-date basis, although some guesswork would undoubtedly be involv e d. We will aim to assemble enough information to give an estimate of the level of nominal incomes in the current quarter and its growth over the preceding six month period. This can then be set alongside the trend in the monetary aggregates calculated for the same months.

In the same way we can look ahead at the prospect for nominal incomes over the next nine months consistent with the latest indicators and the latest view of the economic forecasters.

28. Outturn and prospect can then be compared with the growth rate of nominal incomes expected when the target was set for £M3. This growth rate, which would normally be based on a forecast published at Budget time, would then become a guideline for monitoring performance, similar to that proposed for M1. At present we do not publish a forecast including gross domestic product at current prices explicitly, but if we chose to do so, the extra information divulged would not be very significant.

29. The growth of nominal incomes is partly a real growth of output and partly inflation. Obviously our attitude to the two parts is not in the long run the same. Behind the idea of a constraint on nominal income is some view of the sustainable growth of real output. If we changed our view about that rate - the underlying growth of productive potential - then we might well wish to change our view of the appropriate growth in nominal incomes, and even of the money supply. But unless we do change our view in this way, our response to deviations of nominal incomes from the guidelines would be much the same, whether they were deviations in volume or in price. It is not appropriate therefore to include output (or employment) as such amongst the factors taken into account in setting interest rates.

Real Interest Rates

30. The interest rate cut of November 1980 was largely a response to the decline in the rate of inflation. One line of argument linked this to the growth of nominal incomes, but there was another which was based on the consequent movement in real interest rates. As inflation slows down the stringency of a given nominal interest rate increases. It is plausible, although not at all well documented, that real rather than nominal interest rates influence private sector saving, investment and borrowing decisions.

31. There is no straightforward way of measuring real interest rates, since they depend on the rate of inflation in the future rather than

the past. The best we can do is to examine the implications of inflation forecasts, which will in turn be heavily influenced by experience of inflation in the recent past. In practice, we cannot expect to gain much insight from trying to measure real interest rates, especially now that the rate of inflation is changing relatively slowly.

32. In the past interest rates have not kept pace with actual changes in the rate of inflation; thus rapid rates of inflation have typically been associated with negative real interest rates and low inflation with positive real interest rates. As the rate of inflation slows down, therefore, it is not to be expected that the interest rate will necessarily keep pace. Much depends on the way inflationary expectations are now based; it cannot be assumed that the experience of the last few years has left perceptions unchanged. There does not seem to be a sufficient basis on which guidelines for real interest rates could be devised. But the presumption remains that short-term interest rates will, other things being equal, move down gradually as inflation abates.

Policy Decisions

33. This paper has reviewed the information relevant to decisions about short-term interest rates:

(i) Market Conditions - as we may want to follow the lead of the market, when we consider it is based on a sound interpretation of monetary and other developments.

(ii) The Current Trend in £M3 - over a period of about six months back and three months forward, after adjusting for known distortions;

(iii) The Prospect for £M3 - up to about nine months ahead, but discounting for the unavoidable uncertainty surrounding all financial fore casting;

(iv) The Other Monetary Aggregates - especially M1, for which we might establish a guideline based on the forecast of a growth rate compatible with the £M3 target;

(v) External Considerations - not because we have an exchange rate target, but because depreciation contributes to inflation;

(vi) Nominal Incomes - monitoring outturn against guideline for the value of gross domestic product at current prices, but not the split between price and volume;

and (vii) Real Interest Rates - to the extent that we can measure them.

34. It would be both artificial and arbitrary to attach fixed mathematical weights to each factor. There is a general presumption that £M3 has some primacy over the other indicators. The starting point, therefore, is a judgement of the level of interest rates needed to meet the target for £M3 within a horizon of six to twelve months (we cannot hope for more precise control than that). The events of last year, however, suggest that short-term interest rates cannot always be guided by actual or prospective movements in £M3 alone. At the least, those movements need to be interpreted in a wider context. We need an assessment of why £M3 is growing (or expected to grow) faster or slower than intended. If that assessment shows that there is something odd about the behaviour of £M3 relative to other indicators, we may be persuaded that the general presumption of its primacy has to be discarded in this case.

35. One source of such evidence is the narrow aggregates. We have no targets for either M1 or the monetary base, but we could have a guideline for M1 believed to be consistent with the achievement of the £M3 target. If the relative movement of the aggregates diverged significantly from that predicted, we would regard that as justifying examination of the possibility that £M3 was (as last year) giving a misleading signal.

36. We need also to look beyond the movements in £M3, to try and see what they mean for the achievement of the ultimate objective of reducing inflation. There are exceptions to the rule that the relation of £M3 to nominal incomes is stable and predictable even in the medium term. We have to be on the lookout for changes in institutions (the

relative importance of banks and other financial institutions as intermediaries for example) or in private sector behaviour (the relationship of income to financial wealth for example) which will change the significance of the target aggregate. If changes of this sort occur, and are likely to be longlasting, then the response must either be to change our intentions for £M3 or else to change the path of nominal incomes we expect as a consequence. We cannot keep both.

37. One way of interpreting the movements in monetary aggregates therefore is to set them alongside the behaviour of nominal incomes relative to pre-set guidelines. Usually this procedure will confirm the conclusions that would follow from looking at the money supply alone: excessive monetary growth will usually go with actual or prospective excess in nominal incomes, and vice versa. If it does not, we would want to look again at the judgements behind the forecasts of nominal incomes. Only when we are reasonably confident that those forecasts are well-based would we wish to qualify the normal rule that monetary aggregates are the main influence on short-term interest rate decisions.

38. The considerations set out in this paper are in line with the broad statements in the Budget Speech about the factors taken into account in setting short-term interest rates. Nevertheless, if this approach is confirmed, there would be advantage in setting out for the public in rather more detail the way in which the factors are assessed and their contribution to the overall judgment. This would take the form of a ~~statement~~ describing the regime in general terms, made when the new arrangements come into force, rather than a commentary on particular interest rate movements that develop at a later stage.

CONFIDENTIAL

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

24 July 1981

T Lankester Esq
Private Secretary
Prime Minister's Office
No.10 Downing Street
LONDON SW1

a/c Walters

Dear Tim,

FUNDING

We shall be sending over the papers for the Prime Minister's Monetary Control Seminar. But you may like to have separately a report on the work of the Treasury/Bank Committee on funding which the Prime Minister asked about in her minute to the Chancellor of 4 June. The Committee (of which Alan Walters was a member) reported to the Chancellor in February.

The report showed that the record on funding over recent years has been better than is frequently supposed. The Bank has shown that it has some flexibility over a period of months to vary the pace of funding in response to changing monetary prospects. But we cannot rely on variations in the quantity of debt sales alone either to deliver precise control of £M3 on a monthly or even quarterly basis or to offset major variations from forecasts in its counterparts, the PSBR, bank lending and externals. Beyond a certain point the cost, already high, would rise sharply in terms of interest rates and of the public expenditure burden of servicing the debt. Nor can we forecast accurately what proportion of gross debt sales will be to the non-bank public as opposed to the banking or overseas sectors.

However, although there are limitations on what it is sensible to expect from debt sales, the Committee attach great importance to increasing the flexibility available. Considerable progress has been made on this:

i) The Bank has increased the flexibility of its operations, for example its pricing policy on non-tap stocks.

/ii) One of these new

ii) One of these new instruments is "tranchettes", small quantities of existing stocks which are not treated as an official tap stock.

iii) Indexed gilts sold in a new way - by auction. This is new territory and the first IG was sold at what now looks to have been an unrealistically low yield. This led to some surprises with the second IG and we were criticised for conceding an excessive real yield. But it now seems generally recognised that without it we could not have sustained our funding programme by selling £1bn of stock with short rates and US rates rising and with the exchange rate weak. The yield of up to 3 per cent real has to be compared with current nominal yields on long dated conventional stock of about 15½ per cent.

iv) Issues of convertible gilts can also help in difficult circumstances. We had a successful one in January and may have another later in the year.

v) The National Savings initiative has been a success. We more than achieved the target for 1980-81 and have already got two-thirds of the original 1981-82 target of £3bn in the bag, though conditions in the rest of the financial year for National Savings, as for gilts, are likely to be more difficult than they were immediately after the Budget. We shall be announcing before the Recess that everyone will be able to buy indexed certificates from September onwards, thus raising our target for 1981-82 to £3½bn. (A significant part of the extra £500m will be at the expense of the Building Societies and this may produce an earlier move on mortgage interest rates than would otherwise be necessary. But the Societies would in any case blame increased competition from National Savings for any move they decide to make.)

This useful progress has been made within the present framework and has been generally welcomed. Outside that framework there remains the possibility of a wholesale move to a system of auctions and the Committee considered this. But such a change would involve major uncertainties and probably some disadvantages (greater cost and perhaps a smaller market). It could not in any event be made overnight because it would require a major restructuring of our securities market. We do not recommend such a move. But this does not mean that the present institutional

/structure is sacrosanct.

structure is sacrosanct. The Chancellor has asked the Treasury and the Bank to keep a close eye of developments that are already happening in response to the reference of the Stock Exchange to the Restrictive Practices Court or as a result of market forces.

Meanwhile a useful internal institutional change has been made. The Financial Secretary now holds periodic meetings with the Bank, the Government Broker and the Department for National Savings as well as Treasury officials to consider the broad issues of funding policy over the coming months in addition to taking operational decisions on individual debt instruments.

Yours

John

A J WIGGINS
Principal Private Secretary

PM has seen
MAP 23/vii

CONFIDENTIAL

Econ Pol Dom Mon Policy

1. MR MIDDLETON
2. CHANCELLOR

cc Financial Secretary
Sir D Wass
Sir K Couzens
Mr Ryrie
Mr Burns
Mr Britton
Mr Lavelle
Mr H Davies
Mr Ridley
Mrs Gilmore

INTEREST RATES: NOTE FOR THE PRIME MINISTER

I attach a note which the Chancellor could leave with the Prime Minister, as he asked at his meeting this afternoon.

N MONCK
22 July 1981

Note for the record.

The Prime Minister discussed this v. briefly with the Chancellor on 22 July. They agreed on course (b) in para 3.

T.
30/7

CONFIDENTIAL

MARKETS AND INTEREST RATES

The Markets since last Friday

The money market has been in a very uncertain state. Money market rates have been rising since last Friday. A table showing these changes is attached. Short term inter-bank rates rose sharply on Friday by about ½% following lower bids - which implied higher interest rates - at the Treasury Bill Tender. The tender was influenced by the doubling of the number of 3-month bills on offer to £200 million and the announcement that £800 million of bills maturing on 1 September would be issued at the end of this week. The market has also been influenced by events in the foreign exchange market and the very high federal funds rate in the United States.

2. Over this period the Bank has provided the market with very short term cash at interest rates at or just above 12%. But as the table shows, this has not prevented rates for 7-day money and longer maturities from continuing to rise, though it has held down the overnight inter-bank rate. The Bank's aim was to prevent money market rates from dislodging bank base rates and mortgage rates, particulary during Ministers' absence in Ottawa.

The Choice

3. The Chancellor has today discussed with the Governor the choice for the Bank's money market intervention tomorrow:

a. one possibility is to continue with the present holding tactics by supplying cash at below market rates. This could not be relied on for long to prevent bank base rates and eventually mortgages rates from moving up unless some event occurred either at home or overseas that altered the market's view. No event of this kind is on the horizon at present;

b. the alternative is for the Bank to bring the rate at which it supplies the market with cash more into line with other rates - at around 13%. This would be politically unwelcome, particularly before the Censure Debate next week. On the other hand for the Bank to continue its resistance to market pressures further would not be consistent with our earlier decision to nudge up interest rates primarily for exchange rate reasons or with the aims of our new monetary control arrangements which are designed to de-politicise interest rates. Moreover it would create clear opportunities for round-tripping which would be increasingly exploited. A rise in interest rates would also help to reduce the very rapid growth of bank lending to persons and to increase the chances of achieving our £M3 annual monetary target.

Presentation

4. In presenting option b. Ministers would distance themselves from what had been done. The line would be that the Bank had ceased to resist market pressures at the very short end; it had supplied cash at rates in line with those set by the market which had been reacting to the impact of sterling's depreciation on the inflationary prospect, as well as to very high American interest rates and the firm position taken on them by the American Government at Ottawa.

ANNEX

MONEY MARKET RATES, MARKET ASSISTANCE AND EXCHANGE RATE

Interbank rates at close on:	Overnight	7-day	1-month	3-month	12-months
Friday 17 July	11¾-12½	12⅞	13¾	14 3/16	14 7/16
Monday 20 July	12-12¾	12¾	14 1/16	14¼	14¼
Tuesday 21 July	12⅜	13	14¼	14½	14 7/16
Wednesday 22 July	12½	13 3/16	14 5/16	14½	14 7/16

Eligible bill rates at close on:	7 day	14 days	3 months
Friday 17 July	13¼-13	13½-13¼	13¾-13½
Monday 20 July	13-12¾	13¾-13	13 11/16 - 13 9/16
Tuesday 21 July	13½-13¼	13½-13¼	14 1/4 - 14
Wednesday 22 July (provisional)	13	-	14 1/4 - 14 1/8

Exchange Rate at close:	Friday 17/7	Monday 20/7	Tuesday 21/7.	Wednesday 22/7
$ rate	1.8800	1.8710	1.8468	1.8565
Effective	92.43	92.33	91.68	91.72

Market assistance by the Bank	Friday 17/7	Monday 20/7	Tuesday 21/7
	The Bank bought £70 million of bills for resale on 24/7, providing cash at rates between 12-12½	The Bank bought £300 million of bills for resale part on Wednesday 22/7 and part on Friday 24/7 at rates between 12-12⅜.	The Bank bought £70 million of bills for resale on 22/7 between 12-12⅛.

Wednesday 22/7

The Bank bought £101 of bills for resale on Monday at rates between 12-12¼

cc Mr. Walters
Mr. Ingham
Mr. Vereker
Mr. Wolfson

NOTE FOR THE RECORD

Professor Griffiths of the City University called on the Prime Minister for half-an-hour yesterday morning. Alan Walters and Ian Gow were also present.

The media

The Prime Minister said that almost every newspaper, with the notable exception of the Daily Mail, was now attacking the Government's economic policies. The latest article by David Blake in the Times was particularly damaging. It would be highly desirable if Professor Griffiths and other like-minded economists could write letters and articles of rebuttal to the Times, the Guardian and the FT. Griffiths explained that he had a special arrangement with the Daily Telegraph, which made it difficult for him to write in other newspapers. He would certainly see what he could do in the Telegraph, and he would try to get other people, such as Ralph Harris, Patrick Minford and Alan Budd to write in other newspapers. Alan Walters said he would also follow this up.

The Prime Minister went on to say that she would like to make a major economic speech during August, which would be a detailed defence of the Government's economic policies. This would be an "intellectual" speech on the lines of Nigel Lawson's Zurich lecture: it might be given to the Institute of Economic Affairs. Alan Walters would have to be heavily involved in the drafting.

The Prime Minister also said that she would like to consider bringing together a group of sympathetic economists and economic journalists in early August to see if they could help to mobilise public opinion behind the Government.

Griffiths said that the Government should make more of the fact that it had had to deal with severe external shocks and the legacy of the last Government's policies. It should also make more of the difficulties which have been experienced in operating the policy. For example, despite all the criticisms that the Government was deflecting the economy, sterling M3 had overrun last year, and this was now having an effect on inflation.

/ Monetary control

Monetary control

Griffiths said that the Bank of England were now putting in place new arrangements to control the money supply, but it was not clear whether they were actually going to use them for this purpose. The critical decision still had to be made - whether or not to go over to monetary base control. The Prime Minister commented that the problem now seemed to be in the Treasury: they seemed to be delaying the move to MBC. After her talks with Zjilstra, she was convinced that MBC could be introduced with some degree of discretionary rules. Griffiths commented that if the Bank were given too much discretion, they would simply run the system in the same way as they ran it at present.

Civil unrest

Griffiths said that, in his view, the recent troubles were a reflection of the fact that, as private crime had risen, so collective crime had followed. For various reasons, there had been a weakening of standards and parental authority over the years - with the result that moral restraints had been greatly weakened. He did not believe that unemployment was the major factor: in the USA rioting in the cities had actually started when unemployment was falling. It was, nonetheless, important that the Government should be seen to be doing something on the positive side, even if this was largely cosmetic. Also, we should follow the example of the USA and try to bring in the private institutions.

R

15 July 1981

NOTES FOR THE MEETING WITH PROFESSORS GRIFFITHS ~~AND MELTZER~~

Monetary Control

1. The measures which were announced last November and reaffirmed in the Budget speech are to be all in operation by the end of August. These include:

   a. the elimination of MLR as an operational interest rate;

   b. the setting of a band within which the market will determine interest rates;

   c. the elimination of the reserve asset ratio and the cash ratio applied to clearing banks.

2. The Bank now operates in the bill markets and does not "lead" the market. The intention is to widen the band, although no programme has been set down for this yet. Eventually we shall go on to quantitative rather than interest rate targets. The criteria for moving the band have yet to be determined. It is likely that the narrow aggregates, probably M_1, will play some considerable role in this process. Eventually, it is anticipated that the monetary base will also provide a prime target, but this will probably not occur until we are fully on to a quantitative target.

3. The reason for using this step-by-step approach is that we must have agreement from the Bank staff that they can operate a system of this kind. This they have agreed so far. A second reason is that the use of the Bank of England as a lender of first resort has meant that the banking system in the United Kingdom does not have to hold reserves, other than till cash. The banking system must experience now a period when they have no access to the Bank at near to market interest rates. If they want cash from the Bank then they will have to pay considerably over market rates. This will encourage them to hold reserves. Thus it will provide the basis of an MBC system.

/4. What has been

4. What has been done so far is to provide the <u>institutional basis</u> for quantitative control of the money supply. This basis could in principle be used for many other forms of control and monetary base control.

<u>13 July 1981</u>

<u>ALAN WALTERS</u>

10 DOWNING STREET

PM seen

Prime Minister

Would you like Alan Walters to attend this meeting? I think it would be helpful. Alan has done an aide memoire on where we have got to on monetary control.

TL (in this folder)

13/7

TL o/R

THE CITY UNIVERSITY
Northampton Square London EC1V 0HB
telephone: 01-253 4399 telex: 263896

Centre for Banking and International Finance
Director Professor Brian Griffiths

19 May 1981

The Rt. Hon. Margaret Thatcher MP
Prime Minister
10 Downing Street
London SW1

Dear Prime Minister,

It has been several months since either of us have spoken to you. We have followed the progress of your policies with great interest however, and we continue to admire your courage in maintaining a firm stand in the face of opposition from many quarters.

Some of the progress we expected is now evident to all. Inflation has fallen markedly. Interest rates have been reduced. Private sector productivity has increased substantially. Industrial production shows signs of sustained recovery. Like yourself, we believe these achievements must become permanent.

In our conversation with responsible officials in the Civil Service and the Bank of England, we sense a decline in enthusiasm for implementing the medium-term strategy. The hard choices are not being made in budget policy, monetary policy or regulatory policies affecting productivity. We do not believe that your medium-term strategy will succeed unless there are some new major initiatives affecting the conduct of monetary and budget policies and also the 'supply' side of the economy. At this stage, we believe the problems are primarily political and not economic.

We see no evidence that senior officials of the Bank of England are firmly committed to the support of your policies. They remain hesitant and seem reluctant to introduce those procedural changes which, in our judgement, are necessary to prevent a resurgence of inflation.

We are convinced by experience here and abroad that resolution of these problems cannot be achieved until the management of the Bank of England includes persons committed to implementing your policies. To us, this means more than acceptance of your goals. It means a willingness to take those measures that are required to achieve the goals. We are particularly sceptical that periodic pressure from the Treasury, or from your own close advisers, will be sufficient to avoid a new surge of inflation.

The risks are particularly high now that a recovery is underway. Traditional Bank of England policies cause money growth to rise much too fast during periods of recovery. There is, at present, a very high probability that these traditional mistakes will be repeated. If so, fears of inflation will rise leading to high interest rates, a weak pound and more inflation in 1983-84.

We applaud the present initiative to cut public spending in 1982-83 by 5-7% as an indication of the importance you place on controlling the size of the public sector. We believe that controlling the size of the public sector is far more important for economic growth and the revitalization of the economy than temporary changes in the size of the PSBR or tax reduction without reduction in expenditure. Tax cuts without expenditure cuts have little lasting value.

If the proposed expenditure cuts are made, they will provide room for a further major reduction in personal income taxes and corporation taxes before 1983-84. Tax and spending reduction are the principal means by which your government can encourage the increased saving and investment essential to your medium-term strategy.

Here too, the main problems are political. The more discussion of expenditure cuts can be conducted outside the committees organized by senior Civil Servants, the greater is the chance of success.

We share your goals, are delighted at the progress that has been made and wish you every success for the future. We fear, however, that commitment to your programme has waned, and we wanted to share our concern with you.

Yours sincerely

Allan Meltzer

Professor Allan Meltzer
John M. Olin Professor of
Economics and Public Policy
Carnegie-Mellon University
Pittsburgh
USA

Brian Griffiths

Professor Brian Griffiths
Director of the Centre for Banking
and International Finance
The City University
London

c.c. Mr Walters
Mr Wolfson
Mr Duguid
Mr Ingham

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

Prime Minister

PRIME MINISTER

Prime Minister

Agree? Rd

TL 23/6

PM sem

In your minute of 4 June you suggested a stock-taking seminar on monetary control before the Recess, and I understand a meeting is being arranged for the end of July. I think the seminar will be very useful. We shall need to settle how we shall be operating the new arrangements - the basis for short term interest rates and the Bank's intervention in the money markets - once they have come into effect. This discussion will cover the role of the narrow monetary aggregates, including the monetary base, in these decisions and in any later developments of the system.

2. The Bank have made considerable progress in negotiating the detailed provisions for implementing the new arrangements foreshadowed in my statement last November. Their document setting out these provisions has been circulated this week to the clearing banks on a confidential basis and will be circulated for final comments to the rest of the financial system on Monday. The Bank hope to have the definitive version ready by mid-July and have told the clearers that the provisional date they have in mind for implementation is 20 August, the first day of banking September. A copy of the document is attached. If you would like any further explanation, in advance of the papers which will be prepared for the seminar I should be happy to arrange it.

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

GH

(G.H.)
19 June 1981

MONETARY CONTROL - DRAFT PROVISIONS

Introduction

1 On 24 November 1980, the Bank published a Background Note describing a number of improvements to be made to the existing framework of monetary control. On 12 March this year more detailed proposals on a number of the subjects covered in the Background Note were sent to all recognised banks and licensed deposit-takers (LDTs) in "Monetary control: next steps". The present paper sets out the provisions resulting from discussions that have taken place since with the various associations, as well as with a number of individual institutions.

The cash ratio

2 A substantial part of the Bank's resources and income in recent years has been provided by the average of 1 1/2% of Eligible Liabilities (ELs) maintained by the London clearing banks in non-interest-bearing accounts at the Bank. This sum has also served as a fulcrum for money market management. The Bank's paper in March proposed that this latter purpose should in future be served by the volume of operational funds which the London clearing banks would retain voluntarily at the Bank for clearing purposes, while the Bank's resources and income should additionally be secured primarily by a uniform requirement on all banks and LDTs to hold non-operational, non-interest-bearing deposits with the Bank. The provisions set out in this section have accordingly been designed to provide, in aggregate, broadly the same amount of non-interest-bearing funds initially as did the previous arrangements with the London clearing banks alone.

3 This non-operational requirement will be 1/2% of an institution's ELs and will apply to recognised banks and LDTs (and National Girobank) having ELs which average £10 million or more in the latest period over which the requirement is calculated. The level of an institution's non-operational balance will be set twice a year in relation to its average ELs in the previous six months[1].

---

[1] A deposit due in, say, March would relate to the monthly average of ELs from September to February inclusive.

For institutions not on the present statistical list of banks and whose business mainly comprises the provision of fixed rate finance for periods in excess of one year, the Bank accepts that the introduction of the 1/2% cash ratio may present a special transitional problem. The Bank will be prepared to consider individual representations from such institutions for some temporary alleviation of the requirement.

5 ELs are to be redefined to reflect the changes set out in this paper. In future, offsets will be allowed in the calculation of ELs in respect of:

(i) funds (other than cash ratio deposits or Special Deposits placed with the Bank) lent by one institution in the newly defined monetary sector[1] to any other;

(ii) money at call placed with money brokers and gilt-edged jobbers in the Stock Exchange, and secured on gilt-edged stock, Treasury bills, local authority bills and bills of exchange.

6 ELs will be calculated in uniform fashion for all reporting institutions[2] except:

(i) members of the London Discount Market Association (LDMA), whose ELs will be calculated as the total of sterling deposits other than from institutions within the monetary sector;

(ii) certain banks with money trading departments, who will be allowed to omit from their ELs secured money at call placed by other banks with these departments, up to a limit set by the Bank.[3]

7 It would be contrary to the objective of these agreed arrangements for any institution to reduce its ELs deliberately or artificially on reporting dates. The Bank accordingly reserves the right to make a spot check on the level of an institution's ELs on days when it would not normally report.

---

(1) See paragraph 16 below.

(2) The present arrangements for those finance houses which have observed a 10% reserve asset ratio since 1971 will lapse accordingly.

(3) The banks concerned are: Algemene Bank Nederland, Banque Belge, Charterhouse Japhet, Leopold Joseph and Samuel Montagu. Hitherto, funds placed on this basis, up to a limit set by the Bank, have counted as reserve assets.

Special Deposits

8 The Special Deposits scheme remains in place and will apply to all institutions with ELs of £10 million or more[1]. As hitherto, calls will be set as a percentage of ELs. The scheme for Differential Special Deposits[2] will lapse once the provisions in the 1981 Finance Bill relating to additional exchange control powers become law.

Eligibility

9 As set out in its March paper the Bank has judged applications, by recognised banks wishing their acceptances to become eligible for discount at the Bank, according to the following criteria:

(i) whether the applicant has and maintains a broadly based and substantial acceptance business in the United Kingdom;

(ii) whether its acceptances command the finest rates in the market for ineligible bills;

(iii) whether, in the case of foreign-owned banks, British banks enjoy reciprocal opportunities in the foreign owners' domestic market.

A first list of eligible banks is attached.*

10 A bank may apply for eligibility at any time. An eligible bank which wishes to renounce its eligibility is free to do so on giving notice to the Bank.

---

(1) Hitherto only banks on the statistical list and finance houses observing a reserve asset ratio have been subject to Special Deposits.

(2) The scheme was devised and agreed with banks in 1972 but never used. It would have permitted the authorities to call, as Special Deposits, different proportions of any increase from a specified base in (i) domestic residents' and (ii) overseas residents' sterling deposits. Details can be found in the Bank's Quarterly Bulletin for March 1973.

* It will be attached to the final version of this document.

Undertakings by eligible banks

11 From a date to be announced, each eligible bank undertakes to maintain secured money with members of the LDMA and secured call money with money brokers and gilt-edged jobbers[1] - all at market rates appropriate to the nature of the lending - such that:

(i) the total funds so held normally average [ ]* of that bank's ELs;

(ii) the amount held in the form of secured money with members of the LDMA does not normally fall below [ ] of ELs on any day.

12 In relation to the above undertaking, each eligible bank will

(i) aim to meet the daily average ratio over either six or twelve month periods at its discretion, the ratio on any particular day being calculated as a proportion of ELs at the latest make-up day.

and

(ii) to provide monthly returns of its daily figures, which the Bank will use to assess the bank's performance relative to its long-term commitment.

A bank will go below the minimum only in exceptional circumstances and will be ready to explain such action to the Bank when the relevant monthly return is made.

13 The Bank will be prepared to review these undertakings, in consultation with eligible banks and the LDMA, when sufficient experience has been gained, covering at least a year. The Bank will also be prepared to discuss particular difficulties, as they arise, with any party to the arrangements.

---

[1] The Bank's concern with the adequate availability of funds for the efficient functioning of the gilt-edged market was noted in "Monetary control: next steps". There are six recognised money-brokers - James Capel & Co, Cazenove & Co, Hoare Govett Ltd, Laurie Milbank & Co, Rowe & Pitman Moneybroking and Sheppards & Chase (Moneybroking). Secured call money with these firms has hitherto counted as a reserve asset. The amount of such money which these firms can take will continue to be limited by the Bank.

* The figure in this sub-paragraph will be calculated to produce an aggregate amount of around £3 billion and is expected to be around 5% of ELs as presently defined, or perhaps 6% on the new definition. The figure in sub-paragraph (ii) will be approximately two-thirds of that in (i).

Prudential considerations

14 The Bank has received the assurances mentioned in the Chancellor's Budget Speech, and in its paper of 12 March "The liquidity of banks", that those institutions to whom the reserve asset ratio has applied will discuss with the Bank in advance, in the course of the normal process of prudential supervision by the Bank, changes in their policies for the management of their liquidity and its composition. Discussions on developments in supervision are continuing and a separate paper on liquidity will be issued by the Bank when appropriate.

Statistical changes

15 The present banking sector, as defined for the purposes of calculating the monetary aggregates, currently contains those institutions included in the statistical list of banks and the list of discount market institutions. These lists were drawn up prior to the Banking Act and are no longer appropriate to current circumstances. They exclude a number of recognised banks, many LDTs, and also the trustee savings banks[1] (who are evolving towards banking status and who will become subject to cash ratio and Special Deposit requirements when they cease to be exempt from the Banking Act).

16 A new monetary sector will therefore be defined, to include

(i) all recognised banks and LDTs;

(ii) National Girobank;

(iii) banks in the Channel Islands and the Isle of Man, so long as they are subject to broadly parallel arrangements for a cash ratio.

(iv) the trustee savings banks (TSBs);

(v) the Banking Department of the Bank.

17 Although the population of the monetary sector will be considerably larger than that of the "statistical list", the statistical effect will be comparatively modest since the present business of many of the new contributors is relatively small. In total, the

---

[1]The Central Trustee Savings Bank (CTSB) is a recognised bank.

initial once-for-all adjustment to the stock of the main monetary aggregate, £M3, will probably be of the order of £8 billion (13%), of which the TSBs account for around £6 billion (9 1/2%).

18 Recognised banks and LDTs having either eligible liabilities totalling £10 million or more, or a balance sheet of £100 million or more, will be asked to supply the full range of statistics (comprising both the monthly and other returns); other recognised banks and LDTs will be asked to report only at end-calendar quarters.

The timetable for change and the transitional arrangements

19 The essential features of the new arrangements can be brought rapidly into effect. This section sets out the sequence of developments.

20 The Bank will shortly specify an operative date when:

(i) the Reserve Asset Ratio will be abolished;

(ii) banks whose acceptances are eligible for discount at the Bank will begin to observe the requirements set out in paragraph 11 above;

(iii) the agreement with the London clearing banks, whereby they keep an average of 1 1/2% of their ELs at the Bank, will lapse;

(iv) the Bank will receive the first deposits under the cash ratio requirement.

21 On this operative date, the first cash deposits will be placed by institutions on the present statistical list of banks and by members of the LDMA; the statistics necessary to include other institutions are not yet available. These initial deposits will relate to the average of institutions'ELs over the latest six-month period available, ELs being calculated as at present, except that offsets will be allowed in respect of all lending to the discount market and all secured money at call placed with money-brokers and gilt-edged jobbers and money-trading banks.[1] These initial deposits will remain unchanged until sufficient figures using the new definition of ELs are available (see paragraph 22 below).

---

(1) The Bank can calculate these offsets from statistics already provided.

Thereafter, these deposits will be adjusted every six months. The undertakings by eligible banks will commence on the operative date, on the same definition of ELs and in respect of their latest available ELs figures.

22 As soon as possible thereafter, currently reporting institutions will be asked to produce figures for one reporting date both on the basis used hitherto and on the basis of the enlarged list of institutions comprising the new monetary sector. At the same time, those seventy or so institutions which are not currently on the statistical list of banks and which are above the proposed cut-off points for full statistical reporting will join the reporting network (and will be asked to place cash deposits with the Bank shortly thereafter).

23 Monetary aggregates will be calculated on both bases for this one reporting date; thereafter statistics will only be collected on the basis of the new monetary sector.

24 The remaining institutions not currently reporting and below the cut-off points set out in paragraph 18 will be brought into the reporting network only when the current review of banking statistics has been completed.

FILE

CONFIDENTIAL

SUBJECT

cc masters ops.

~~PS~~ Mr Walters
Mr Watson
Mr Duguid
Mr Ingham

10 DOWNING STREET

THE PRIME MINISTER

Personal Minute

No. M 8/81

CHANCELLOR OF THE EXCHEQUER

MONETARY CONTROL

It is now more than six months since the new measures for monetary control were announced in the November 1980 statement. The last progress report was in January. I understand that, since then, considerable progress has been made; but my impression is that it has not been quite as rapid as you had originally envisaged.

For example, in the first place, it seems that the Reserve Asset Requirement still remains in place. It was envisaged in the progress report that it would be abolished by the Budget.

Secondly, I understand that the Bank still have not been able to abolish the 1½ per cent cash ratio and introduce the new ½ per cent reserve requirement which was announced at the time of the Budget.

Thirdly, it was envisaged in the progress report that the various changes in money market management and in the Bank's role as lender of last resort (including, I thought, the abolition of MLR) could be implemented at Budget time. I understand that progress has been made in that the Bank has

CONFIDENTIAL

/substantially

RH

CONFIDENTIAL

substantially reduced its discount window lending and is now operating primarily through open market operations; but the interest rate band apparently still remains to be put into effect, and MLR is still with us.

Fourthly, possible new funding techniques were being studied by a Treasury/Bank committee. I am not clear what has emerged from this work.

I am told that you now envisage making the new measures fully operational by August. I understand that we would then be in a position to move to Monetary Base Control if we so wished. I can only say that I very much hope that the programme does not slip any further. Although I know you have misgivings about a full move to MBC, I am more than ever convinced - especially after my conversations with Dr. Zijlstra - that we must change over to some such system of quantitative control and sooner rather than later. I believe MBC could be introduced and implemented provided it includes a suitable discretionary element.

I would like to hold a stock-taking seminar before the Recess, and my office will be in touch with yours to arrange this.

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

Margaret Thatcher

4 June, 1981

CONFIDENTIAL

FILE

CONFIDENTIAL

SUBJECT

cc masters ops.

cc: Mr Walters
Mr Wolfson
Mr Duguid
Mr Ingham

10 DOWNING STREET

THE PRIME MINISTER

Personal Minute

No. M 8/81

Carlmin

Pls: see last para. and arrange 1½ hour meeting 1st week August.

RTA
Walters
~~Chancellor~~, ~~FST~~ } + officials
Governor

TL.

CHANCELLOR OF THE EXCHEQUER

MONETARY CONTROL

It is now more than six months since the new measures for monetary control were announced in the November 1980 statement. The last progress report was in January. I understand that, since then, considerable progress has been made; but my impression is that it has not been quite as rapid as you had originally envisaged.

For example, in the first place, it seems that the Reserve Asset Requirement still remains in place. It was envisaged in the progress report that it would be abolished by the Budget.

Secondly, I understand that the Bank still have not been able to abolish the 1½ per cent cash ratio and introduce the new ½ per cent reserve requirement which was announced at the time of the Budget.

Thirdly, it was envisaged in the progress report that the various changes in money market management and in the Bank's role as lender of last resort (including, I thought, the abolition of MLR) could be implemented at Budget time. I understand that progress has been made in that the Bank has

CONFIDENTIAL /substantially

substantially reduced its discount window lending and is now operating primarily through open market operations; but the interest rate band apparently still remains to be put into effect, and MLR is still with us.

Fourthly, possible new funding techniques were being studied by a Treasury/Bank committee. I am not clear what has emerged from this work.

I am told that you now envisage making the new measures fully operational by August. I understand that we would then be in a position to move to Monetary Base Control if we so wished. I can only say that I very much hope that the programme does not slip any further. Although I know you have misgivings about a full move to MBC, I am more than ever convinced - especially after my conversations with Dr. Zijlstra - that we must change over to some such system of quantitative control and sooner rather than later. I believe MBC could be introduced and implemented provided it includes a suitable discretionary element.

I would like to hold a stock-taking seminar before the Recess, and my office will be in touch with yours to arrange this.

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

Margaret Thatcher

4 June, 1981

10 DOWNING STREET

R.

MR. GOW

Attached are my notes on

John Moore's paper, as requested.

19 June 1981 ALAN WALTERS

cc Mr. Wolfson
Mr. Hoskyns
Mr. Lankester

NOTE ON JOHN MOORE'S PAPER

I think there is a misconception about the present role of government in credit markets. As he will observe in the recent Bank of England Quarterly, the role of the Bank has changed very considerably over the past 3 or 4 months. MLR has ceased to have any function. It is jokingly called the rate at which the Bank will not lend any money! And this is broadly true. The Bank has done very little business through its Discount Window. It no longer gives any guidance to the market about interest rates. It operates through open market operations. It does not quote prices at which it would buy and sell bills.

Thus during the rapid fall of the pound against the dollar which occurred some three weeks ago, there was an increase in interest rates on three-months and six-months money, and this occurred without any guidance from the Bank whatsoever. Had interest rates shot up very high, then the Bank would have provided assistance by buying bills. But even under these rather exigent circumstances, the market solved its own liquidity problems without any assistance, or at least unusual assistance, from the Bank.

These interim arrangements do provide for an unpublished interest rate band below which and above which the Bank will intervene. But if there is persistent pressure on the markets then the Bank will move that interest rate band either upwards or downwards. In particular they will be moved upwards if there is a tendency for the monetary aggregates to overrun their target values, and downwards if they are undershooting. This movement will not be done automatically and in a knee-jerk fashion. It is intended that the movement of the bands take account of the need to achieve the appropriate monetary targets in a relatively long run, round about a year.

Ultimately, it is anticipated that the bands will be widened until they are irrelevant and all the Bank's operations will be in the open market, primarily in the bill market, and the criteria will be simply the appropriate monetary aggregates.

/Now to turn

Now, to turn to the long end of the market, the intervention of Government here is primarily through their demand for credit in terms of sales of gilt-edged securities. It is primarily through the demand for Government finance that the authorities effect this market. Of course, some effects will be transmitted from the short end to the long end. But they are muted and uncertain.

The net result of all this is to argue that primarily interest rates are to be determined by the market. Government operations affect rates at both ends of the market. At the short end they are affected primarily by the Government's supply of cash and reserves to the banking system. In any medium-term period, such as, say, a year, the supply of cash and reserves will be determined by the Government's monetary targets; thus interest rates are determined by the achievement of the monetary targets, at least as far as Government activity is concerned. At the long end they are determined, as far as Government action is concerned, by the PSBR, and of course the impact of changes at the short end and the expectations generated thereby.

Now let me deal with Mr. Moore's particular points.

Government Funding and Lower Interest Rates

I think Mr. Moore is quite right here. He says "increased taxation is more honest than increased borrowing made possible only by rates of interest which impoverish the private sector". I think that the last budget was designed precisely with that in mind. And I believe it has been demonstrably successful. We have lower interest rates than many of our competitors, and lower real interest rates than most of the developed world. But at the long end we are still high, as high as America and indeed higher than Germany. This I am afraid reflects the fact that the market still does not believe that our policies will be successful. On the whole one cannot blame the market; they have been disappointed by every previous Government of the United Kingdom. But as confidence in the policy has grown, so the price of long-dated gilts has increased. It will take us a while yet to earn the confidence of the cynical managers of funds.

/The Exchange Rate

The Exchange Rate

Here again Mr. Moore is substantially correct. It is both existing interest rates and anticipations of the change in foreign exchange rates which determine the exchange rate. What matters is that the rate of return on financial assets should be equalised in terms of whatever currency one chooses. Thus, when we had very high interest rates in 1980 the pound appreciated very rapidly because everyone was anxious to acquire sterling assets and this meant that the pound having been driven to a considerable appreciation, was widely expected only to go one way, down, and it obliged in the first five months of 1981. I think it is important to get the causation right though. Under a system of free exchange rates, it is monetary policy relative to that of ones main trading partners, that determines exchange rates. It is not exchange rates that determine monetary policy, or monetary conditions.

Inflation

I find some difficulty with this part of Mr. Moore's thesis. Supposing that we reduced short-term interest rates by increasing cash and reserves of the banking system. This would inevitably lead to an expansion of the money supply, probably initially the narrow aggregates. Now Mr. Moore is quite right that historically there has been virtually always some expansion of production as a consequence of an increase in the rate of growth in the money supply. But that increase in production has taken place only for a few months then production falls back even to below its previous trend value. We are left then with merely the effects of an increased growth in the money supply with, if anything, a lower level of production, and so we go through the dreary cycle of inflation and stagnation. Over the past historical record we have seen that the stimulus to production has become smaller and smaller. I suspect that with present expectations the effects on real output would be small, and the effect on inflation large. You can see these effects working in the last two expansionary periods in the United Kingdom, in 1971-73 and in 1977-78. In both cases there was some increase in output and in employment. But again both of them saw a sharp fall in output, an increase in unemployment and yet another twist in the inflationary spiral.

/Furthermore,

Furthermore, as the inflation gets under way, or strictly as expectations of inflation become ingrained in people's consciousness, then interest rates will rise even higher than they were before the monetary expansion took place. This again is the sad story which has been repeated over and over again since the 1950s.

I do not share Mr. Moore's belief that most businessmen do not take a sophisticated view of real interest rates. My experience in a large number of economies is that businessmen and indeed ordinary small investors are much influenced by the real interest rate and are not fooled by any money illusion. In some economies I have seen interest rates in more than 100% and with almost as high rates of inflation. However, Mr. Moore is perfectly correct in saying that businessmen will not take out credit for which they have no use. What will deter the demand for credit is the lack of an outlet for profitable use of those funds - which is reflected nowadays in the very low rate of return on real assets. The explanations for this low rate of return are, of course, many; trade union practices, planning restrictions, government regulations, local authority rates, etc.

Property Boom

Again I think that Mr. Moore is right that to a large degree the property boom was stimulated by the laxity of the monetary authorities. But I would also argue that it was generated by the profligacy of the Heath government in first expanding the rate of the growth of the money supply which was less than 9% before September 1971 and after that never less than 20%, sometimes over 30% until 1973. This was also to some extent a consequence of the dirigiste policy of the Heath government in keeping down artificially the rates of interest. And that should be a lesson to us all.

I do not share Mr. Moore's enthusiasm for limiting the mortgage relief only to the standard rate. This is a very complicated matter since it links up with all the chaotic absurdities of the housing market, with its regulations and rigidities. Perhaps this subject is best left to a later discussion.

Conclusion

I believe that our objective should be to get the money supply right and government borrowing right, and then leave interest rates to be determined by the market. If we are on course with our money supply and our government borrowing, then interest rates can be left to look after themselves. Furthermore, that enormously important factor expectations and confidence will be working with us rather than against us.

AW

19 June 1981

ALAN WALTERS

PROFESSOR ALAN WALTERS

1. Herewith Memorandum dated 16th June from John Moore M.P., who is Under-Secretary of State at the Department of Energy, and who is a strong supporter of the Prime Minister.

2. I think that his Memorandum does contain a number of fallacies.

3. Would you be kind enough, please, to let me have your comments on his Memorandum? Thereafter, perhaps it would be helpful for you and him to have a chat.

4. I repeat that John Moore is a good man.

18th June 1981

IAN GOW

WHY THE ARGUMENTS AGAINST REDUCING INTEREST RATES ARE NOT VALID

There is general agreement that reducing interest rates would stimulate economic growth by encouraging productive investment. Yet the Government hesitates to reduce them because of a mistaken belief that the action would:

1) be inflationary 2) hurt the exchange rate

3) make it more difficult to fund Government debt

4) lead to an unproductive property boom as in the early 1970s.

None of these assumptions is necessarily true, and most of them stem from misunderstanding of the nature of financial markets and in particular the US market. There is much talk currently of the high US "prime rate" being the reason for the stronger dollar, talk which automatically assumes the prime rate plays the same role as MLR. That is not so, the US prime rate tells you nothing about the rates at which government, the municipalities and most of business are actually borrowing. Municipal bonds, with very low interest rates attract high taxpayers because they are tax free and so are quite special instruments. Both business and government borrow on the bond market at rates of interest well below prime. Well-rated businesses are right now probably paying half prime or less.

In Britain, by contrast, MLR really is the rate at which most businessmen have to borrow, and some have to borrow at overdraft rates ABOVE MLR. In such a situation a high MLR has a much more stifling effect on business growth than a high prime.

The contrast between the British and US situation is further heightened by the dominant role the Government play in the British market. The stock market here is now 80 per cent geared to funding government and local authority debt. In the US, Government is a minority interest in the money markets compared to private enterprise. In Britain, the Government can set a rate of interest that reflects its own need for funds. The private sector, the minority interests in Britain, then is forced to compete with the Government for funds. What should be a Government tail is wagging the business dog.

Given this background, and thus an acceptance that the US situation is substantially different from the British, we can address the particular British arguments against lowering interest rates:

<u>Effect on funding Government debt</u> The first question that arises, then, about a proposal to cut interest rates is whether the Government would then be able to go on funding its debt. Undeniably, lower interest rates will make gilts less attractive, but what is the elasticity of demand? At what point do we think that the Government would not be able to raise all that it required? And how large would that shortfall be - £1 billion, £2 billion?

If we reached the point of such a shortfall, so what? We would be forcing the Government at a given rate of interest to convert part of its debt into something else - either reduced spending or increased taxation. We ought to regard pressure towards either one of those as healthy. Increased taxation is more honest than increased borrowing, made possible only by rates of interest which impoverish the private sector.

There will be offsetting factors. As interest rates fall, and Government debt becomes harder to raise, so new debt and some existing debt will be cheaper to finance. Furthermore, as lower interest rates stimulate activity, so higher tax flows will accrue, particularly from VAT. The switch to a 15% rate of VAT and the switch that we have made towards higher real excise duties gives us a much greater revenue bouyancy which we often seem to neglect.

<u>The exchange rate</u> The conventional wisdom is that a wide differential between interest rates here and American rates or average foreign rates will weaken the pound. But interest rates are only the determining factor when foreign investors already have doubts about the economic viability of the country. Anticipation of the future is what determines investor actions. Hence Switzerland is able to maintain low interest rates ~~but~~ because she has a sound currency. The pound's recent decline against the dollar is more to do with increased confidence in the Reagan Administration, and some reduction in confidence in Britain as real oil prices ease, than with differential interest rates.

<u>Inflation</u> The policies of the Government are rightly based on the assumption that it is the creation of new money <u>without increased productivity</u> that is inflationary. Cutting interest rates will boost credit, but it will also <u>boost gross domestic product</u>. There is therefore no prima facae reason for a cut to be inflationary. High interest rates have not been effective in reducing inflation. They have made it easier for Government to

[illegible]

borrow, and in the recession hard-pressed businesses have been forced to continue borrowing even at the highest rates. It is not clear, therefore that high interest rates have acted to hold down the money supply.

If a reduction in the rate of interest brings an increase in the amount of credit, there will be some offset to that from the greater difficulty of government borrowing, and the further reduction of that borrowing as VAT and excise duty receipts pick up with increased economic activity. Furthermore I do not believe that most businessmen take a sophisticated view of real interest rates at any time. To them rates of interest above, say, 10 per cent seem very high whatever the rate of inflation, and so act as a major psychological impediment to investment. I do not think that in general businessmen will take out credit for which they have no use just because the rate of interest is near the rate of inflation.

Not so!

<u>Property boom</u> There is a danger that some of the upturn in activity might be vitiated in a property boom. On past experience the danger is more likely to arise in the commercial property sector rather than the domestic, and we might have to look at measures to deal with that. In fact the 1970s boom was closely associated with the emergency of secondary banks. Since then new banking legislation has given us much more effective controls against them.

On the domestic side we should not be afraid to abolish tax relief above the standard rate of tax and so cover the most likely area of difficulty. Of 5½ million tax-payers currently claiming mortgage interest relief, only about 0.7 million claim it on rates other than standard. The other 4.8 million would therefore be unaffected by such a change. However, they would stand to gain substantially from cuts in the mortgage interest rate. For example, a 4% cut would reduce the effective payment of interest on a £15,000 mortgage by £420 per year.

For the 0.7 million who do claim relief above the standard rate of tax the effect of abolishing the higher levels of relief will vary according to income. The married man earning £20,000 with no special tax allowances and the maximum amount of mortgage qualifying for relief (25,000) would be better off by about £698 a year if interest rates fell 4 per cent. But if at the same time as falling 4 per cent the higher reliefs were abolished he would end up only £305 a year better off.

A man in the same position earning £40,000 (therefore receiving relief on his interest at the top rate of 60 per cent) would gain by £400 from a 4% reduction in interest rates. But if at the same time relief at the higher rates were abolished, he would end up £275 a year <u>worse</u> off.

This limitation of tax reliefs is, let us not forget, the natural counterpart of having reduced the top rates of tax in our first budget. And indeed we should now be considering a further reduction in the top rate.

Conclusion

This note has sketched the case for a reduction in interest rates, and addressed some of the most readily perceived objections to such a course. What is missing from it are several numbers and estimates.

What, for example, is our best estimate of the elasticity of demand for gilts as interest rates fall? The answer to that is likely to depend on the state of confidence in the Government, and naturally this would be presented as a coherent policy capable of retaining that confidence. Another complex factor is the exchange rate, in which once more confidence plays a crucial role. What impact would a reduction in interest rates have on the cost of Government borrowing? And what effects might follow from our now greater revenue bouyancy as economic activity picked up?

We can of course turn to the Treasury for guidance on these matters. But this outline need not, I think, be delayed awaiting that work.

John Moore

JOHN MOORE

16/6/1981

3

Prime Minister

Econ Pol

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

8 June 1981

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

PM seen

TL 9/6

Dear Tim,

MONTHLY NOTE TO THE PRIME MINISTER ON THE BORROWING REQUIREMENT

I am enclosing this month's note for the Prime Minister. The main points are summarised on the first page.

The borrowing requirement in May was large - £2,827 million - because of the effect of the strike. We have already stated implicitly in a recent written answer that the strike effect in May was about £1 billion so commentators should be prepared for a fairly high figure.

The note gives "underlying" forecasts which exclude effects of the strike. It has not been possible to include sensible estimates of the future effects of the strike with, as yet, many uncertainties over the level of extended industrial action. Slow-down of payments such as pensions and unemployment benefit would of course reduce the CGBR temporarily.

The provisional estimate of the growth of £M3 in banking May will be released tomorrow. It will show growth of 1½ per cent in the month, of which the Bank of England's Press Release will attribute "perhaps ¾ per cent to 1 per cent" to the Civil Service dispute. The implied underlying growth of £M3 - at ½ per cent to ¾ per cent - will therefore be similar to that of March and April and will mean that £M3 in "underlying" terms is remaining well within the current target range. Although this development is likely to be received quite favourably by domestic markets, there could be some residual concern about the high recorded figures themselves and the fact that the cumulative effect of the dispute is now put at over 2 per cent of £M3.

Consideration is now being given to problems of recovery after the strike comes to an end. We hope to report on this in the near future.

Yours
John

A.J. WIGGINS

MONTHLY NOTE ON THE CENTRAL GOVERNMENT BORROWING REQUIREMENT

Outturn for May 1981 and Forecast to End-August 1981

Summary

- the provisional estimate of the CGBR in May is £2,827 million, including the effects of the civil service strike.

- just over £1 billion reflects delays in tax and national insurance collected. Otherwise, CGBR would have been £1¾ billion, £½ billion better than forecast a month ago because there was hardly any lending to the rest of the public sector.

- for the five months to end-August the underlying CGBR excluding effects of the strike is forecast to be around £7 billion, the same as last year. The actual CGBR seems bound to be higher, even if the strike stops quickly.

CGBR IN MAY

1. The provisional estimate of the CGBR in May is £2,827 million and the cumulative total since 1 April is £5,244 million. The figures will be published in the regular press notice on Tuesday 9 June.

2. It is estimated that just over £1 billion of tax and national insurance receipts were delayed by the civil service pay dispute in May. Apart from this, the outturn in May would have been around £$1\frac{3}{4}$ million, that is, £$\frac{1}{2}$ billion better than forecast a month ago. Lower lending to local authorities and public corporations accounts for most of the difference.

3. Table 1, attached, presents a detailed comparison of the forecast and outturn for May. The presentation below explains the principal differences, distinguishing between effects of the strike and other factors.

Outturn: May

	Effect on CGBR £ million (- means adverse)
Strike Effect	
Inland Revenue taxes (Mainly PAYE)	-450 (approx)
National insurance contributions (included in "other funds and accounts" in table 1)) National insurance surcharge (included in Consolidated Fund "other" receipts))	-650 (approx)
Customs & Excise taxes (net of blocked VAT refunds)	0 to +100
	-1,000 to -1,100
Other factors	
Other Customs and Excise receipts	0 to -100
Lower net lending to local authorities	+210
and public corporations	+230
Other (net)	+ 90
	+430 to +530
Net effect on CGBR	-570

Strike effects in May

4. The main impact of the dispute has continued to be on revenue delayed through the strikes at the Customs and Excise VAT centre and Inland Revenue PAYE centres, which began in March. In the case of VAT, the effect of the strike on revenue is reduced by the inability to make repayments of VAT due to traders. Strikes at various departmental computer centres, including the Paymaster General's Office, have so far been having little effect on the level of payments, but are creating accounting problems. However it is estimated that selective industrial action at the joint Ministry of Agriculture Intervention Board (IBAP) computer centre is now halting payments by MAFF/IBAP of about £17 million a week.

5. The effects of the dispute on Government revenue have been measured by comparing actual receipts into Exchequer accounts with what might have happened had there been no strike. The differences reflect forecasting errors as well as the effects of the dispute, so published estimates are presented as ranges. As time goes on, forecasting errors may grow and make estimates of the strike effects more and more approximate.

6. About £1 billion of Inland Revenue receipts were delayed by the strike in May. Slightly under three-quarters of the revenue thought to be due was banked. This is thought to be slightly higher than the underlying proportion because a backlog of cheques were processed in May which helped to keep receipts up. The proportion may be reducing slightly as small payers give up making remittances.

7. For Customs and Excise the strike may even have added to net receipts in May: most of the VAT receipts were due from large payers, whose payments are all being called in successfully by hand, and in addition, May benefitted from some payments delayed from March and April; meanwhile the regular VAT repayments were still not being made.

Strike effects to date

8. Our best estimate of the cumulative backlog of revenue since the strike began is £3 to $3\frac{1}{2}$ billion, given in reply to a written Parliamentary Question on 4 June (Mr Marlow (C) - Northampton North). Over three quarters of the revenue believed due since the start of the strike has been paid in. The civil service unions' estimate of the backlog is rather higher at just under £5 billion, partly because they ignore VAT repayments, and partly because they have underestimated the amount of revenue getting through.

9. Other strike effects on the CGBR such as interest payable on additional borrowing (only £40 million so far) and, in the opposite direction, the small saving on wages not paid to striking civil servants, are not itemized in our analysis.

Other effects in May

10. Much of the usual detail continues to be lacking because of the strike.

11. Customs and Excise duties were lower than forecast mainly because of the effect of the Budget on tobacco sales.

12. Net lending to local authorities and public corporations in May was about £450 million below forecast. Local authorities may have been borrowing in the market at short-term rates, which have been very low. The evidence so far is that public corporations have not been borrowing from the UK market or overseas.

FORECAST FOR THE NEXT THREE MONTHS

13. Forecasts for June, July and August presented in Table 2 are largely formal, in line with the Budget forecast, and will serve mainly as a base against which to measure effects of the strike. The forecasts are subject to a wider margin of error than usual because the strike has halted some information upon which our estimates would normally be based.

14. Table 3 shows the outturn forecast month by month and cumulatively to the end of August, compared with last year's outturn. The underlying 'strike free' forecast to the end of August would bring the cumulative CGBR to between £6.8 and £7.1 billion, about the same as last year.

15. Escalation of the strike following the break-down of talks last week means that at present we are unable to make sensible forecasts of future strike effects. If payments of benefits and pensions are slowed down the effect will be to reduce the CGBR. On the revenue side, if the level of industrial action remains much the same at Inland Revenue and Customs and Excise we would expect about £1$\frac{1}{4}$-1$\frac{1}{2}$ billion of receipts to be delayed each month. This includes a larger proportion than up to now of delayed VAT payments because computerised returns calling in payments from June onwards have been halted by the strike (as many as possible are being dealt with by hand). However, by the end of August, whether the strike escalates or comes to an end quickly, the CGBR is almost certain to be larger than the strike free forecast.

CONFIDENTIAL

TABLE 1

CENTRAL GOVERNMENT BORROWING REQUIREMENT - MAY

£ million

	Forecast (excluding strike effects)	Outturn (including strike effects)	Difference on CGBR
RECEIPTS			
Consolidated Fund			
Inland Revenue	2,450	2,010	-440
Customs and Excise	1,780	1,782	+ 2
Other	730	273	-457
National Loans Fund			
Interest etc receipts	210	190	- 20
Total receipts	5,170	4,255	-915
EXPENDITURE			
Consolidated Fund			
Supply services and Contingencies Fund	5,600	5,620	- 20
Other	270	275	- 5
National Loans Fund			
Service of the national debt	1,270	1,308	- 38
Net lending	390	29	+361
Total expenditure	7,530	7,232	+298
Other funds and accounts	+100	+150	+ 50
CGBR	-2,260	-2,827	-567
of which: estimated strike effect	-	-1,000 to -1,100	-1,000 to -1,100
excluding strike effect (say)	-2,260	-1,800 to -1,900	+ 450 to + 550

CONFIDENTIAL

TABLE 2

CENTRAL GOVERNMENT BORROWING REQUIREMENT

	Latest Forecast (excluding effect of strike)		
	June	July	August
RECEIPTS			
Consolidated Fund			
Inland Revenue	2,300	3,470	2,340
Customs and Excise	1,840	2,600	1,880
Other	820	700	570
National Loans Fund			
Interest, etc, receipts	270	210	310
Total receipts	5,230	6,980	5,100
EXPENDITURE			
Consolidated Fund			
Supply services	5,600	5,700	5,900
Other	270	300	270
National Loans Fund			
Service of the national debt	450	1,400	760
Net Lending	230	570	380
Total expenditure	6,550	7,970	7,310
Other Funds and Accounts	-	+150	+400
CGBR excluding strike effect	-1,320	-840	-1,810

CONFIDENTIAL

TABLE 3

CENTRAL GOVERNMENT BORROWING REQUIREMENT

£ billion

	1980-81		1981-82			
			Outturn/Forecast excluding estimated strike effect		Outturn including strike effect	
	In Month	Cumulative	In Month	Cumulative	In Month	Cumulative
April	0.9	0.9	1.0-1.2	1.0-1.2	2.4	2.4
May	2.4	3.3	1.8-1.9	2.8-3.1	2.8	5.2
June	1.3	4.6	(1.3)	(4.1-4.4)		
July	0.8	5.4	(0.8)	(5.0-5.3)		
August	1.6	7.0	(1.8)	(6.8-7.1)		
September	0.8	7.9				
October	0.2	8.0				
November	2.8	10.9				
December	2.2	13.1				
January	-1.8	11.3				
February	0.7	12.0				
March	0.9	12.9				

Notes: - Forecast for 1981-82 in Financial Statement and Budget Report is £11,497 million.

- Some rows may not add across because of rounding.

SUBJECT

cc master

SECRET

cc. A.W.

file

Econ Pol

2

10 DOWNING STREET

From the Private Secretary

4 June, 1981.

The Chancellor and the Governor called on the Prime Minister at 1300 hours today to discuss the situation in the Foreign Exchange Market.

Having described developments in the market overnight and this morning, the Governor said that the Bank were intervening on a modest scale in order to provide some steadying, and so as not to give the impression that they were conniving in sterling's decline. Their intention was rather to demonstrate an attitude than to hold the rate at any particular level. Having taken in a certain amount of dollars when sterling was going up, the market might take it as a sign that they wanted the rate to go down if they were to spend nothing now. However, if the market was determined to pull the rate substantially further down, there was no way in which intervention would prevent this - unless it was on an absolutely massive scale. For the present, he proposed that the Bank should continue to show a modest presence in the market by spending not more than $100 m per day; and they would only spend up to this figure if they thought it would have a steadying influence. If, however, the rate were to fall to $1.90 or below, it would in his judgement be necessary to consider a change in policy. By this he meant a rise in interest rates. If it were decided to increase interest rates to support sterling, this might need to be accompanied briefly by a large scale intervention.

The Chancellor said that he essentially agreed with the Governor's position. But he was anxious that the Bank should not intervene on too large a scale. The figure of up to $100 m a day seemed on the high side. It was important that the Bank's intervention should not be interpreted as a decision to defend any particular rate.

Following a short discussion, the Prime Minister said that the Governor was authorised to continue with the present smoothing tactic. It should be left to him and his colleagues at the Bank to decide how this should be put into practice, as long as it was understood that they were not to be seen as

SECRET

/ defending

SECRET

defending any particular rate. Rather than their being set a maximum figure for each day, they should have authority to spend up to $500 m between now and next Thursday. If the downward pressure on sterling intensified, then the option of raising interest rates would have to be considered.

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

TPL

A.J. Wiggins, Esq.,
HM Treasury

SECRET

BF 30/7/89

10 DOWNING STREET

Tim.

Caroline —

Set up for Monday 31 July at 10.00
CS 11/6.

Governor can't manage August for monetary seminar. Have to bring it forward. Can you talk to them pls.

D.

SECRET

1a

PM seen
TL 3/6

PRIME MINISTER

At noon sterling had fallen to 2.016 against the dollar.

The Bank's view is that without some significant intervention, sterling could fall below $2 before the end of the day. They believe that with intervention of up to somewhat less than $100 million, they can hold the rate above $2.

Ken Couzens is recommending to the Chancellor that they be authorised to spend up to $70 million today in order to prevent the rate from falling further. Anything more than $100 million on the day would be regarded as massive intervention, and a complete turnabout on our exchange rate policy of allowing the exchange rate to move with the market, subject to some smoothing. But even $70 million will be noticed, and will be taken as something of an aberration. However, my own view is that it is justified. A fall in the rate below $2 would, I believe, be psychologically rather damaging at this point - coming after the substantial decline over recent weeks. But if the downward pressure continues, the position will obviously have to be reviewed. We cannot go on spending $70 million a day for very long without it being seen as a change in basic policy.

Since dictating the above, Ken Couzens has telephoned me with one gloss. If the Bank judge that spending $70 million will not stop the rate from falling below $2, they will not spend that much - for in that case, the $70 million will simply be wasted. So if the rate does fall below $2, and they have not spent $70 million today, we should not be surprised. Ken emphasised that we should not put ourselves in the position of being seen to defend a particular rate: in that case, we would be in a new ball game altogether.

3 June 1981

TL

SECRET

BRIEFING NOTES FOR THE PRIME MINISTER ON DRAFT LETTER TO BE SENT FROM THE PRIME MINISTER TO THE CHANCELLOR OF THE EXCHEQUER AND THE BANK OF ENGLAND.

A. Phasing out the Reserve Asset Ratio

The banks have agreed not to make any major changes in the holding of liquid assets pending completion of the talks on prudential liquidity (these talks are being conducted by John Page of the Bank of England). Towards the end of last month they had not been completed. It is intended that the interim arrangements will ultimately be replaced by individual norms for particular banks around which there will be some considerable flexibility.

One of the concerns here is that the Bank does not introduce another type of reserve asset requirement. The prudential operation, under John Page, is rather opaque: the announcement of their conditions for prudent management added very little to our knowledge of how the prudential arrangements were actually to work. There is apparently soon to be a new paper on prudential arrangements which focuses on the Bank's own assessment and the supervisor's views. This may shed some light on it.

B. Cash Ratio

This issue was left for discussion between the Governor and Sir Douglas Wass. The present agreement was reported at the time of the Budget in Monetary Control - Next Steps (BEQB March 1981 p.38).

There are a number of technical problems, mainly concerned with the definition of the eligible banks under the new ½% system. I believe it is hoped that by the middle of the month those issues will have been, if not solved, then sufficiently progressed to enable the new system to go into operation.

The primary objective of the cash ratio is to provide the Bank with its income. The ½% deposit liabilities of all banks will, of course, expand with the rate of inflation. The size of the deposits at the Bank is, therefore, indexed. But the rate of return on those deposits will also vary directly with the rate of interest and so the rate of inflation. If we assume what is

/approximately

approximately true for the past decade or so, that is the rate of inflation and the rate of interest are roughly equal, then this means that if the rate of inflation doubles the Bank's indexed income doubles. Thus, for example, if the rate of inflation goes up from 5% to 10% and the interest rates move upwards in the same way, the Bank will enjoy a doubling of its real income!

All this seems a most unsatisfactory way in which to provide the Bank with an income. However, it might be wise to avoid disturbing agreement between the Treasury and the Bank, at least until the new monetary arrangements are in place.

C. Money Market Management and Lender of Last Resort

It appears that the Bank is doing very little business through the discount window, with the exception of a brief period at the end of April when there was a cinsiderable shortage in the money market, and virtually all of its intervention now is in the form of dealing in bills. The discount houses and call money are, and will remain, an important feature of the system.

At present the Bank's operations in the bill market tend to be at interest rates, for seven day money, which are something like half-a-point below MLR. In effect the Bank is at present working with a very narrow interest rate band below MLR. The main change envisaged is first to widen the band, and secondly to keep it confidential in the Bank. When the rate band appears to be under sustained pressure, criteria for moving it will be brought into play. When the authorities believe that interest rates are satisfactory, the Bank will accept offers of sufficient paper at prevailing rates to achieve the level of bankers' cash consistent with those rates. When upward movement in rates was required, the market would be squeezed for cash and banks which were unsuccessful in getting cash by selling paper would have to resort to the discount market, that is to say to borrow at penal rates. If the average rates persistently pushed against the undisclosed ceiling, then the discount window would be operated fairly freely or, alternatively, open market operations would ease the demand for cash.

/Several critical

Several critical decisions need to be taken. The first is the width of the interest rate band initially. There will then be subsequent decisions about widening the band to make the system more flexible. Discussions at present proceeding with the Treasury suggest that the Treasury would like a rather narrow band initially, but they may retreat on this point. Second, and perhaps the most important decision, is the targeting arrangements for the movement of the interest rate band. In a strict monetary base control system the immediate target would be the monetary base itself. The aim would be to keep the growth of the monetary base over a period of many months (probably six months to a year) within a target range. If, for example, one observed the monetary base growing very rapidly, far outside the target range, and for no obvious extraneous reason, one would begin to raise interest rates and take bank reserves, both cash and deposits, out of the system until the growth rate was back on course. This should normally be done over a period of some months.

The discussion of this targeting arrangement has only just begun and I expect it will not be settled very quickly. One particular problem is the relationship between targeting the monetary base, (or M_1) and the relationship with £M_3, which remains the main long-run target in the medium-term financial strategy. In my view there is no inconsistency between controlling the base and retaining £M_3 as the medium-term target. But we must be clear that £M_3 cannot be used as a short-run target variable. A second problem is the programme of shifting away from interest rate bands to open market operations directed simply at changing the quantity of reserves. Then interest rates are market determined. A third issue is the fixing of a penalty rate. I suggested three percentage points above the previous Monday's 7-day inter bank rate - but others may have superior suggestions which remain to be discussed. Whatever the details, however, it is important that the banks do not have "lender of first resort" (or "seller of first resort") facilities at rates very near to market values. Only when there is a swingeing financial penalty for being caught short will they willingly hold reserves in their tills instead of in those of the Bank.

/D. Funding

D. Funding

(This is rather a special subject in the general problem of monetary control, but you may find it necessary to get into these issues.)

I attended many of the meeting of the Treasury/Bank Committee on Funding techniques. I do not think that the Report, which was completed some months ago, has yet been considered by Ministers. There is little that is innovative or surprising in it. The Bank is predictably solicitous for the gilt jobbers and clearly prefers to keep the present tap system. But there have been a number of recent developments that are more like placements and auctions within the existing system. One of the main concerns is that the Bank have sufficient time to achieve a change in target sales of gilts. A slightly surprising conclusion was also that it would be best either to have a general tender system or a normal tap system; mixtures of the two were thought to be less efficient.

Your Ref

with compliments

P. E. MIDDLETON

Treasury Chambers
Parliament Street
London SW1P 3AG
Tel: Direct Line 01-233
Switchboard 01-233-3000

cc Mr Lankester (MO10) personal.

PL.

Chancellor of the Exchequer

cc Financial Secretary
Sir Douglas Wass
Mr Ryrie
Mr Monck
Mr Britton

MONETARY CONTROL

1. I understand that the Prime Minister is likely to devote most of the time at your meeting with her this afternoon to a discussion of monetary control. She apparently had a long session with Mr Walters on the subject last Friday and he has apparently provided her with a brief for this meeting. So far as I can tell from conversation with him he is more or less content with the administrative arrangements which the Bank is negotiating with the banking system. But he wants the companion discussions which we are having on the factors which determine interest rate decisions to take place under a Ministerial directive that primacy should be given to the monetary base. He does not see this as incompatible with achieving the £M3 objectives for the medium term strategy.

The Latest Position

2. The Bank's talks with the banking system are now virtually complete. The clearing banks yesterday accepted the proposals set out in the Bank's paper "Monetary Control: Next Steps". This elaborated the proposals put forward following your November statement last year and was issued in March, two days after the Budget. There are a few minor loose ends, but these will be tidied up pretty quickly and will not hold up progress.

3. The Characteristics of the System you know. But I repeat them to give you a self-contained note to draw on. They are:

a. there will be no Reserve Asset Ratio for the purposes of monetary control: it will have a transitional role as a prudential norm.

b. Access to the discount window will be less freely available - and then - apart from exceptional cases - only at a penal rate.

c. MLR will be abolished or suspended.

d. Bank operations will be conducted mainly in bills.

e. The Bank will operate to keep interest rates within an unpublished band.

4. There are a number of points to be resolved about how the system will operate. These are of two sorts.

5. First there are some outstanding questions on the operation of the new arrangements. These were set out in my minute of 14 May. We are already discussing them with the Bank. Mr Walters is taking part. Briefly these are:

a. the question of whether and when MLR should be abolished or suspended.

b. the new prudential arrangements.

c. the size of the penalty element in discount window lending.

d. movements of interest rates within the band.

e. presentational issues; how to get this sytem off the ground so that we depoliticise interest rates - despite the large element of of continuing discretion - and make it easier to move them rather than the reverse.

We expect to resolve these issues in the next 4-6 weeks.

6. Second there are questions concerning the determination of interest rates. We have sent a paper to the Bank and Walters for discussion. A meeting is to take place this week. There are a lot of issues to resolve if we are to formalise things sufficiently to provide a clear presumption about when rates should move. This work includes considering the role of the monetary base which is relatively undistorted by the Civil Service strike and the other narrow aggregates - plus the other factors mentioned in the Budget Speech. There is a separate paper on monetary base control, which is being discussed with the Bank though Walters has not seen it yet. But we shall want to avoid anything which looks like a move away from £M3 at this stage. We intend to make a report on this work in the next 4-6 weeks also.

Timetable

7. In your minute of 18 May, you suggested that we should aim to have another round up on where we should go before the summer recess so you could report to the Prime Minister. The Bank - and Mr Walters - have agreed with this objective. The next steps are:

a. about 5 June: a revised and expanded draft of "Monetary Control: Next Steps" to Ministers.

b. 19-24 June - draft sent to banks and LDTs by Bank - only marginal changes will be possible at this stage.

c. 16 July - definitive provisions sent out.

d. Now to mid-July - report to Ministers on the outstanding issues set out in 5 and 6.

e. August - new system becomes operational.

Tactics

8. Everything is set on the timetable you suggested. There will be plenty of time for Ministerial discussion. It would not however be helpful to have just now a seminar with the Prime Minister of the sort we had last autumn. I suggest you say:

a. You will report the outcome of the Bank's discussion with the banks this month. This is in line with previous decisions and does not pre-empt decisions on the key issue of the basis for interest rate changes. Mr Walters is fully informed. Much of it is very detailed and is not appropriate for a seminar. We will of course be happy to explain the arrangements in detail to the Prime Minister - if she so wishes, but she might be content to leave this to Treasury Ministers.

b. Talks on the points in para 5 and 6 are in the early stages. Mr Walters is taking part. When Treasury Ministers have considered them, on the timetable you set out, you will report to the Prime Minister. It would then be appropriate to hold a seminar type discussion if she so wished.

Funding

9. This is rather separate - and the ball is in your court

to discuss Sir Douglas Wass's submission with us. But:

a. the tranchettes of stock issued last week represented a more flexible approach to funding.

b. the next issue is expected to be a further tranche of indexed stock.

c. the funding programme - including National Savings - has been going very well, though savings inflows are now much smaller.

Points to Make

10. I attach a note of points you might make if you get drawn into an extended discussion. It is familiar stuff.

E. K. Clarke

pp P E MIDDLETON
2 June 1981

Points to Make

1. The Government is committed to £M3 as the basis of the medium term strategy. The Prime Minister agrees with this. (Remember her comments on Walters minute). It would be a mistake to let it be thought that this question was to be re-opened.

2. MBC is therefore virtually ruled out as a means of medium term monetary control. In any case we would not now wish to contemplate, as would some pure monetarists, fixing the growth in the monetary base at a particular figure as the sole means of bringing inflation down, and keeping it down, some time over the next century or so. Policies with this cosmic time dimension are of very limited value.

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

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

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

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

d. But work so far suggests that it has some serious drawbacks. It is in many ways inferior to other narrow aggregates such as M1. Only the currency component of the base appears to show any systematic relationship to money incomes or prices, but since this is entirely demand determined, it provides no firm evidence of a causal link. It is also currently a good deal higher than Walters would wish. 5% is the figure he mentions compared with a 6 monthly rate of 8% at present.

e. The relationship of the base to interest rates is not well determined and looks to be pretty unstable; in any case there would be far reaching implications for building societies and mortgage rates.

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

4. This certainly does not rule out taking the base into account amongh the other factors which determine interest rates. We now have a series and shall wish to monitor the base and its components. It might be of particular value this year as other aggregates are distorted by the strike. All this is being discussed currently with the Bank and Mr Walters. But this is not the same as basing policy exclusively on targeting the base.

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

6. The discussions taking place at present (Bank, Walters, Treasury) are an attempt to reconcile these various factors and turn them into operational rules. Best to let them go further without prejudging the issue at this stage.

Prime Minister 1A

Alan Walters endorses the proposition that we finance the tax short-fall by reducing the Bank's holdings of Treasury bills and, if necessary, increasing the issue of bills. He draws the fairly obvious conclusion that there is no scope for an early cut in MLR.

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

PRIME MINISTER

THE MONETARY OUTLOOK AND THE CIVIL SERVICE STRIKE

.... I attach the report prepared by Treasury officials on the Monetary Outlook and the Financial Effects of the Civil Service strike promised in my private secretary's letter of 11 May about the central government borrowing requirement in calendar April.

TL 15/5

2. The salient points, subject to the inevitable uncertainties of all such forecasts which are compounded by the strike, are:

(a) £M3 figures are likely to rise by 2 per cent or more in each of the next 2 or 3 banking months. (The M1 figures rise a good deal faster, at least in the early part of the period.) As the table in paragraph 4 of the note shows, these increases will have been swollen by the estimated strike effect of nearly 1½ per cent a month. But even without that the underlying growth in £M3, over the first 5 months of the new target period may exceed the target range. The unexpected strength of bank lending seems to be the main factor behind this;

(b) the monthly effect of the strike on revenue will remain at about £1¼-1½ billion, if, as we expect, we continue to get about three quarters of the forecast revenue paid in;

(c) officials have not been able to identify ways of stepping up the flow of revenue without jeopardising the (much larger) existing flow. They have also considered whether any special funding device could contribute usefully towards containing the effects of the strike on £M. I endorse their conclusion (discussed more fully in the Annex to the attached paper) that transactions in bills are the appropriate way of responding to the situation;

(d) I have on balance decided to approve the proposal that the Inland Revenue should open an account with Giro into which uncleared cheques would be paid. Even though the money is not likely to reach central government during the strike, it would be helpful that the liquidity of the private sector will be reduced as a result. (See paragraphs 12-15 of the note.)

(e) Over 80 per cent of the missing revenue is not in the form of uncleared cheques but has simply not been paid. This means that it will take longer to unwind the financial effects of the strike than has been assumed for the purpose of the forecast. This will ease money market problems but lengthen the uncertainty about interpreting monetary statistics.

3. The prospect is thus not a comfortable one. But I do not think it is unmanageable and I am sure we should maintain the line that the strike is not putting the economic strategy at risk.

(G.H.)

13 May 1981

6/6/81

MANAGEMENT IN CONFIDENCE

SECRET

1. MR MIDDLETON
2. Mr Ryrie
3. CHANCELLOR

This note has been prepared in a form which could be sent to the Prime Minister. We promised her a full report when sending the CGBR figures over yesterday

[initials] 4/6

cc Chief Secretary
Financial Secretary
Minister of State (L)
Minister of State (C)
Sir Douglas Wass
Mr Ryrie
Mr Burns
Sir K Couzens
Mr Britton
Miss Brown
Mr Collinson
Mr Pirie
Mr Turnbull
Mrs Lomax
Mr Ingham
Sir D Lovelock - C&EX (Personal)
Sir L Airey - IR (Personal)
Mr Fforde - B/E

THE MONETARY OUTLOOK AND THE FINANCIAL EFFECTS OF THE CIVIL SERVICE STRIKE

This note reports the outcome of Mr Ryrie's meeting with the Bank about the monetary outlook for the next 3 months and of a meeting of Mr Middleton's group of officials concerned with the financial effects of the strike.

Monetary Prospects: May-July

2. The £M3 figures for banking April, the first to be published since the strike, were published last week. The Press generally accepted official briefing that although the recorded growth was about 2%, the underlying growth, ignoring the strike effect was about ½%. This would place the growth of £M3 over the past 6 months at just over 8% at annual rate (using the new seasonal adjustments). Nevertheless, this did not entirely reassure the markets.

3. The prospects for the next 3 months are naturally dominated by the effects of the Civil Service dispute. Trying to disentangle

55915

the underlying position from the likely published figures is a difficult exercise requiring a large number of assumptions about the size of the effect on the CGBR and the way companies respond to the improvement in their liquidity. Through it all we reached the following conclusions.

i. There appears to be some deterioration in the underlying prospect, with growth over the next 3 months averaging 1¼%, and with the figure for May being around 1½%. Although we had always expected £M3 to grow rather faster in the first half of the target period (and considered including a statement to that effect in the Budget Speech), the position is nevertheless worrying.

ii. We had no direct way of estimating the CGBR at present and it is being projected forward in line with the forecast. The degree of front loading is expected to be as great as it turned out to be last year.

(iii) The main cause for concern is bank lending. Successive monthly exercises have raised the estimate of the underlying rate from £450 million per month to £600 million. At this level it is difficult but not impossible to achieve the monetary target without overfunding and reducing bank liquidity. Were it not for the dispute this might indeed have been taking place. There are no signs as yet of the hoped for weakening of lending to persons. The next quarterly survey - to mid May - will be available in June and we will need to examine these figures carefully.

(iv) Although National Savings are doing well - probably unsustainably so sales of gilts have been disappointing in May. The short tap has been reactivated but yields had to rise considerably to bring that about. Built into the forecasts are some fairly ambitious figures for gilt sales which it will not be easy to achieve in adverse circumstances.

4. Whatever our view of the underlying position, the actual monetary figures will attract attention. The table below shows the estimated effect of the dispute on the CGBR and £M3. It is constructed on the assumption that the strike ends in June and is unwound in July. (This is not necessarily the most realistic assumption but it allows one to look at the prospects over the period excluding the effects of the dispute.)

	Banking Months				
£ billion	Mar	April	May	June	July
CGBR underlying s.a.	635	575	1375	840	730
Strike effect	200	1350	1410	1320	-4280
Actual CGBR	835	1925	2785	2160	-3550
Per cent					
Increase in £M3, underlying	0.6	0.7	1.4	0.6	1.6
Strike effect	0.2	1.3	1.4	1.4	-4.1
Actual increase	0.8	2.0	2.8	2.0	-2.5

5. The actual £M3 figure for May could be between 2½-3 per cent and June around 2 per cent. In addition to the monetary statistics, there will be a cumulative CGBR, not seasonally adjusted, of around £10 billion. Such figures are likely to cause increasing concern in the Press and the markets, particularly as it will become increasingly apparent that we have no independent source of information for the underlying figures: we could be understating them if the Budget forecasts of revenue were optimistic. As an independent cross-check we can use statistics for earnings, employment and retail sales. We do not get these promptly enough to be of much use yet, though if anything they suggest the Budget forecasts of revenue might be a little on the low side.

6. The discovery that only a small part of the uncollected tax is in the form of uncleared cheques is worrying. It could cast doubt on the estimates of the strike effect, it could imply greater freedom for companies to deploy the funds and it could slow the process of unwinding.

Funding and unwinding the effects of the strike

7. Officials have considered whether the funding arrangements should be changed in response to the effects of the strike and whether there should be any changes in our methods of operating in the money markets both to cope with increasing bank liquidity and to improve the prospects of unwinding the strike smoothly. The arguments are set out in the attached Annex. It concludes that there is not much prospect of being able to sell additional gilts or National Savings and that to offer a special interest bearing instrument for companies to hold would encourage and sanction non payment of tax. The effects of the strike should* continuing to run down the Bank's holdings and then by issuing Treasury bills. When the strike is unwound the Bank will buy back the bills, though it is possible that there could be pressure on bank liquidity.

* be financed in the bill markets first by

Bringing in More Revenue

8. Customs and Excise see the possibility of some slippage in deferred duties after May but both departments agree that the best working assumption for the next few months is that the proportion of forecast revenue being paid in will remain at about three quarters overall, with the Inland Revenue achieving slightly less than that figure, and the Customs and Excise slightly more. The strike effect on revenue and the CGBR is likely to remain about £1$\frac{1}{4}$-1$\frac{1}{2}$ billion per month.

9. The Revenue departments have no way of knowing which taxpayers have failed to pay, though they know that they are predominantly small payers*. But in any case, few enforcement staff are available to chase up overdue payments and those that are lack their normal computer information. There is therefore no scope for stepping up enforcement activity. However the Revenue hope to be able to cash the large cheques at present in their offices (see paragraph 17 below). Those should bring in over £100 million.

10. An alternative would be to draw more attention to the mean of payment still available; ie through the banking system and Giro. But the clearers have advised that a change from the present low-key approach may be interpreted as a hostile action by their own staff many of whom have still not accepted their employers' pay offer, and so jeopardise the payments, mainly by large payers, now made via the banking system which are crucial to the success of the present arrangements. (There has already been some blacking of the payments through this route in some of the Northern Irish banks.) Similarly, the Giro, whose staff are members of the civil service unions, consider it essential to maintain a low profile if present revenue flows are to continue (though a small step in Giro's case is discussed below). We conclude that this option must be ruled out at least until the outcome of the ballot by BIFU and its aftermath are known. BIFU is on the look out for an excuse for escalating its industrial action.

* and that some taxpayers are netting off VAT repayments due from the payments that are being made.

11. However, officials did consider that a carefully presented Ministerial appeal to those employers who have not yet paid might be worth considering. Such an appeal might be made as a minor part of a statement by the Prime Minister or Chancellor which would be mainly designed to underline the success of the present arrangements (without encouraging the unions to further disruption) and would carefully avoid explicit reference to the alternative methods of payment available. We shall be considering this further with the Revenue departments.

Girobank

12. There is a special problem relating to Girobank on which we seek a decision from Ministers. The flow of revenue by credit transfer through Giro presents no difficulties; some £200 million per month reaches each of the Revenue departments by this route. But a number of cheques made payable to the Inland Revenue are mistakenly sent to the Giro. In normal circumstances these would be forwarded to Inland Revenue at Worthing, but the Giro unions (ie the civil service unions) have blocked this arrangement for the duration of the strike.

13. Although initially the amounts involved were small, some 200 cheques worth £45-50 million are now stuck with Giro, and the amount could rise quite sharply, particularly after the next PAYE payments due on 19 May. The Inland Revenue have up to now accepted this because Giro management consider that if some special means of getting these cheques to Inland Revenue were adopted, the much larger monthly flow of £200 million through Giro credit transfer would be at risk. But if the cheques are not cleared in some way, the senders of the cheques may not bother to make further tax payments. Inland Revenue have therefore asked the Treasury to agree that Giro should open an account on their behalf into which the cheques could be paid and then block the account until the end of the strike. Giro consider that the unions are likely go along with this. The Inland Revenue have copied their letter to Exchequer and Audit who will also see our reply.

14. The proposal would not change the £M3 statistics compared with the present arrangements because the sums represented by the cleared cheques would be shifted from one (private) part of the banking system to another (public) part. But it would have the advantage of reducing the liquidity of the private sector; and to the extent that Giro invested this money in the public sector, less interest would be paid to the private sector. Giro think a formal agreement to pay interest on the blocked account may provoke the unions unnecessarily at present; but they would accept eventual payment in some form. Treasury officials consider that it would not be right for the Treasury simply to authorise the opening of a blocked account. But we have to recognise that if we authorise the opening of a new account it is in practice likely to be blocked.

15. This raises presentational difficulties, which might be exploited by the unions if the amounts involved grow significantly. But there are also problems with the alternative. If no action is taken, the unions will have just as much presentational leverage while the Government will not gain anything at all. If the Revenue or the Treasury were to insist that these cheques should be forwarded to Inland Revenue the present arrangements for obtaining revenue through the Giro would be put at risk. On balance, we would therefore recommend agreement to the opening of a Giro account on behalf of Inland Revenue; we would not give approval to the proposal that it should be blocked but recognise the probability that it would in practice be blocked and make it a condition that if that happens, payment of interest or equivalent financial compensation in lieu of interest will be obtained from Giro.

Recovery at the End of the Strike

16. It was originally thought that following a return to normal working, very large payments of tax would be made extremely rapidly, which might create a serious shortage in the money markets. However, we now think the period of unwinding the financial effects of the strike

may be extended. This will ease money market problems but lengthen the period of exceptional uncertainty about interpreting money statistics.

17. The Inland Revenue have reviewed their estimate of the breakdown of revenue not received between that in the form of low denomination cheques which it has not been possible to clear and that which employers have failed to pay. It is now reckoned that there are nearly 500,000 cheques awaiting clearance worth perhaps £300 million. Most of the shortfall in tax receipts is therefore in the form of tax not paid - some 80% or so of the shortfall.

18. This could have serious implications for recovery time, particularly since both Revenue departments face the prospect of an overtime ban by staff returning to work which may be imposed for the same period as the strike. If recovery staff are needed for collection of unpaid revenue, the backlog is likely to take some considerable time to clear, since enforcement staff are normally fully occupied at this time of the year in the processing of employees' deduction cards. Some 37 million of thes are annually processed by the Inland Revenue and the DHSS before being sent on to local tax offices to ensure the correct payment of tax during the forthcoming tax year. This operation has also been blacked for the duration of the strike; instead of 2 million cards sent weekly to DHSS at this time of year, only 250,000 in all have gone since 5 April.

19. The Revenue departments will have to deal with many problems at the end of the strike including returned cheques and Payable Orders and cheques which cannot be cleared; and the repayment of VAT. Both departments are now considering what their priorities should be during the recovery period, and will consult Ministers about the various options in due course. Relevant factors will include the general economic conditions at the time and the CGBR position and the markets' expectation of an early return to normal of the money supply figures.

20. The Revenue departments presently reckon that for a return to work at the end of June recovery* would take place during the following

* In the sense that the bulk of the missing revenue would be recovered during the following quarter.

quarter. However, the Paymaster General's Office consider that they are already at the point beyond which "recovery" for the period of the strike looks extremely remote; a strike lasting until June would eliminate all prospect for recovery of fraudulent payments made during the dispute.

Presentation

21. In the further briefing for Ministers that we shall be preparing, we shall be recommending that the present line - that the strike is not threatening the economic strategy - should be maintained. When the money figures for banking May are published in June we shall consider whether further special briefing of the Press would be useful.

Conclusions

22. We have no reason at present to expect the monthly effect of the strike on revenue to rise from its present level of £1¼-1½ billion, though a deterioration remains possible.

23. The high underlying CGBR figure for banking May means that both the recorded and the underlying £M3 figures to be announced on 7 June will be uncomfortably high. The prospect is that over the first 5 months of the new target period, underlying monetary growth may exceed the target range. The main factor behind this appears to be the strength of bank lending. All this will add to the anxieties about the absence of any direct independent source of information about the "underlying" revenue flow, as the cumulative CGBR [not seasonally adjusted] rises, perhaps to £10 billion by the end of June.

24. Despite these problems the Government should continue to maintain that the strike is not putting the economic strategy at risk.

25. We cannot identify any way of stepping up the flow of revenue without jeopardising the (much larger) existing flow. Nor do we see any special funding device which can reduce the effect of the strike on the £M3

figures. Relying on bills seems the appropriate response.

26. We recommend Ministers to agree that we should authorise the Inland Revenue to open an account with Giro on the basis in paragraph 15.

27. The recovery period now seems likely to be a long one. This will have some advantages for managing the money markets but will prolong the uncertainties about monetary growth.

N MONCK
12 May 1981

FUNDING AND UNWINDING THE EFFECTS OF THE STRIKE

1. Hitherto the shortfall has been financed largely by reducing the Bank's holdings of bills which at a peak reached £3.5 billion out of a total of around £5 billion. So far the Bank's bill holdings have declined to around £2.3 billion. There will come a point when it will be necessary to increase the issue of Treasury bills. In monetary terms this is a continuum; there is no particular significance to be attached to the point at which we cease to finance the shortfall by running down assets and begin to issue new debt. Either way the shortfall adds to money except to the extent that there are offsets in bank lending and the externals. The Treasury Bill tender has remained at £100 million a week and the stock is historically very low. Thus there should be some scope for increased sales both within and outside the banking system.

2. One advantage of financing the shortfall via bills is that it provides the mechanism for unwinding. In order to offset the cash shortage created by the flood of tax payments, the Bank will buy back the large stock of bills in market hands.

3. However, there could be diffulties in unwinding the effects of the strike painlessley. First the sums involved could be very large - possibly over £5 billion of market assistance being required if the strike were unwound in July. Secondly, in underlying terms the liquidity of the banks may have been deteriorating with strong bank lending being matched by an overfunded PSBR.

4. What are the implications of trying to mop up the extra liquidity by more funding? The first point to consider is who has the money. In general this will be companies who in general are not large holders of public sector debt, rather than financial institutions. It is likely that these companies will want capital certain assets to match tax payments of a

predetermined amount, and assets of shortish maturity, as there is uncertainty about when the strike will be unwound. Gilts look a rather unsuitable outlet for the tax money. Thus there is a problem of habitat - the money is not accruing in the right place; and of assets - most debt instruments are unsuitable.

5. The case for accelerating the sale of gilts is weak. In present circumstances there are worries enough about achieving the "normal" funding programme. To raise more could require a very sharp adjustment of medium and long term interest rates. It is doubtful too whether National Savings could be pushed even harder at the moment.

6. An alternative might be to devise some new instrument which would be short term, reasonably capital certain, which could be sold to non-banks and surrendered when the tax is eventually paid. This would mean that the idle balances would not score as money but would be just over the definitional border. Why not market CTD's more actively? There are several difficulties here. First, CTD's cannot at present be used for PAYE for VAT or NI contributions. Secondly, interest on CTD's ceases to be paid on the due date; thus by definition they would not be useful in these circumstances. The PAC might have something to say about HMG overtly paying interest on tax due and encouraging non-payment though it is, of course, doing this indirectly. Thirdly, most of the natural customers for CTD's are the big companies from whom we are getting most of the tax due. If cheques can be collected and cleared in payment for CTD's, it could be done for the tax itself.

7. Thus there appears to be relatively little that can be done to increase funding either by more aggressive sale of existing instruments or by offer of new instruments. It will then be necessary to continue to operate in bills. When the Bank's holdings of commercial bills have depleted, it will be necessary to increase the Treasury Bill tender.

When the strike effects are unwound, the Bank will provide assistance by buying back these bills. It will be difficult to complete this operation smoothly.

10 DOWNING STREET

MR. MIDDLETON

I attach some notes on Monetary Control - The Next Steps.

12 May 1981 ALAN WALTERS

cc Mr. Burns
Mr. Wiggins
Mr. Hoskyns
Mr. Wolfson
Mr. Duguid
Mr. Lankester

CONFIDENTIAL

NOTES ON MONETARY CONTROL - THE NEXT STEPS

Paragraph 3(b)

Is it not important to state what is penal in relation to those established by the market? Should we not say that funds will be supplied at say 3%, or maybe 2%, above the market rate of the day that the funds are borrowed? We might have to define this even more precisely in terms of time, etc. Secondly, should not the rate apply to all borrowers? I would be reluctant to think that the Bank will supply funds at one rate for one borrower and another rate for a different borrower. But perhaps I am being pernickety there because presumably the Bank should operate a system where they do not discriminate between borrowers.

Paragraph 4

I find this part of the new system the most unsatisfactory. I don't think anyone will imagine that we are going to set interest rates at all by reference to M3. After all we haven't done so in the past and we are unlikely to change now. In its present formulation this suggests a whole rag-bag of factors and we really have not got agreement here at all. In my view it would be best to state unequivocally that the objective would be to have a constrained growth of a monetary base over moving six to twelve months periods of 5% per annum this year, and thereafter declining to virtually zero per cent per annum in 1985. This does not mean that in the interim period one couldn't use liquidity considerations, exchange rates and even real interest rates to vary the open market operations of the Bank at this short end. But there is a considerable distinction between varying interest rates to secure a long-run target of the growth of M_0 and day-to-day operations which may take into account all the factors you list, such as the exchange rate, the behaviour of other variables, such as liquidity considerations in the banking system, other interest rates, etc. I think in its present state the crucial problem is to distinguish between the long-run objectives and short-run accommodations. This doesn't appear in the present note. It is, however, relatively simple to argue

/that, in the

CONFIDENTIAL

that, in the long-run, the movements of the monetary base and M_3 are fairly highly correlated. This then gives us an argument for using the monetary base as an intermediate target for the control of M_3 and PSL aggregates. This is then consistent with the medium term financial strategy.

12 May 1981

NOTES ON MONETARY BASE CONTROL - THE PRESENT SITUATION

1. Since November 1980 there has been no rule for interest rate control and open market operations. The general procedure has been to sell as many gilts as the market will take, but this is at prevailing interest rates. We are not moving interest rates in order to control any monetary magnitude. In short there is no monetary control. We are responding to the demand for money and not determining its supply.

Monetary Base Control

2. There is no reason why we should not attempt to control the monetary base of the system. Since M_3 is influenced, but certainly not determined by, the sales of gilts to the non Bank private sector, there is no reason why this policy should not continue alongside the system of monetary base control. In this control system we are only concerned with the liabilities of the Bank of England in the form of cash held by the public, cash in bank tills and bankers' deposits. There does not seem to be any marked inconsistency between controlling these liabilities to some specified 5% growth rate, on the one hand, and pursuing existing policy of selling gilts in order to influence the path of M_3 on the other. Thus monetary base control is entirely consistent with the present control mechanisms used in medium term financial strategy.

The Disadvantages

3. It is thought that the main disadvantage would be the fact that interest rates will oscillate more than under present conditions. But this depends very much on the monetary base policy pursuit. If we try to keep a growth path day-in day-out of 5%, there certainly will be marked oscillation, but if instead we are concerned with growth over much longer periods, say six months to one year, then there is no reason why there should be induced liquidity crises of this nature.

/In fact we

In fact we should make it clear that the day-to-day operations of the system are concerned with supplying adequate liquidity to the banking system. The control of growth rate at 5% per annum would be over a period longer than six months and probably about a year in duration.

12 May 1981

CONFIDENTIAL.

DMC.

Prime Minister

Mr Walters

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

TL 12/5

11 May 1981

T Lankester Esq
No. 10 Downing Street

Dear Tim,

MONTHLY NOTE TO THE PRIME MINISTER ON THE BORROWING REQUIREMENT

... I am enclosing this month's note for the Prime Minister. The main points are summarised on the first page.

The borrowing requirement in April was large - £2,410 million - mainly because of the effect of the strike. Most commentators are expecting a figure of about that size, since we announced in a recent written answer that the strike had added £1¼ to 1½ billion to the borrowing requirement. We also briefed the press when the provisional money supply figures were published last Wednesday.

The note gives "underlying" forecasts and also estimates of the possible effects on the CGBR if the strikes continue. The key numbers are in the summary.

The Civil Service dispute, through its effect on the CGBR and its effects on other aspects of the money supply, especially bank lending, will continue to dominate the monetary prospect. If we continue to do as well as we have up to now in getting revenue in, and the dispute continues until the end of next month, £M3 could be cumulatively over 4% higher than forecast as a result of the dispute. Because these are in any case heavy months for the CGBR we shall have some difficult presentational problems - especially next month. The effort we mounted to get over the April figures shows that these can be overcome. But the Chancellor will be letting the Prime Minister have a full appraisal of the effects of the strike on monetary and economic management early this week.

Yours ever,
Richard Tolkien , for, A.J. Wiggins

CONFIDENTIAL

MONTHLY NOTE ON THE BORROWING REQUIREMENT

May 1981

Summary

- the provisional estimate of the CGBR in April is £ 2,412 million, including effects of the civil service strike.

- probably £1¼-1½ billion reflects the delays in tax and national insurance collections. That aside, the CGBR would have been much the same as a year ago; and less than forecast a month ago because lending to local authorities and public corporations was much less than expected.

- the latest forecast puts the CGBR in the four months April-July at £5½-5¾ billion excluding all strike effects. This is consistent with the Budget forecasts.

- adding the April strike effect raises this to about £7 billion and more than £1 billion needs adding for each future month of delay through the strike.

The CGBR in April

1. The provisional estimate of the CGBR in April is £2,412 million . This will be published in the regular press notice on Tuesday 12 May.

2. The civil service pay dispute is estimated to have delayed some £1¼ to £1½ billion of tax and national insurance receipts in the month. That aside, the outturn was better than the strike-free forecast of £1,530 million made a month ago. Lower lending to local authorities and public corporations accounts for most of this. The detail is as follows:-

	Effect on the CGBR (- means adverse) £ million
Strike Effect	
Inland Revenue taxes (mainly PAYE)	-700 (approx)
National insurance contributions (included in "other funds and accounts") (in table 1) ; National insurance surcharge (included in "other consolidated fund receipts")	-400 (approx)
Customs and Excise (mainly VAT)	-100 to -300
	-1,200 to -1,400
Other factors	
Other Customs and Excise	-80 to +120
Lower net lending to local authorities	+170
public corporations	+340
Other	-110
Net effect on CGBR	-880

3. Civil service pay dispute: As far as the CGBR is concerned, the main impacts of the dispute continue to be the loss of revenue due to the strike of Customs and Excise staff at the VAT centre at Southend, which started on 9 March, and the strike of Inland Revenue staff at the PAYE centres at Shipley and Cumbernauld which started on 16 March. In the case of VAT, the effect of the stike is reduced by the inability to make refunds of VAT to traders. Strikes at various departmental computer centres, including the Paymaster General's Office, are so far having little effect on the level of payments but continue to create accounting problems.

4. Whilst it is not possible to give a precise estimate of the effect of the dispute on Government income, actual receipts into the Exchequer accounts can be compared with a forecast of what might have happened if there had been no strike. The difference reflects forecasting errors as well as the effects of the dispute and these will become more important over time because of the lack of facts.

5. The best estimate is that between £1¼ and £1½ billion of tax and national insurance receipts due in April have been delayed, bringing the cumulative backlog of revenue since the strike started to £2 to £2½ billion. These estimates were given in answer to a written Parliamentary Question on 30 April.

6. Overall, since the strike started, probably 80 per cent of the revenue due has been paid into the Exchequer accounts. In April the proportion was probably slightly less.

7. Table 1, attached, presents a detailed comparison of the forecast for April and the outturn.

8. Inland Revenue Taxes: Virtually all the difference of £700 million between the forecast and outturn is attributed to PAYE receipts delayed by the strike. This forms part of the total effect in the month of the strike at Inland Revenue of some £1,100 million; the remainder is attributed to lower national insurance revenue. However, the strike has made it impossible to distinguish between tax and national insurance receipts and so the split is somewhat arbitrary.

9. In April, Inland Revenue were successful in banking just under three quarters of the revenue believed to be due. Of the 25 per cent of revenue outstanding at the end of April, something around a fifth (or 5 per cent of revenue) was in hand as unbanked cheques in tax offices and the rest money not yet received.

10. Customs and Excise: Receipts in April were £180 million below the forecast. The estimate of the effect of the strike on net receipts of VAT is more uncertain and is put in the range £100 to £300 million. The signs are that the other major taxes were much as forecast.

11. Net Lending to local authorities and public corporations in April was well below forecast but this may have been accompanied by higher borrowing from the market.

12. Supply Services and Contingencies Fund: Because of the strike at the Paymaster General's Office, no breakdown is available of net Supply issued in April.

Forecast for the next three months

13. Forecasts for May, June and July can only be speculative. How long the dispute continues, the rate of future losses, and the rate of recovery when the dispute is settled are additional unknowns.

14. Table 3 gives forecasts which, as in last month's note, exclude all effects of the strike. This provides a base against which the effects of the strike can be measured. This forecast is subject to an even wider margin of error than usual; certain information normally used in the preparation of the three month forward look has not been available since the strike started.

15. Table 2 shows that the latest forecast to the end of July would bring the cumulative CGBR, excluding the effects of the strike, to between £5.6 and £5.8 billion, slightly above the £5.4 billion for the same period last year but consistent with a preliminary look at the monthly profile of the Budget forecast. "Front-end loading" this year is influenced by Supplementary Petroleum Duty and the Special tax on banking deposits which are to bring in £2¼ billion in 1981-82 but not before September since collection must await the Finance Act.

16. Further effects of the strike: If there is no significant escalation in the dispute and revenue losses continue at about the same rate, the present backlog of £2 to £2½ billion of delayed revenue will grow to £3¼ to £3¾ billion by the end of May and £4½ to £5 billion by the end of June and so on. Apart from the eventual recovery of them, the CGBR will also benefit from the revenue delayed from March, put at £¾-1 billion.

TABLE 1

CENTRAL GOVERNMENT BORROWING REQUIREMENT - APRIL

£ million

	Forecast (excluding strike effects)	Outturn (including strike effects)	Difference on CGBR
RECEIPTS			
Consolidated Fund			
Inland Revenue	2,600	1,987	-703
Customs and Excise	2,240	2,060	-180
Other	480	175	-305
National Loans Fund			
Interest etc receipts	270	356	+ 86
Total receipts	5,590	4,488	-1,102
EXPENDITURE			
Consolidated Fund			
Supply services and Contingencies Fund	5,800	5,690	+110
Other	300	307	- 7
National Loans Fund			
Service of the national debt	380	408	- 28
Net lending	490	- 17	+507
Total expenditure	6,970	6,388	+582
Other funds and accounts	-150	-512	-362
CGBR	-1,530	-2,412	-882
of which: estimated strike effect	-	-1,200 to - 1,400	-1,200 to -1,400
excluding strike effect (say)	-1,530	-1,000 to - 1,200	+350 to + 550

CONFIDENTIAL

TABLE 2

CENTRAL GOVERNMENT BORROWING REQUIREMENT

	1980-81		1981-82			
			Outturn/Forecast excluding estimated strike effect		Outturn/Forecast if strike continues at same rate	
	In Month	Cumulative	In Month	Cumulative	In Month	Cumulative
April	0.9	0.9	1.0-1.2	1.0-1.2	2.4	2.4
May	2.4	3.3	(2.3)	(3.3-3.5)	(3.5-3.7)	(5.9-6.1)
June	1.3	4.6	(1.5)	(4.8-5.0)	(2.7-2.9)	(8.6-9.0)
July	0.8	5.4	(0.8)	(5.6-5.8)	(2.0-2.2)	(10.6-11.2)
August	1.6	7.0				
September	0.8	7.9				
October	0.2	8.0				
November	2.8	10.9				
December	2.2	13.1				
January	-1.8	11.3				
February	0.7	12.0				
March	0.9	12.9				

Notes: - Forecast for 1981-82 in Financial Statement and Budget Report is £11,497 million

- Some rows may not add across because of rounding.

CONFIDENTIAL

TABLE 3

CENTRAL GOVERNMENT BORROWING REQUIREMENT

	Latest Forecast (excluding effect of strike)		
	May	June	July
RECEIPTS			
Consolidated Fund			
Inland Revenue	2,450	2,300	3,470
Customs and Excise	1,780	1,840	2,600
Other	730	720	610
National Loans Fund			
Interest, etc, receipts	210	380	210
Total receipts	5,170	5,240	6,890
EXPENDITURE			
Consolidated Fund			
Supply services	5,600	5,650	5,600
Other	270	270	300
National Loans Fund			
Service of the national debt	1,270	450	1,400
Net Lending	390	280	450
Total expenditure	7,530	6,650	7,650
Other Funds and Accounts	+100	-70	+30
CGBR excluding strike effect	-2,260	-1,480	-830

10 DOWNING STREET

~~Mr Lankester~~

MBC

This was a record of my attempt to "ginger up" the Chancellor in April. You may think that the PM should at least know about it

AL

AW - What do we go from here ?

Copies to DW

CONFIDENTIAL

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Mr Burns
Sir K Couzens
Mr Ryrie
Mr Middleton
Mr Monck
Mr Unwin
Mr Turnbull
Mr Ridley
Mr A Walters)
Mr T Lankester) No.10

NOTE FOR THE RECORD

MONETARY BASE CONTROL

Mr Allan Walters called on the Chancellor this morning at 10.00 a.m. Mr Burns, Mr Middleton and Mr Ridley were also present.

2. Mr Walters said he felt that now the Budget was out of the way, the Government should take the decision to move to Monetary Base Control (MBC). He had no objection to the use of £M3 as an aggregate to be monitored, and he thought it appropriate that £M3 should be the focus of the MTFS. However, in the short run he thought the monetary base should be the control variable. His concern was to de-politicise decisions on interest rate movements; at present it appeared that MLR movements were very substantially affected by the requirements of the political situation. MBC by contrast would allow interest rates to be set by reference to an objective rule. In establishing such a rule, the move to MBC would fill a clear gap in the Government's current policy stance. There should be no particular difficulty about choosing numbers for a monetary base target, although a decision would be needed about the time period over which the authorities would aim to hit a target. Decisions would be needed about the future of the discount market, and perhaps also about the operation of building societies.

3. The Chancellor noted that Professor Griffiths, who had been an advocate of MBC, had recently produced a paper which argued for the retention of £M3 as the target variable. Given the extent of the Government's commitment to £M3, it would be very difficult to move away from this without a major change in the presentation

/of policy.

of policy. At the least it would seem sensible to wait until the next Budget; for the current year the £M3 target would have to remain. Although the movement of £M3 during the course of 1980 had given rise to serious problems, £M3 had proved a more reliable current policy in the circumstances of the earlier 1970s. There were reasons for thinking that last year's experience was likely to prove wholly exceptional; the 1979 switch from direct to indirect taxation, coupled with the removal of exchange, price and dividend controls could be seen as having resulted in a once-for-all shift in the demand for money. Mr Walters noted that the monetary base would in practice have given the right signals about interest rate movements in the latter part of 1980; while movements in £M3 gave no support to the interest rate reductions implemented by the authorities, the very slow growth of the monetary base would have provided a clear explanation for them.

4. In further discussion, Mr Burns and Mr Middleton said they thought the substance of the issue was how far the Government wanted to move now towards a situation in which the monetary base was the sole determinant of short-term interest rates. It was questionable how far it would be sensible at this stage to emphasise the monetary base to the exclusion of other factors. So far policy had been cautious and pragmatic, with the authorities seeking to learn from the market's response to each step towards a greater role for them in the determination of interest rates. Given the very slow growth of the monetary base and other narrow aggregates over the last eighteen months, it was questionable how far the authorities should now limit the flexibility within which they would operate; it seemed likely that it would continue to be necessary to take some account of movements other aggregates and in the exchange rate.

5. Meanwhile it seemed undesirable for the authorities to commit themselves too deeply to the early introduction of MBC. Further

/work still needed to

work still needed to be done on the relationships between the monetary base and the various monetary aggregates. In these circumstances it would be better to concentrate for the time being on the further steps already outlined by the Chancellor for improving short-run monetary management: the introduction of the (unpublished) band within which interest rates would fluctuate, and the spension of MLR. While it now seemed likely that the cash ratio would have to remain, although transformed into a minimum applicable to all banks instead of an average applicable only to the clearers, the Bank had introduced a useful measure of flexibility into the reserve asset ratio. The best course seemed to be to work towards the successful implementation of these further changes, while at the same time paying close attention to movements in the monetary base and the narrower monetary aggregates. In this way the authorities might hope to learn more about controlling the base and M1 by regarding them as in a sense "shadow targets", without any commitment to a move away from £M3. It was noted that the monetary base seemed to have moved fairly closely in line with M1, and that operating by reference to a six month average of the monetary base might not be very different from using M1 as the target variable. As well as moves to enhance the role of the markets and setting short-term interest rates, further attention should be given to possible funding initiatives in the fields of indexed debt and national savings.

6. It was agreed in the light of the discussion that it would be appropriate to stick to the programme of monetary control changes already outlined by the Chancellor. At Mr Walters' suggestion, Mr Middleton undertook to provide a note setting out a possible timetable for the work needed to reach the necessary further decisions in this field, which could then form the basis for a discussion with the Bank. Mr Walters would thus be associated with the Treasury in keeping up the pressure on the Bank to ensure that they made the promised changes.

JW

A J WIGGINS
28 April 1981

Econ Pol

10 DOWNING STREET

TL

PM

MR. MIDDLETON

I did not realise that the Chancellor read Griffiths' papers. It so happens that I had a discussion with Griffiths about these matters and I wrote him the enclosed letter on his presentation.

Obviously I did not deal with all the points on which there was disagreement. That would have taken for ever. But I think there is still a substantial common ground between us. What I am more worried about is the methodological and, in some cases I think logical slips in Griffiths' arguments.

Please show thise to the Chancellor if you think he would like to see it!

AW

28 April 1981

ALAN WALTERS

cc Mr. Lankester
Mr. Wolfson
Mr. Hoskyns
Mr. Duguid

PERSONAL AND CONFIDENTIAL

10 DOWNING STREET

22 April 1981

Dear Brian,

Thank you for sending me your Supplement 1 to your Annual Monetary Review "How Tight Was Monetary Policy in 1980?". As you might imagine, although there is a great deal of common ground between us I cannot follow some of your arguments and I thought it might be useful if I put one or two issues down on paper.

First, I agree with you that the most unambiguous indicator of monetary policy is usually some measure of the quantity of money. That is common ground between us. When I worked on the quantity of money from 1865-1961, I found that all the main monetary magnitudes, at least on an annual basis, moved broadly in a similar way. In fact when I fitted demand for money functions there was very little difference between them. Even when one extended the definition of money to readily encashable assets, the parameters did not change very much. But I am sure you would agree that there is a possibility of a particular measure of money being rendered if not useless then very misleading by either Government restrictions or by movements in interest rates, applicable to certain items in the aggregate, far far outside their normal range. I believe that this is what happened in 1980 and I think that your Table 4 results are consistent with that. On the other hand I have never been enamoured of the savings ratio account of the difference, which Meltzer and indeed the Treasury put forward. It seems to me the stock effect would dominate the flow effect of a change in the savings ratio. Again your results seem to bear this out.

Secondly, I find it difficult to understand your argument that the "exchange rate has jumped without any changes in monetary policy". You seem to attribute it to a large extent to the oil price shocks and the fact that the UK is somehow insulated from such shocks. But if this is true for the United Kingdom, should it not also be true for Canada? Yet we know Canada has a very weak dollar and it has slumped relative to the US dollar over the period 1975-80. Similarly, I cannot find evidence of the bolivar increasing in value, and I believe the rial is a weak currency. I am sure one could go round the world looking at other oil exporting nations and find both strong and weak currencies among them. The important point is I do not wish to deny that the presence of oil makes UK assets somewhat more attractive than they would be in the absence of oil. But I would argue that the massive appreciation of sterling,

/unprecedented

unprecedented in any currency since the period of floating, is not conceivably attributable only to oil. Whereas I cannot for the life of me find an occasion where since 1971 there has been a monetary squeeze (relatively) which has not been accompanied by an appreciation of the currency. And in a period of fixed exchange rates the normal effect was, of course, a balance of payments surplus. We seem to have got those in Britain. Again, however, to avoid misunderstanding, may I say that no-one should use evidence of a marked appreciation of the exchange rate as evidence of a monetary squeeze. One should use it merely as evidence which corroborates a theoretical proposition. One should look for one's monetary squeeze in the monetary aggregates.

Similarly, I do not disagree with your basic proposition about real interest rates. They can be very difficult to measure and quite misleading. But under conditions where the money supply is being distorted by Government regulations of one sort or another, even the most hazy notions about real interest rates may be useful. I think also you miss an important point that the inflation rates which enter into the real interest rate calculation should be for storable goods and assets such as houses, work in progress, stocks etc. and should exclude services, electricity supply and rides on the tube and trains. I think if you do this analysis you will find interest rates in real terms in the latter part of 1980 were enormously high, and as far as I can recollect higher than any other period in monetary history. But I have not done any detailed analysis of these phenomena. I think the important point is that you need the expected rate of inflation. In principle you need some theory of expectations to calculate real interest rates and, of course, there you are on much more treacherous ground. I suppose most of us implicitly take the actual rate as an indicator of the expected rate, at least when we are analysing historical series. And perhaps that is about the best we can do. But it does indicate, I think, very high real interest rates certainly in the latter part of 1980.

On your Statistical Discussion of M_3 and M_1, I am rather surprised that both M_1 and M_3 perform as well as they do. Is there any statistical difference between the two $\bar{R}^2$? I suspect that they are roughly the same. But also, since you are concerned with early warning systems and the average lag for M_1 is a long, long seventeen quarters compared with ten for the sterling M_3 equation, would not this lead you to prefer to use M_1 as an early warning system rather than M_3? It is also worth noting that the M_1 figure has been distorted by the operation of competition and credit control in 1971. And you did not adjust for that. I suppose you could do it by putting in dummy variables or something of the sort.

Finally, something of a quibble but on page 11 you remark that the nominal money supply is not affected either by changing real factors or changes in the expected rate of inflation. If you take nominal money supply as being determined by the authorities as an instrument variable, then of course it's a tautology. But that is certainly not true in the real world determination of M_3 or M_1. The expected rate of inflation and changing real factors will determine asset preferences which will have an effect on M_3.

/I find

Although I find some of your conclusions acceptable, there are one or two I cannot follow. Of course I agree that it takes some years for changes in money growth to make a significant impact on the rate of inflation. But on your statistics which show that the half life of the M_3 effect is ten years, would imply that the reduction in the growth rate of M_3 in 1978-79 from 18% to 14% would have an effect of roughly 2% reduction in the rate of inflation by 1981. But I think the reduction in the inflation rate has been much more rapid than your equation forecast. I would ask you to also contemplate a considerable reduction in the rate of growth of M_3 in 1981. If this occurs, say the growth rate drops to 7-8%, would you expect that the deflation to appear in 1982,83,84?

Another difficulty I have with your conclusions, is the argument that the high real exchange rate depressed export demand. As far as I can see export demand remained high and on a level during 1980 and into 1981. Surely the point is that as you remark in the next sentence on page 28, exports rose. And this was surely because the fall in the supply schedules, denominated in sterling prices, in export markets. This fall was due to the monetary squeeze.

Similarly, I am not convinced of your argument that the real problem in 1980 was the excess stocks which had been built up in 1978 and 79 when money growth was high and producers thought they were facing a growing real demand for their goods. I was, as, you know, in America at the time but everyone was fearing the most enormous slump from about 1976 onwards. And if America would have gone into a slump then it would have dragged Britain and Europe along with her. If you accept the argument that real interest rates reached an all time high in 1980/81 then of course it is easy to explain the de-stocking of that period and the depth of the slump is also more tractably explained. But I must confess I am in very grave doubts about all these explanations since there are lots of loose ends to be tied up yet awhile.

Now to the general programme of monetary control. I think that the best aggregate to have as a target is the monetary base. I would not wish to have any of the other broader aggregates as the target, except that of course I would keep a close monitoring watch of them over the medium term. That after all is supposed to be the main rationale of the medium term strategy. Even for monetary base, however, one must recognise that it should be controlled, for the purpose of restraining inflation, only over quite long periods. One might easily have short run variations in the monetary base to accommodate incipient liquidity crises; but these would be of short duration, certainly less than a year and preferably they should be over in two or three months. I must say that ultimately I would prefer to have constant monetary base so that the technological changes in the financial markets would probably induce the growth of M_1 and perhaps also M_3 at some two or three percentage points. This would be enough to accommodate real growth with a non-inflationary price level. I suppose that target is a long way away, but I think it is one we should keep in mind. It is a policy that has eminently respectable supporters. You will recall that Denis Robertson recommended such a policy in those halcyon days of the mid-1950s. And it seemed Eisenhower was pursuing a very similar policy in the United States.

Yours ever
Alan

Professor Brian Griffiths

CONFIDENTIAL

Econ Pol

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Mr Burns
Sir K Couzens
Mr Ryrie
Mr Middleton
Mr Monck
Mr Unwin
Mr Turnbull
Mr Ridley
Mr A Walters)
Mr T Lankester) No.10

NOTE FOR THE RECORD

MONETARY BASE CONTROL

Mr Allan Walters called on the Chancellor this morning at 10.00 a.m. Mr Burns, Mr Middleton and Mr Ridley were also present.

2. Mr Walters said he felt that now the Budget was out of the way, the Government should take the decision to move to Monetary Base Control (MBC). He had no objection to the use of £M3 as an aggregate to be monitored, and he thought it appropriate that £M3 should be the focus of the MTFS. However, in the short run he thought the monetary base should be the control variable. His concern was to de-politicise decisions on interest rate movements; at present it appeared that MLR movements were very substantially affected by the requirements of the political situation. MBC by contrast would allow interest rates to be set by reference to an objective rule. In establishing such a rule, the move to MBC would fill a clear gap in the Government's current policy stance. There should be no particular difficulty about choosing numbers for a monetary base target, although a decision would be needed about the time period over which the authorities would aim to hit a target. Decisions would be needed about the future of the discount market, and perhaps also about the operation of building societies.

3. The Chancellor noted that Professor Griffiths, who had been an advocate of MBC, had recently produced a paper which argued for the retention of £M3 as the target variable. Given the extent of the Government's commitment to £M3, it would be very difficult to move away from this without a major change in the presentation

/of policy.

of policy. At the least it would seem sensible to wait until the next Budget; for the current year the £M3 target would have to remain. Although the movement of £M3 during the course of 1980 had given rise to serious problems, £M3 had proved a more reliable current policy in the circumstances of the earlier 1970s. There were reasons for thinking that last year's experience was likely to prove wholly exceptional; the 1979 switch from direct to indirect taxation, coupled with the removal of exchange, price and dividend controls could be seen as having resulted in a once-for-all shift in the demand for money. Mr Walters noted that the monetary base would in practice have given the right signals about interest rate movements in the latter part of 1980; while movements in £M3 gave no support to the interest rate reductions implemented by the authorities, the very slow growth of the monetary base would have provided a clear explanation for them.

4. In further discussion, Mr Burns and Mr Middleton said they thought the substance of the issue was how far the Government wanted to move now towards a situation in which the monetary base was the sole determinant of short-term interest rates. It was questionable how far it would be sensible at this stage to emphasise the monetary base to the exclusion of other factors. So far policy had been cautious and pragmatic, with the authorities seeking to learn from the market's response to each step towards a greater role for them in the determination of interest rates. Given the very slow growth of the monetary base and other narrow aggregates over the last eighteen months, it was questionable how far the authorities should now limit the flexibility within which they would operate; it seemed likely that it would continue to be necessary to take some account of movements other aggregates and in the exchange rate.

5. Meanwhile it seemed undesirable for the authorities to commit themselves too deeply to the early introduction of MBC. Further

/work still needed to

work still needed to be done on the relationships between the monetary base and the various monetary aggregates. In these circumstances it would be better to concentrate for the time being on the further steps already outlined by the Chancellor for improving short-run monetary management: the introduction of the (unpublished) band within which interest rates would fluctuate, and the spension of MLR. While it now seemed likely that the cash ratio would have to remain, although transformed into a minimum applicable to all banks instead of an average applicable only to the clearers, the Bank had introduced a useful measure of flexibility into the reserve asset ratio. The best course seemed to be to work towards the successful implementation of these further changes, while at the same time paying close attention to movements in the monetary base and the narrower monetary aggregates. In this way the authorities might hope to learn more about controlling the base and M1 by regarding them as in a sense "shadow targets", without any commitment to a move away from £M3. It was noted that the monetary base seemed to have moved fairly closely in line with M1, and that operating by reference to a six month average of the monetary base might not be very different from using M1 as the target variable. As well as moves to enhance the role of the markets and setting short-term interest rates, further attention should be given to possible funding initiatives in the fields of indexed debt and national savings.

6. It was agreed in the light of the discussion that it would be appropriate to stick to the programme of monetary control changes already outlined by the Chancellor. At Mr Walters' suggestion, Mr Middleton undertook to provide a note setting out a possible timetable for the work needed to reach the necessary further decisions in this field, which could then form the basis for a discussion with the Bank. Mr Walters would thus be associated with the Treasury in keeping up the pressure on the Bank to ensure that they made the promised changes.

JW

A J WIGGINS
28 April 1981

10 DOWNING STREET

FL(O/R)
MJS

MR. BURNS
MR. MIDDLETON

In order to attempt, perhaps vainly, to clear my mind in the current confusion of "progress" in monetary base control, I have prepared the enclosed notes. Would you please let me know if I have been grossly inaccurate or unfair?

I am depressed by the thought that I shall have to go back to the Prime Minister and tell her that very little progress has been made. Can we see what can be done about it?

AW

15 April 1981

ALAN WALTERS

cc Mr. Hoskyns
Mr. Wolfson
Mr. Sanders

NOTES ON MOVEMENT TO MONETARY BASE CONTROL

Phasing Out the Reserve Asset Ratio

The reserve asset ratio was reduced from 12½% to 10% on 2 January. It was said that final abolition of the reserve asset ratio depends on making sufficient progress with new arrangements for assuring adequate liquidity for the banks so that confidence in the banking system is fully maintained. Such measures were referred to in the article on the liquidity of banks in the Bank of England Quarterly Bulletin March 1981. However, there has been no formal progress on reducing the reserve asset ratio below 10% and no sign of eventual abolition. Presumably this is being held up while additional discussions are taking place on the nature of acceptable and applicable bases for measuring the overall liquidity of banks. The Bank was supposed to provide a paper as a basis for further discussion of this aspect but so far as I know, it has not appeared. The Bank still envisages the early abolition of the reserve asset ratio which it says is not a prudential ratio and is not regarded by the Bank as such. But apparently it is still being held up because the Bank wants to discuss with individual banks the appropriate normal level of holdings of assets which at present are required for the reserve asset ratio. It says that these discussions may not have been completed when the reserve asset ratio is abolished as a minimum requirement.

It is clear that progress on this is extraordinarily slow. It is difficult to see why the reserve asset ratio should not be abolished now.

Cash Ratio

So far as we know the discussions between Sir Douglas Wass and the Governor have not yet produced an alternative source of income to the 1½% cash ratio deposits at the Bank of England. It is quite clear that the 1½% cash ratio has nothing to do with the business of monetary control, it merely supplies the Bank with its most important source of income. It was expected that recommendations on this issue were to be made before the Budget. Yet apparently none have appeared.

Money Market Management, Lending Operations and the Bill Market

It does seem that the Bank has retreated from the discount window and instead of providing funds in that way it is buying bills. The Bank clearly wants to extend its bill operations so that it has an adequate market in which to conduct open market operations in eligible commercial bills. The eligible acceptance houses largeley are restricted to British banks. In discussing (in the Bank of England Quarterly Bulletin March 1981) the extensions of these eligibility criteria to foreign banks in London, the Bank lists as one of its undertakings that the banks would agree to place an average level of funds with the discount houses. This would enable the discount houses to make a market in bills. Superficially it seems to be a mechanism for keeping the discount houses in business, or at least in the bill business.

Minimum Lending Rate

The Bank still appears to be publishing minimum lending rate and apparently will go on publishing it, even though little or no business is done by the Bank at this rate. So far there doesn't appear to be any agreed bands within which the rate of interest is to be operated. This is a matter of urgency. The Bank now does not quote prices at which it will buy eligible bills of over one month maturity and simply now responds to offers of sale of such bills. It would be nice to know the criteria on which sales are accepted. And how is the band to be moved.

Sales of Debt

The Committee chaired by Sir Douglas Wass broadly reported that it was not really possible to mix the tender system with our existing form of tap issues. The successful tender issue of the indexed gilts suggests there were very few problems with tenders of indexed or perhaps non-indexed stock. It is likely, however, that the issue of indexed stock will expand quite rapidly. The Bank, however, are still clearly concerned to keep their gilt edged jobbers in business, see para 11 on page 39 of the Bank of England Quarterly Bulletin March 1981. They clearly regard the efficient functioning of the market as requiring the jobbing operation, and so are continuing with the tap issues.

Conclusions

The main conclusion is that the movement to monetary base control is clearly a long, long way behind the timetable of the programme that was outlined in November of last year and in January this year. The reserve asset ratio has not gone; the cash ratio is still operative; the minimum lending rate is still announced and there is no evidence of the band of rates being used. Unless the Treasury takes a new initiative it is difficult to see how any progress will be made.

15 April 1981

Econ Pol

H. M. TREASURY

Parliament Street, London SW1P 3AG, Press Office: 01-233-3415
Telex 262405

9.4.81

CENTRAL GOVERNMENT TRANSACTIONS
(INCLUDING BORROWING REQUIREMENT)

Summary

It is provisionally estimated that the central government borrowing requirement in 1980-81 was £13,030 million compared with £8,227 million in 1979-80. The estimate for 1980-81 overtakes the forecast of £12,760 million published on Budget day in the Financial Statement and Budget Report 1981-82 (FSBR). In March this year the central government borrowed an estimated £901 million compared with some £570 million implicit in the FSBR (and £157 million in March 1980). Some £$\frac{3}{4}$-1 billion of tax and national insurance receipts were delayed by the Civil Service dispute. This has been partly off-set by other factors not related to the dispute. Supply issues were £400 million below the expected level. Details of the relevant transactions on the Consolidated Fund and National Loans Fund and other central government funds and accounts are set out in the tables attached.

Consolidated Fund revenue

2. In the year to March 1981, Consolidated Fund revenue amounted to £66,213 million compared with the estimated out-turn of £66,814 million published in the FSBR. The short-fall of £601 million is more than accounted for by the effect of the dispute mentioned above. There was an increase of £11,882 million (or 22%) over 1979-80; Inland Revenue receipts increased by £4,829 million and Customs and Excise by £4,063 million. Revenue in March 1981 amounted to £7,888 million, an increase of £2,192 million on March 1980. Within the total, Inland Revenue and Customs and Excise receipts were respectively £571 million higher and £32 million lower than in March 1980. Miscellaneous receipts increased by £1,603 million (see paragraph 3 below).

Consolidated Fund expenditure

3. Consolidated Fund expenditure in 1980-81 amounted to £76,170 million compared with the estimate of £76,728 million published in the FSBR and shows an increase of £15,163 million (or 25%) on 1979-80. Of the total expenditure for 1980-81 Supply issues at £67,997 million were less than estimated in the FSBR (see the summary above) and were £14,223 million (or 26%) higher than in 1979-80. In

March 1981 expenditure amounted to £8,148 million, an increase of £1,990 million on the March 1980 total. The figures for Supply issues in March include the payment of £1,284 million to the National Enterprise Board in respect of the transfer of BL to the Secretary of State for Industry; the repayment of Public Dividend to the same value by the National Enterprise Board is included in Miscellaneous Consolidated Fund Receipts.

National Loans Fund

4. The total of net lending to March 1981 was £3,557 million compared with the estimated out-turn of £3,371 million published in the FSBR. Further details of this lending are given in Table 4.

Other funds and accounts

5. In March 1981 there was a deficit of £356 million on the National Insurance Fund affected by the delay in some receipts of contributions. There was an increase of £123 million in departmental balances etc allowing for the transfer of £900 million on 31 March from the National Oil Account to the Consolidated Fund. This transfer, announced by the Secretary of State for Energy on 31 March, took account of receipt late in the month of advance payments for the British National Oil Corporation's oil. Other central government accounts items reduced the borrowing requirement by £484 million in 1980-81; in 1979-80 they reduced the borrowing requirement by £732 million.

61/81

PRESS OFFICE
HM TREASURY
PARLIAMENT STREET
LONDON SW1P 3AG
01-233 3415

NOTES TO EDITORS

This series of Treasury Press Notices, published on the seventh working day of each month, is designed to present in convenient and compact form up-to-date information on central government revenue, expenditure and borrowing. Comparable figures of the outturn for 1979-80, the 1980 Budget forecast and the 1981 Budget estimated outturn are also included. The figures given in this Press Notice are an advance presentation of information which will appear later in Financial Statistics.

2. In this Press Notice figures are given for the year 1980-81, March 1980 and March 1981. Comparisons between the figures for particular months in the same year or with a particular month a year earlier can be seriously misleading because of the effect of seasonal and random variations. Seasonally adjusted figures are not at present available on a calendar monthly basis.

3. The pattern of Petroleum Revenue Tax receipts has changed between 1979-80 and 1980-81. £266 million was received in May 1979, £460 million in November 1979, £709 million in March 1980, and £1,087 million in September 1980 and £1,321 million has been received in March 1981.

4. The information contained in this Press Notice should be read in conjunction with the footnotes to the relevant tables in recent issues of Financial Statistics, particularly Tables 3.1 and 3.5, and the description of those tables contained in the Explanatory Handbook which was published in April 1980. Details of Inland Revenue and Customs and Excise receipts are to be found in Tables 3.2 and 3.3 of the current issue of Financial Statistics. Details of the financing of the central government borrowing requirement are published on a quarterly basis in Table 3.8 of Financial Statistics and details of transactions in government securities in Table 3.9.

5. The service of the National Debt is met in the first instance from the National Loans Fund (Table 2, item 20). Against this are set receipts from interest on loans from that Fund and the net profits of the Issue Department of the Bank of England (principally interest on the securities held as backing of the fiduciary note issue) (Table 2 item 17). Any balance is met month by month from the Consolidated Fund (Table 1, item 10 and Table 2, item 18).

6. Figures for the borrowing requirement of the whole of the public sector (general government, comprising central government and local authorities; and public corporations) are compiled on a quarterly basis only and are available in a press notice about 7 weeks in arrear. Estimates for the fourth quarter of 1980-81 will be published by the Central Statistical Office on 21 May 1981. Monthly estimates of local authority borrowing are published about 8 weeks in arrear in Table 4.3 of Financial Statistics.

7. The transfer of £900 million from the National Oil Account to the Consolidated Fund referred to in paragraph 5 of this notice was made on 31 March. Whilst receipts into the National Oil Account reduce the borrowing requirement, the transfer itself had no effect on that requirement. The receipt into the Consolidated Fund which appears as a plus (+) in Table 1, item 7 is accompanied by an equivalent decrease (-) in departmental balances etc which appear in Tabe 3, item 24. On this occasion, there was a reduction in the increase in these balances for the month as a whole.

SUMMARY TABLE A[1]

£ million

	1979-80 Outturn	1980-81: 1980 Budget forecast	1980-81: 1981 Budget Estimated Outturn	1980-81: Outturn	March: 1980	March: 1981
Consolidated Fund (see Table 1)						
Revenue	+54,331	+65,415	+66,814	+66,213	+5,696	+7,888
Expenditure	-61,007	-73,175	-76,728	-76,170	-6,158	-8,148
Deficit	- 6,676	- 7,760	- 9,914	- 9,957	- 462	- 260
National Loans Fund[2]						
Consolidated Fund deficit (as above)	- 6,676	- 7,760	- 9,914	- 9,957	- 462	- 260
Other transactions: (see Table 2)						
Receipts	+ 8,400	+10,000	+ 9,950	+ 9,854	+1,049	+1,073
Payments	-10,683	-12,905	-13,321	-13,411	- 826	-1,446
National Loans Fund deficit (met by borrowing)	- 8,959	-10,665	-13,285	-13,514	- 239	- 633
Other funds and accounts (net) (see Table 3)	+ 732	+ 1,352	+ 525	+ 484	+ 82	- 268
Central government borrowing requirement	- 8,227	- 9,313	-12,760	-13,030	- 157	- 901

(1) In these tables, all payments creating a borrowing requirement are marked with a minus sign (-), all receipts reducing the borrowing requirement are marked plus (+).

(2) Excluding National Debt and other transactions concerned with the financing of the borrowing requirement.

SUMMARY TABLE B

CENTRAL GOVERNMENT BORROWING REQUIREMENT

£ million

	In month		Cumulative		
	1979-80	1980-81	1979-80	1980-81	Difference
April	1,289	934	1,289	934	- 355
May	1,536	2,354	2,825	3,288	+ 463
June	972	1,331	3,797	4,619	+ 822
July	27	804	3,824	5,423	+1,599
August	1,076	1,592	4,900	7,015	+2,115
September	1,739	850	6,639	7,865	+1,226
October	114	162	6,753	8,027	+1,274
November	1,817	2,835	8,570	10,862	+2,292
December	1,613	2,248	10,183	13,110	+2,927
January	-2,458	-1,718	7,725	11,392	+3,667
February	345	737	8,070	12,129	+4,059
March	157	901	8,227	13,030	+4,803

TABLE 1

CONSOLIDATED FUND(1)

£ million

	1980-81			March	
	1980 Budget forecast	1981 Budget Estimated Outturn	Outturn	1980	1981
Revenue					
1. Inland Revenue(2)	+32,860	+33,400	+32,982	+2,631	+3,202
2. Customs and Excise(2)	+24,000	+22,135	+22,095	+1,615	+1,583
3. Vehicle excise duties	+ 1,411	+ 1,403	+ 1,419	+ 123	+ 152
4. National insurance surcharge	+ 3,509	+ 3,585	+ 3,542	+ 249	+ 269
5. Broadcast receiving licenses	+ 535	+ 529	+ 533	+ 64	+ 53
6. Interest and dividends	+ 300	+ 246	+ 239	+ 5	+ 17
7. Miscellaneous	+ 2,800	+ 5,516	+ 5,403	+1,009	+2,612
8. Total revenue	+65,415	+66,814	+66,213	+5,696	+7,888
Expenditure					
9. Supply Services	-64,765	-68,358	-67,997	-5,590	-7,486
10. Consolidated Fund share of service of the National Debt (see Table 2, item 18)	- 4,950	- 5,180	- 5,044	- 293	- 344
11. Northern Ireland	- 1,136	- 1,236	- 1,236	- 100	- 138
12. European Community	- 2,301	- 1,930	- 1,906	- 173	- 167
13. Contingencies Fund	-	-	+ 38	-	- 11
14. Other services	- 23	- 24	- 25	- 2	- 2
15. Total expenditure	-73,175	-76,728	-76,170	-6,158	-8,148
16. Surplus (+) or deficit (-)	- 7,760	- 9,914	- 9,957	- 462	- 260

(1) Figures for past periods are published in Financial Statistics, Table 3.1.

(2) Details are shown in Financial Statistics, Tables 3.2 and 3.3 (see Notes to Editors, paragraph 3).

TABLE 2

NATIONAL LOANS FUND[1]

£ million

	1980-81			March	
	1980 Budget forecast	1981 Budget Estimated Outturn	Outturn	1980	1981
Receipts					
17. Interest receipts and profits of note issue	+ 5,050	+ 4,770	+ 4,810	+ 756	+729
18. Service of the National Debt met from the Consolidated Fund (see Table 1, item 10)	+ 4,950	+ 5,180	+ 5,044	+ 293	+344
19. Total receipts	+10,000	+ 9,950	+ 9,854	+1,049	+1,073
Payments					
20. Service of the National Debt	-10,000	- 9,950	- 9,854	- 843	-937
21. Loans (net) (see Table 4) Nationalised industries	- 800	- 982	- 1,008	+ 262	+165
Other public corporations	- 1,064	- 1,188	- 1,253	- 93	-368
Local and harbour authorities	- 915	- 1,154	- 1,260	- 149	-303
Private sector	+ 3	+ 3	+ 3	+ 1	+ 1
Within central govt.	- 129	- 50	- 39	- 4	- 4
Total loans (net)	- 2,905	- 3,371	- 3,557	+ 17	-509
22. Total payments	-12,905	-13,321	-13,411	- 826	-1,446

TABLE 3

CHANGES IN OTHER CENTRAL GOVERNMENT FUNDS AND ACCOUNTS[1]

23. National Insurance Fund	+1,352	+525	- 25	+ 77	-356
24. Departmental balances, etc (net)			+ 542	+ 17	+123
25. Northern Ireland central govt.			- 33	- 12	- 35
26. Net total	+1,352	+525	+ 484	+ 82	-268

(1) Figures for past periods are published in Financial Statistics, Table 3.1.

TABLE 4

LOANS FROM NATIONAL LOANS FUND (NET)(1)

£ million

	1980-81	March 1980	March 1981
Nationalised Industries			
National Coal Board	-573	- 21	+ 56
British Gas Corporation	+ 3	+ 52	+ 78
Electricity (England and Wales)	-296	-221	-
North of Scotland Hydro-Electric Board	-147	-	- 15
South of Scotland Electricity Board	+ 46	-	-
Transport Industries (2)	- 91	- 4	- 27
Aviation Industries (3)	+ 7	+ 4	+ 4
Post Office	- 9	+371	+ 45
British Steel Corporation	+ 49	+103	+ 24
British Aerospace	+ 3	- 22	-
British Shipbuilders	-	-	-
Total	-1,008	+262	+165
Other public corporations			
New Towns Development Corporations and Commission	-468	-156	-179
Scottish Special Housing Association	- 44	- 4	- 6
Housing Corporation	-324	- 18	- 41
Covent Garden Market Authority	-	-	-
Civil Aviation Authority	- 2	- 5	- 2
Regional Water Authorities	-436	- 13	-145
National Enterprise Board	+ 40	+113	+ 1
Scottish Development Agency	-	- 1	-
Welsh Development Agency	-	-	-
Land Authority for Wales	- 1	-	-
Development Board for Rural Wales	- 4	- 1	- 2
Royal Mint	+ 1	-	-
Royal Ordnance Factories	+ 7	-	+ 1
Property Services Agency Supplies Division	+ 3	- 8	-
Her Majesty's Stationery Office Trading Fund	- 25	-	+ 5
Total	-1,253	- 93	-368
Local and harbour authorities			
Local authorities	-1,257	-149	-303
Harbour authorities	- 3	-	-
Total	-1,260	-149	-303
Private sector			
Building societies	+ 2	+ 1	-
Housing associations	-	-	-
British Nuclear Fuels Limited	+ 1	-	+ 1
Total	+ 3	+ 1	+ 1
Within central government			
Northern Ireland	- 40	- 5	- 5
Married quarters for armed forces	+ 1	+ 1	+ 1
Total	- 39	- 4	- 4
Total Loans (net)	-3,557	+ 17	-509

(1) Figures for past periods are published in Financial Statistics, Table 3.5 (industry and sector sub-totals only).
(2) Scottish Transport Group, British Railways Board, National Bus Company, National Freight Corporation, British Transport Docks Board and British Waterways Board.
(3) British Airways Board and British Airports Authority.

Covering Confidential

Prime Minister

Note that the forecast for April-June shows v. heavy 'front-end loading' (para 16). If the civil service dispute continues, it will be even worse.

T.L. 9/4

cc Masters

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

9 April 1981

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

Dear Tim,

MONTHLY NOTE TO THE PRIME MINISTER ON THE BORROWING REQUIREMENT

..... I am enclosing this month's note for the Prime Minister. The main points are summarised on the first page.

The CGBR for March and for 1980-81 as a whole will be published at 2.30 this afternoon. The main interest will be what the Press Notice reveals about the effect of the Civil Service pay dispute. Last month, we published the outturn up to end of February on the same day that the Financial Statement and Budget Report gave totals for the year. Simple arithmetic gives the forecast for March. However, we have already made known, in answer to a Parliamentary Question on Tuesday, that an estimated £$\frac{3}{4}$ to £1 billion of revenue has been delayed into the new financial year. Offsetting factors have left the CGBR just £$\frac{1}{4}$ billion above the forecast in the Financial Statement and Budget Report.

The note gives an estimate of the possible effect on the CGBR if the strikes continue through April and into May. There is no need to change our public stance that these figures present no risk to economic management. But we are keeping the financial position including the effect on the monetary numbers under close scrutiny and will keep you informed of the position. The key numbers are in the summary.

Yours

John

A.J. WIGGINS

CONFIDENTIAL

MONTHLY NOTE ON THE BORROWING REQUIREMENT

April 1981

Summary

- The provisional estimate of the CGBR in March is £901 million. This gives a cumulative total for 1980-81 as a whole of £13,030 million, £270 million more than the forecast of £12,760 million published in the Financial Statement and Budget Report on 10 March.

(paragraph 1 to 2)

- £$\frac{3}{4}$ to 1 billion of tax and national insurance receipts were delayed into the new financial year by the civil service pay dispute. Partly offsetting this, supply services were £400 million below the forecast in the Financial Statement and Budget Report. Interest payments and receipts provide a further £140 million gain.

(paragraph 3 to 14)

- Forecasts for the CGBR in the next three months can only be speculative. The note gives a base forecast, excluding all effects of the dispute, of over £5 billion, and an assessment of the possible impact on the CGBR if the dispute continues. At present, three quarters or more of the revenue due is being paid into the Exchequer accounts. At that rate the cumulative backlog would be £2$\frac{1}{2}$ billion by the end of April, £4 billion by the end of May. If only half the revenue due could be banked, the backlog would reach £4 billion by the end of April, £7 billion by the end of May.

(paragraph 15 to 18)

THE CGBR IN MARCH

1. The provisional estimate of the CGBR in March is £901 million giving a cumulative total for the year as a whole of £13,030 million, compared with the forecast of £12,760 million published in the Financial Statement and Budget Report on 10 March. The outturn will be published in the regular Press Notice on Thursday 9 April.

2. The difference between the outturn and forecast for the year as a whole is £270 million. This can be explained as £¾ to 1 billion of tax and national insurance receipts delayed into the new financial year by the Civil Service pay dispute, partly offset by other items, mainly lower Supply services, unrelated to the dispute.

3. Effect of the Strike: As far as the CGBR is concerned, the main impact has been from the strike of Customs and Excise staff at the VAT centre at Southend which started on 9 March, and the strike of Inland Revenue staff at the PAYE centres at Shipley and Cumbernauld which started on 16 March. The strike at the Paymaster General's Office is creating some accounting problems, but does not seem to have had any effect on the level of payments.

4. It is difficult to give a precise estimate of the effect of the dispute on Government income. Actual payments into the Exchequer accounts can be compared with the forecast made before the strikes started; but the difference will reflect the normal forecasting errors as well as the effect of the dispute. In the case of VAT there is the added complication that the effect of the strike is reduced by the inability to make refunds of VAT to traders entitled to them.

5. However, the best estimate is that between £750 to 900 million of tax and national insurance contributions due in March have been delayed into the new financial year. This estimate includes tax which has simply not been paid to the revenue Departments, unbanked cheques held up in the tax offices, and money which was due in March but was not paid into the Exchequer accounts until after the 31st. The estimate includes the effect of failing to make the normal VAT repayments.

6. Overall, however, more than 80 per cent of the revenue due in March was paid into the Exchequer accounts. Total revenue in March includes £1,300 million or so of Petroleum Revenue Tax and other revenue received before the strike started. If this is excluded from the calculations the proportion is still over three quarters.

7. Table 1 attached presents a detailed comparison of the forecast for March and the outturn, in a format which is a summary of the regular Press Notice. The Press Notice giving the outturn up to the end of February was published on the same day that the Financial Statement and Budget Report gave totals for the year as a whole, so commentators will be able to deduce details of the forecast for March and compare it with the outturn. The effect of the strike is not immediately identifiable in that format. As the table below shows, the effect is spread between the figures for Inland Revenue taxes, national insurance contributions which Inland Revenue collect but which affect the National Insurance Fund component of "Other Funds and Accounts", and Customs and Excise duties.

8. The net deterioration in the CGBR of £270 million can be explained as follows:-

	Effect on the CGBR £ million
Strike effect	
Inland Revenue taxes (mainly PAYE)	-400 (approx)
National insurance contributions (collected by Inland Revenue but included in "other funds and accounts")	-200 (approx)
Customs and Excise (VAT)	-150 to 300
Total strike effect	-750 to 900
Other Factors	
Other Customs and Excise duties	+110 to+260
Lower Supply Services	+400
Lower interest payments and higher interest receipts	+140
Higher net lending to local authorities and public corporations	-180
Other, including revisions to earlier figures	-130
Net effect on CGBR in March	-270

9. Inland Revenue taxes. Almost all the difference between the forecast and outturn can be attributed to PAYE receipts delayed by the strike. The split of the strike effect between Inland Revenue taxes and National Insurance contributions is largely notional. The strike has made it impossible to identify receipts of Inland Revenue duties separately from national insurance contributions and payments into the National Insurance Fund are being made on the basis of an assumed split. Total Inland Revenue receipts for March include some £1,300 million of Petroleum Revenue Tax paid in on 2 March and incorporated in the forecast.

10. Customs and Excise: The estimate of the effect of the strike on Customs and Excise receipts is particularly uncertain. VAT has been difficult to forecast recently and it is not easy to distinguish the effect of the strike from the normal forecasting error. If the effect of the strike is £150 to 300 million as separate information now suggests, then other duties in March were £110 to 260 million above forecast. The usual detailed analysis of tax has not been compiled because of the Civil Service pay dispute so the position is far from clear. Tobacco duties are known to have been £60 million above forecast, however, oil duties were more than expected even allowing for the duty increase on 10 March, and some beer duty due in February failed to clear the banking system before the last day of the month and has been credited to March.

11. Supply services in March were £400 million below forecast. About half of this related to lower defence expenditure than had been assumed for internal purposes - the overspending against the revised cash limit is around £200 million, some £60 million lower than the Spring supplementary estimate, and £200 million less than included in the forecast a month ago. The remainder of the underspending was mainly on expenditure not subject to cash limits.

12. Interest payments were about £100 million below forecast, mainly because of the difficulty of forecasting when certificates of tax deposit will be cashed and therefore the interest due on them. Interest receipts were £40 million higher than forecast, giving a net improvement in the CGBR of £140 million.

13. Net lending to local authorities was about £110 million above forecast. It is not yet clear whether this simply reflects a switch from market borrowing. Net lending to public corporations was about £70 million above forecast. This is more than explained by net lending to New Town Development Corporations.

14. During the course of the month, £276 million was received from the EEC under the 30 May agreement.

Forecast for the Next Three Months

15. At this stage, forecasts for April to June can only be speculative. It all depends how long the present dispute continues, whether the revenue losses continue at their present rate, and how fast the money comes through when the dispute is settled. Table 3 gives a base forecast which excludes both the effect of a continuing dispute and of the unwinding of the existing backlog of receipts; it is consistent with the Financial Statement and Budget Report, as if the strike had

never happened. It provides a banchmark against which to measure the effect of the strike.

16. The base forecast shows the familiar "front-end-loading". It implies that if the strike had never happened the borrowing requirement would be £1.5 billion in April, £2.1 billion in May and £1.6 billion in June, a total of £5.2 billion, or almost 45 per cent of the total for the year. This is a higher percentage than in 1980-81, but much the same as in 1979-80, and is consistent with the Budget forecast of £11,479 million. The base forecast is, however, subject to a wider margin of error than usual. The normal departmental profiles are not available yet; and the pay dispute has meant that some information normally used in the preparation of the three month forward look has not been available.

17. Borrowing in the early months of the year will, however, be reduced by the backlog of £¾ to 1 billion of tax and national insurance receipts which has been carried forward from 1980-81 and which will be paid in as soon as the pay dispute is settled. Until that time, the backlog will grow.

18. At present, some three quarters of the revenue due is being paid in to the Exchequer Accounts. If that rate could be maintained, the backlog of revenue would be £2½ billion if the dispute continued until the end of April, and £4 billion by the end of May. However, any escalation in the action will reduce the amount of money coming through. If only a half of the revenue due could be paid into the Exchequer accounts, the backlog would be £4 billion by the end of April. £7 billion by the end of May. The money will eventually be paid in, but the interest costs would start to become significant. As a rough rule of thumb, the interest cost of £1 billion is £10 million a month. Moreover, the longer the dispute continutes, and the larger the backlog, the greater will be the difficulty of managing the money market when the revenue eventually floods in.

CONFIDENTIAL

TABLE 1

CENTRAL GOVERNMENT BORROWING REQUIREMENT - MARCH

£ million

	Forecast	Outturn	Effect on CGBR
RECEIPTS			
Consolidated Fund			
Inland Revenue	3,620	3,202	-418
Customs and Excise	1,623	1,583	- 40
Other	3,246	3,103	-143
National Loans Fund			
Interest etc receipts	689	729	+ 40
Total receipts	9,178	8,617	-561
EXPENDITURE			
Consolidated Fund			
Supply services and Contingencies Fund	7,896	7,497	+399
Other	330	307	+ 23
National Loans Fund			
Service of the national debt	1,033	937	+ 96
Net lending	323	509	-186
Total expenditure	9,582	9,250	+332
Other funds and accounts	-157	-268	-111
CGBR	-561	-901	-340

Note: The difference between the outturn and forecast for March is not the same as the difference between the outturn and forecast for the year as a whole because of revisions to the figures for earlier months.

CONFIDENTIAL

TABLE 2

CENTRAL GOVERNMENT BORROWING REQUIREMENT

£ billion

	In month		Cumulative		
	1979-80	1980-81	1979-80	1980-81	Difference
April	1.3	0.9	1.3	0.9	-0.4
May	1.5	2.4	2.8	3.3	+0.5
June	1.0	1.3	3.8	4.6	+0.8
July	-	0.8	3.8	5.4	+1.6
August	1.1	1.6	4.9	7.0	+2.1
September	1.7	0.8	6.6	7.9	+1.2
October	0.1	0.2	6.8	8.0	+1.3
November	1.8	2.8	8.6	10.9	+2.3
December	1.6	2.2	10.2	13.1	+2.9
January	-2.5	-1.7	7.7	11.4	+3.7
February	0.3	0.7	8.1	12.1	+4.1
March	0.2	0.9	8.2	13.0	+4.8

	1980-81	1981-82	1980-81	1981-82	Difference
April	0.9	(1.5)	0.9	(1.5)	+0.6
May	2.4	(2.1)	3.3	(3.7)	+0.4
June	1.3	(1.6)	4.6	(5.2)	+0.6

Forecast for 1981-82 in Financial Statement and Budget Report - £11,497 million.

Note: Some rows may not add across because of rounding.

TABLE 3

CENTRAL GOVERNMENT BORROWING REQUIREMENT

£ million

	1980-81		1981-82			
	Estimated outturn for whole year	1981 FSBR forecast for whole year	Base forecast for April	Base forecast for May	Base forecast for June	1981 FSBR forecast for whole year
RECEIPTS						
Consolidated Fund						
Inland Revenue	32,982	33,400	2,600	2,450	2,300	39,100
Customs and Excise	22,095	22,135	2,240	1,780	1,840	26,000
Other	11,136	11,279	480	630	630	10,424
National Loans Fund						
Interest etc receipts	4,810	4,770	270	230	370	4,900
Total receipts	71,023	71,584	5,590	5,090	5,140	80,424
EXPENDITURE						
Consolidated Fund						
Supply services	67,959	68,358	5,800	5,600	5,650	73,741
Other	3,167	3,190	300	280	280	3,756
National Loans Fund						
Service of the national debt	9,854	9,950	380	1,270	450	11,100
Net lending	3,557	3,371	490	270	260	4,034
Total expenditure	84,537	84,869	6,970	7,420	6,640	92,631
Other Funds and Accounts	+484	+525	-150	+200	- 60	+710
CGBR	-13,030	-12,760	-1,530	-2,130	-1,560	11,497

*The base forecast excludes any effect of continuing industrial action or the unwinding of the existing backlog of tax receipts.

Note: Some columns and rows do not add because of rounding.

Econ Pol

MR. LANKESTER

WBPM

PQ

econ. pol.

It might be useful to draw to the Prime Minister's attention the fact that the traditional economic establishment, Lord Balogh, Walter Heller, John Kenneth Galbraith and others were convinced in 1948-50 that Erhardt's reforms would be disastrous. They were all proved wrong in a matter of months after they were written. There is a nice succinct footnote in Gottfried Haberler's paper "The Great Depression of the 1930s Could it Happen Again?" which I have copied. It might be useful for some future Question Time or some other occasion. Balogh and Galbraith are convinced opponents of our policies and it might be useful to show that they got it all wrong before, so why not now?

AW

3 April 1981

The price level, unlike that in the United States, remained remarkably stable.

It would be tempting to attribute the rapid recovery to large spending on armaments. Heavy government spending there was, but massive rearmament came later. Possibly German public spending was comparatively larger than in the United States, but this would not explain the different price performance. The main difference between the American and German recovery policy lies elsewhere. In the United States the New Deal combined deficit spending with deliberate wage and price boosting, through NRA, AAA, the Wagner Act and other measures. Thus, an exceptionally large part of the rising nominal GNP took the form of higher prices rather than larger output and employment.[28] In Germany, by contrast, money wage rates remained fairly constant, although the average annual earnings of labor rose rapidly in monetary and real terms, because unemployment disappeared and the workweek lengthened.[29]

True, under the Hitler dictatorship there were wage and price controls which later, after full employment was reached and massive preparation for war came into full swing, became very oppressive. Scarcities, unavailabilities and quality deterioration of numerous commodities combined with rationing made the stable price index increasingly unreal. But this does not alter the fact that the recovery from the depression was handled very effectively. Hitler was able quickly to liquidate the miseries of the depression and to provide guns and butter at the same time. The great economic successes strengthened his hold on the German people enormously. The gold parity of the mark was formally not altered. There was no devaluation, but an increasingly tight web of exchange control, import restrictions and export subsidies amounted to a disguised, messy, discriminatory and exploitative devaluation of the currency—the Schachtian System.[30] Hitler's economic success made a deep impression on many economists, on Keynes himself, who however soon changed his mind,[31] and on Keynes'

---

[28] Keynes sympathized with Roosevelt's reform measures but felt that "undue haste in the reform program" would prejudice recovery; and recovery should have priority over reform. For Keynes' criticism of the New Deal see R. F. Harrod, "The Life of John Maynard Keynes." London-New York, 1951, p. 447.

[29] See Gerhard Bry, "Wages in Germany 1871–1945," National Bureau of Economic Research, Princeton University Press, 1960.

[30] So named after Hjalmar Schacht, Hitler's economic wizard.

[31] Richard (Lord) Kahn in his paper "Historical Origins of the International Monetary Fund" (in Keynes and International Monetary Relations, The Second Keynes Seminar held at the University of Kent at Canterbury, 1974, edited by A. P. Thirlwall, St. Martin's Press, New York 1974) quotes a memorandum that Keynes distributed in the Treasury in September 1941 entitled "Post-War Currency Policy." In this memorandum Keynes said "It was only in the last years, almost in the last months, before the crash, that . . . Dr. Schacht stumbled in desperation on something new which had in it the germs of a good technical idea. . . . Dr. Schacht's idea was to introduce 'what amounted to barter'. . . . In this way he was able to return to the essential character and original purpose of trade whilst discussing the apparatus which . . . had been supposed to facilitate, but was in fact strangling it. This innovation worked well, indeed brilliantly." Two years later (October 1943) Keynes wrote in the same vein to a U.K. Treasury official: "I believe that the future lies with (I) state trading for commodities; (II) international cartels for necessary manufacturers; and (III) quantitative import restrictions for non-essential manufactures. Yet all these instrmentalities for orderly economic life in the future you (and the U.S. State Department) seek to outlaw" (quoted in R. F. Harrod, "The Life of John Maynard Keynes," London-New York 1951, p. 568.) Harrod remarked: "In the preceding ten years he (Keynes) had gone far in reconciling himself to a policy of planned trade: these ideas had sunk deeply in. Even for him, with . . . his power of quick adaptation, it was difficult to unlearn so much." (loc. est.) But unlearn he did, and very fast indeed. In May 1944 in a letter to The Times defending the Bretton Woods agreement against criticism by Thomas Balogh, Keynes wrote: "Since we are not (so far as I am aware), except perhaps Dr. Balogh, disciples of Dr. Schacht, it is greatly to our interest that others should agree to refrain from such disastrous (Schachtian) practices." (The Times, May 20, 1944,

(Continued)

radical followers who were strengthened in their conviction that only comprehensive controls and central planning can assure full employment and rapid growth without inflation. Fortunately, another German economic miracle, the sustained economic recovery and growth after World War II, conclusively demonstrates that liberal trade policy and sound finance, the "classical medicine" as Keynes called it, works even better than the Schachtian system of comprehensive controls. Equally important, the German economic success also shows that a liberal policy can successfully be carried out in a democracy.[32]

IV. The International Monetary System During the Interwar Period

It is misleading to speak of an international explanation of the Great Depression in contrast to explanations in terms of mistakes of U.S. monetary policy, or other domestic circumstances in the United States or elsewhere.[33] There can be no doubt, however, that the world

(Continued)

reprinted in Thomas Balogh's "Unequal Partners," Vol. II, Oxford 1963, p. 118.) Keynes, reconversion to liberalism (which was probably due largely to listening to James Meade, Redvers Opie, and Lionel Robbins) is described in detail in Harrod's book (see especially p. 609.) In his famous posthumously published article, "The Balance of Payments of the United States" (The Economic Journal, June 1946) Keynes urged that "the classical medicine" should be allowed to work and concluded "that the chances of the dollar becoming dangerously scarce . . . are not very high," thus rejecting the theory of the permanent dollar shortage which was propounded by his radical disciples as the basis of their violent objections to the policy of non-discrimination. Keynes criticized these theories "as modernist stuff, gone wrong and turned sour and silly." (See ibid. pp. 185–186.) In a letter to Lord Halifax he expressed himself even more strongly (see "The Collected Writings of John Maynard Keynes," Vol. 24, "Activities 1944–1946, The Transition to Peace," edited by Donald Moggridge, Cambridge 1979, p. 626).

[32] It is not surprising that the German economic "miracle" which started with the currency reform of 1948 and the simultaneous abolition of all controls by Ludwig Erhard, was completely unforeseen and misjudged, even after its early success had become apparent, by British admirers of Schacht. On this see T. W. Hutchison "Notes on the Effects of Economic Ideas on Policy: The Example of the German Social Market Economy" in Zeitschrift für die Gesamte Staatswissenschaft. Currency and Economic Reform, West Germany after World War II, A Symposium, Vol. 135, Tübingen, September 1979, pp. 436–441. I cite only one example: Thomas (Lord) Balogh predicted that the policies of Erhard could not be sustained. "The currency was reformed according to a wicked formula." It "helped to weaken the Trade Unions . . . . Their weakness may even inhibit increases in productivity, since large scale investment at high interest does not pay at the present low relative level of wages. In the long run the income pattern will become intolerable and the productive pattern unsafe." Balogh said that Dr. Erhard and his "satellite economists" are trying to discredit "enlightened Keynesian economic policies" and "to apply to real life an abstract obsolescent and internally inconsistent economic theory and certainly did not succeed." Balogh predicted alarming political consequences and pointed in "a final warning to the gains which the Soviet Zone of Germany has been able to record." Balogh was however right in pointing out the extreme contrast between the economic ideas and policies prevailing in the Federal Republic of Germany and those in Britain. However, the results were the opposite of what Balogh and the other critics had predicted: German real GNP per capita has grown to almost twice that of Britain. (See T. W. Hutchison, op. cit. pp. 435–439 and Thomas Balogh "Germany: an Experiment in 'Planning' by the 'Free' Price Mechanism", Banca Nazionale Del Lavoro Quarterly Review 3, Rome 1950, pp. 71–102.) Hutchison also shows that German economic policies were similarly misjudged by American representatives of the "New Economics", Walter Heller among them.

I offer a supplement to Hutchison's list of misjudgments by advocates of central planning and comprehensive controls of the German revival of laissez faire liberalism: In 1948, criticizing the view "that if, somehow, the German economy could be freed from material and manpower regulations, price controls and other bureaucratic paraphernalia, then recovery could be expedited", John K. Galbraith concluded: ". . . There never has been the slightest possibility of getting German recovery by this wholesale repeal [of controls and regulations]". (J. K. Galbraith, "The German Economy" in Foreign Economic Policy for the United States, edited by Seymour E. Harris, Harvard University Press, Cambridge, Mass. 1948, p. 95). Galbraith's paper abounds with predictions of dire political and economic consequences of Erhard's dash for economic freedom. To quote Keynes again: Rarely has "modernist stuff gone wrong and turned sour and silly" so fast!

[33] Charles P. Kindleberger "takes exception to the findings of those" who stress monetary policy in the United States and other major countries, slower population growth or autonomous changes in the propensity to spend, and "insists that the origins of the Great Depression were international." Charles P. Kindleberger "The International Causes and Consequences of the Great Crash", The Journal of Portfolio Management, Fall 1979, p. 11. This paper summarizes Kindleberger's full-dress analysis, *The World in Depression 1929–1939*, London-New York 1973.

THE CITY UNIVERSITY
CENTRE FOR BANKING AND INTERNATIONAL FINANCE

PR

PM monetary policy.

ANNUAL MONETARY REVIEW
SUPPLEMENT 1

HOW TIGHT WAS MONETARY POLICY IN 1980?

BY

ROY BATCHELOR
BRIAN GRIFFITHS
KATE PHYLAKTIS
GEOFFREY WOOD

MARCH 1981

SUMMARY : THE PROBLEM

NARROW MEASURES OF 'MONEY' HAVE GROWN MUCH MORE SLOWLY THAN BROAD MEASURES OF MONEY IN THE UNITED KINGDOM DURING 1980. AT THE SAME TIME INTEREST RATES HAVE BEEN HIGH AND THE POUND STRONG. A LARGE PART OF NATIONAL INCOME HAS BEEN SAVED RATHER THAN SPENT, AND REAL NATIONAL PRODUCT HAS FALLEN. THIS CONJUNCTION OF EVENTS RAISES FOUR VITAL QUESTIONS

HAS MONETARY POLICY BEEN TIGHT, RATHER THAN EASY?

HAVE THE AUTHORITIES BEEN WRONG TO TARGET THE BROAD MONETARY AGGREGATE, STERLING M3?

ARE THE DIFFERENCES BETWEEN THE GROWTH RATES OF ALTERNATIVE TYPES OF MONEY DUE LARGELY TO THE CHANGE IN THE LEVEL OF PRIVATE SAVINGS?

HAS THIS MONETARY SQUEEZE CAUSED THE RECESSION?

FROM THE TEXT OF THE RECENT FINANCIAL STATEMENT WHICH ACCOMPANIED THE MARCH 10 BUDGET, IT IS CLEAR THAT THE GOVERNMENT WOULD ANSWER ALL THESE QUESTIONS IN THE AFFIRMATIVE. THIS ARGUMENT HAS ALSO FOUND FAVOUR WITH INFLUENTIAL COMMENTATORS OUTSIDE GOVERNMENT, AND WITH THE PRESS.

IN THIS PAPER, WE SHOW THIS INTERPRETATION OF EVENTS TO BE COMPLETELY WITHOUT FOUNDATION.

MONETARY POLICY HAS IN FACT BEEN EASY, AND IS POTENTIALLY INFLATIONARY. STERLING M3 IS STILL THE BEST MEASURE OF MONEY. THE SCALE OF SAVINGS DOES NOT TEND TO DRIVE M1 AND M3 GROWTH RATES APART. AND THE RECESSION HAS OCCURED NOT BECAUSE OF A TIGHT MONETARY POLICY, <u>BUT IN SPITE OF A LAX MONETARY POLICY</u>.

SUMMARY: THE ARGUMENT

OUR ARGUMENT STARTS WITH A REVIEW OF RECENT DEVELOPMENTS IN THE REAL AND MONETARY ECONOMY.

WE THEN CONSIDER IN PRINCIPLE WHETHER SOME MONETARY AGGREGATE SHOULD BE PREFERRED TO THE INTEREST RATE OR EXCHANGE RATE AS AN INDEX OF THE TIGHTNESS OF MONETARY POLICY.

DATA ON UNITED KINGDOM EXPERIENCE OVER THE PAST FIFTEEN YEARS IS THEN USED TO TEST STATISTICALLY TWO KEY PROPOSITIONS. FIRST, DOES SAVINGS BEHAVIOUR CONTRIBUTE ANYTHING TO THE EXPLANATION OF DIVERGENCES BETWEEN NARROW AND BROAD MONEY GROWTH ; OR CAN THESE BE WHOLLY EXPLAINED BY INTEREST RATE MOVEMENTS? SECOND, WHICH MONETARY AGGREGATE GIVES THE BEST EARLY-WARNING OF INFLATION ; AND DOES IT MATTER FOR INFLATION WHETHER MONEY GROWTH IS PRIMARILY DUE TO THE ACCUMULATION OF LIQUID FORMS OF SAVINGS, RATHER THAN THE GROWTH OF TRANSACTIONS BALANCES ?

LOGIC AND EXPERIENCE SUPPORT THE FOLLOWING CONCLUSIONS :

- IT IS WRONG TO JUDGE THE TIGHTNESS OF MONETARY POLICY BY LOOKING AT INTEREST RATES OR EXCHANGE RATES. SOME MONETARY AGGREGATE MUST BE USED.
- NARROW AND BROAD MEASURES OF MONEY HAVE IN THE PAST GROWN AT DIFFERENT RATES FROM YEAR TO YEAR PRIMARILY BECAUSE OF THE BEHAVIOUR OF INTEREST RATES. IN 1980, STERLING M3 GREW FASTER THAN M1 PRIMARILY BECAUSE INTEREST RATES WERE HIGH, AND PARTLY ALSO BECAUSE OF THE ENDING OF THE 'CORSET' CONTROL SCHEME. THE BEHAVIOUR OF PRIVATE SAVINGS DID NOT GIVE ANY ADDITIONAL BOOST TO STERLING M3 GROWTH.

- IN CHOOSING BETWEEN NARROW AND BROAD AGGREGATES AS POLICY TARGETS, THE RELEVENT CRITERION IS - WHICH CAUSES INFLATION? ON THIS CRITERION, OUR EXPERIENCES OVER THE PAST FIFTEEN YEARS SHOW STERLING M3 TO BE A MORE SUITABLE TARGET THAN, SAY, M1.
- VARIATIONS IN SAVINGS BEHAVIOUR DO NOT AFFECT THE WAY MONEY GROWTH FEEDS INTO SUBSEQUENT INFLATION.

SUMMARY: POLICY IMPLICATIONS

THESE FINDINGS HAVE STRONG IMPLICATIONS FOR THE CONDUCT OF MONETARY POLICY :

- THE TREASURY SHOULD NOT BE TEMPTED TO USE M1 RATHER THAN STERLING M3 AS AN INTERMEDIATE POLICY TARGET.
- THE TREASURY SHOULD NOT SET TARGETS FOR TWO OR MORE MONETARY AGGREGATES AT THE SAME TIME. THESE TARGETS WILL BE COMPATIBLE ONLY BY CHANCE, AND CANNOT BE MET IF RELATIVE INTEREST RATES ARE TO BE ALLOWED TO MOVE FREELY.
- THIS CHOICE OF STERLING M3 AS AN INTERMEDIATE TARGET DOES NOT PREJUDICE THE CHOICE BETWEEN INTEREST RATES AND THE MONETARY BASE AS THE DAY-TO-DAY OPERATING TARGET WHICH THE TREASURY SHOULD SET FOR THE BANK OF ENGLAND. WE HAVE ARGUED THE CASE FOR BASE CONTROL ELSEWHERE.
- WHATEVER CONTROL DEVICE IS USED BY THE BANK, IT SHOULD NOT - LIKE THE CORSET - DISTORT THE MEASUREMENT OF THE INTERMEDIATE TARGET WITHOUT CHANGING UNDERLYING GROWTH IN THAT TYPE OF MONEY. INFLATION OVER THE PAST FIFTEEN YEARS IS MORE CLOSELY ASSOCIATED WITH A BROAD MONEY STOCK MEASURE WHICH IS NOT AFFECTED BY SUCH DISTORTIONS, THAN IT IS WITH THE STERLING M3 FIGURES OFFICIALLY RECORDED.

SECTION I The Economic Background

The major indicators of real growth and inflation in the United Kingdom in the period 1978-80 are summarised in Table 1. Since the middle of 1979, the real performance of the economy has clearly deteriorated, and an obvious scapegoat for this recession is the avowedly 'monetarist' policy of the Thatcher government which came to power in May 1979. Indeed, many monetarist gurus such as Professor Hayek have encouraged the public to believe that our current travail is a price which must be paid to reduce inflation. This theme has been taken up by the Prime Minister herself.

TABLE 1

TABLE 1 THE UK IN RECESSION

Indicator	Growth through 1978	1979	1980
The 'Real' Economy			
Gross Domestic Product	3.0	1.0	-2.5
Manufacturing Production	0.7	0.8	-14.2
Unemployment Rate	5.5	5.2	8.7
The 'Nominal' Economy			
Retail Prices	8.1	17.2	15.2
Interest Rates	12.4	17.1	14.8
Exchange Rate	- 1.8	9.7	11.1

Source : CSO Economic Trends

BUT HAS THERE BEEN A MONETARY SQUEEZE AT ALL? DIFFERENT DEFINITIONS OF MONEY GIVE DIFFERENT ANSWERS. AS TABLE 2 SHOWS, NARROW MONETARY AGGREGATES SUCH AS THE MONETARY BASE AND M1 HAVE GROWN VERY SLOWLY INDEED. OTHER, VERY BROAD, MEASURES OF PRIVATE SECTOR LIQUIDITY SUCH AS PSL1, AND PSL2 HAVE GROWN MUCH FASTER; AND THE GOVERNMENT'S OWN CHOSEN MEASURE, STERLING M3 HAS GROWN FASTEST OF ALL. THROUGH 1980, STERLING M3 GREW BY 20 PER CENT, AS AGAINST A TARGET OF 7-11 PER CENT. ON THIS DEFINITION OF MONEY, POLICY HAS BEEN EASY, NOT TIGHT; THE GOVERNMENT HAS NOT BEEN FOLLOWING MONETARIST POLICIES; AND THE RECESSION HAS OCCURRED, NOT BECAUSE OF MONETARY POLICY, BUT IN SPITE OF IT.

TABLE 2 WHICH MONEY SUPPLY?

MONEY SUPPLY MEASURE	GROWTH THROUGH 1978	1979	1980
M0	15.2	9.7	5.3
M1	16.6	9.0	5.8
STERLING M3	15.0	12.6	19.6
PSL1	15.6	16.8	16.4
PSL2	15.1	13.7	15.7

SOURCE : CSO FINANCIAL STATISTICS

THE REACTION OF MANY MONETARISTS TO THIS CONUNDRUM IS TO REJECT STERLING M3 AS A RELIABLE INDICATOR OF MONETARY CONDITIONS. PROFESSOR WALTERS, THE PRIME MINISTERS PERSONAL ECONOMIC ADVISOR, HAS ARGUED THAT THE HIGH LEVEL OF THE STERLING EXCHANGE RATE AND THE HIGH LEVEL OF INTEREST RATES MEAN MONEY MUST BE TIGHT, SO MONETARY POLICY SHOULD BE DIRECTED AT CONTROLLING NARROW DEFINITIONS OF MONEY. THIS IDEA HAS FOUND FAVOUR WITH THE CHANCELLOR OF THE EXCHEQUER. THE RECENT <u>FINANCIAL STATEMENT AND BUDGET REPORT 1981-2</u> STATES

> 'THE HIGH EXCHANGE RATE AND HIGH REAL INTEREST RATES HAVE ENSURED MONETARY CONDITIONS REMAINED TIGHT AND THAT PROGRESS IN REDUCING INFLATION IS MAINTAINED' (P.16, PARA.10)

AND FURTHER THAT

> 'SOME OF THE FACTORS WHICH HAVE BEEN IDENTIFIED AS CONTRIBUTING TO THE RAPID GROWTH OF £M3 IN 1980-81 MEAN THAT IT SHOULD NOT HAVE THE IMPLICATIONS FOR FUTURE INFLATION WHICH GENERALLY FOLLOW AN INCREASE IN MONEY SUPPLY' (IBID).

A SIMILAR SUGGESTION HAS BEEN MADE, ON SLIGHTLY DIFFERENT GROUNDS, BY PROFESSOR MELTZER IN HIS PAPER, <u>TESTS OF INFLATION THEORIES FROM THE BRITISH LABORATORY</u>. BOTH THE OFFICIAL VIEW OF THE RELATIVELY FAST STERLING M3 GROWTH, AND THE MELTZER VIEW, ASCRIBE IT TO A PERMANENT ONCE-OFF RISE IN THE STOCK OF PRIVATE SECTOR LIQUID ASSETS.

SPECIFICALLY, THE <u>FINANCIAL STATEMENT</u> ARGUEMENT IS THAT IN 1979 THE PRIVATE SECTOR WAS CONFRONTED WITH A RATE OF INFLATION HIGHER THAN IT EXPECTED - DUE, SAY, TO THE VAT INDUCED PRICE RISE, AND THE OIL PRICE RISE TOWARDS THE END OF THAT YEAR. AS A RESULT IT ENTERED 1980 WITH STOCKS OF LIQUID ASSETS WHICH WERE, IN TERMS OF THEIR REAL PURCHASING POWER, LOWER THAN DESIRED. A LARGE PART OF THE INCOMES EARNED BY INDIVIDUALS AND COMPANIES IN THE PRIVATE SECTOR WAS THEREFORE, CHANNELED INTO FORMS OF SAVING - DEPOSIT ACCOUNTS, BUILDING SOCIETIES

AND THE LIKE. BY THE END OF 1980, THIS ADJUSTMENT WAS COMPLETE. THE MELTZER ARGUMENT IS THAT IN 1979 TAXES ON CONSUMPTION OF GOODS WERE RAISED RELATIVE TO TAXES ON SAVING, THROUGH THE INCREASE IN VAT AND THE FALL IN INCOME TAXATION. A RATIONAL RESPONSE, HE ARGUES IS TO HOLD MORE WEALTH IN THE FORM OF REAL SAVINGS AND LESS AS CONSUMPTION GOODS. SO IN 1980 THE RATIO OF SAVINGS TO INCOME ROSE AS INDIVIDUALS AND COMPANIES ADJUSTED THE PATTERN OF THEIR ASSET HOLDINGS.

BOTH ARGUMENTS ARE CONSISTENT WITH THE OBSERVED RISE IN THE PERSONAL SECTOR SAVINGS RATIO FROM 13 PER CENT EARLY IN 1979 TO 17 PER CENT IN 1980. BOTH ARGUMENTS IMPLY A FAST RISE IN STERLING M3 RELATIVE TO M1 BECAUSE THE FORMER INCLUDES INTEREST-BEARING DEPOSITS HELD AS ASSETS WHEREAS THE LATTER COVERS ONLY 'TRANSACTIONS BALANCES' (SEE PANEL 1). AND BOTH ARGUMENTS ALSO IMPLICITLY ASSERT THAT MONEY GROWTH IS NOT INFLATIONARY IF IT TAKES THE FORM OF AN ADJUSTMENT TO THE STOCK OF WEALTH, RATHER THAN AN ADJUSTMENT TO THE STOCK OF MONEY HELD TO FACILITATE TRANSACTIONS IN GOODS.

SECTION II - THE INDICATOR OF MONETARY POLICY

AT A TIME WHEN DIFFERENT MONETARY INDICATORS GIVE DIFFERENT READINGS OF THE CURRENT THRUST OF MONETARY POLICY, IT IS IMPORTANT TO BE CLEAR REGARDING THE CRITERIA WHICH WE USE IN PREFERRING ONE INDICATOR TO ANOTHER. THE MOST PREFERRED MONETARY INDICATOR IS THAT WHICH BEST PREDICTS THE FUTURE RATE OF GROWTH OF EITHER MONEY INCOME OR THE RATE OF INFLATION. THIS IN TURN POSES TWO QUESTIONS: FIRST SHOULD WE CHOOSE A QUANTITY (MONEY, MONETARY BASE, PSL) OR A PRICE (THE INTEREST RATE OR EXCHANGE RATE) AND, SECOND, SHOULD WE CHOOSE ONE TARGET (SUCH AS THE GOVERNMENT DID IN LAYING OUT THE MTFS) OR MULTIPLE TARGETS (AS THE FEDERAL RESERVE HAVE DONE IN THE US) AND IF THEY DIVERGE HOW SHOULD WE FORM A JUDGEMENT?

THE ANSWER TO THE FIRST QUESTION IS THAT IT MAKES NO DIFFERENCE WHETHER WE CHOOSE A QUANTITY OR A PRICE, PROVIDING WE DO NOT HAVE EITHER CHANGING RATES OF INFLATION OR CHANGES IN 'REAL' FACTORS IN THE ECONOMY. CONSIDER USING INTEREST RATES AS AN INDICATOR OF MONETARY POLICY. INTEREST RATES CAN BE AFFECTED BY REAL FACTORS SUCH AS THE PRODUCTIVITY OF INVESTMENT, OR BY A NOMINAL FACTOR, THE EXPECTED RATE OF INFLATION. THE MARKET RATE IS THE SUM OF THE REAL RATE AND THE EXPECTED INFLATION RATE. BECAUSE IT IS THE REAL RATE THAT MATTERS FOR ECONOMIC DECISIONS, IT IS THIS RATE RATHER THAN THE MARKET RATE WHICH POLICY-MAKERS SHOULD CONTROL. CAN ONE INFER ANYTHING ABOUT THE REAL RATE FROM THE BEHAVIOUR OF THE MARKET RATE?

THE REAL INTEREST RATE FACING ANY INVESTOR IS THE EXPECTED MONEY TERMS INTEREST RATE OVER THE PERIOD OF THE LOAN MINUS THE EXPECTED RATE OF INFLATION OVER THAT PERIOD. CALCULATIONS OF "REAL" INTEREST RATES BASED ON ANY OTHER DEFINITION ARE TOTALLY MISLEADING.

IT IS PLAINLY FAR FROM STRAIGHTFORWARD TO CALCULATE THE REAL INTEREST RATE CORRECTLY. EVEN IF ONE IS WILLING TO LOOK AT CURRENT INTEREST RATES AND CURRENT INFLATION, AN ENORMOUS RANGE OF THE CALCULATED "REAL" RATES CAN BE PRODUCED. DOES ONE TAKE A LONG RATE, REGARDING THAT AS APPROXIMATING EXPECTED RATES OVER THE PERIOD OF THE LOAN, OR A SHORT RATE AS REPRESENTING THE CURRENT COST OF IT? AND FOR INFLATION, DOES ONE TAKE THE LATEST MONTH, SIX MONTHS, A YEAR, OR WHAT?

IN OTHER WORDS, THE REAL INTEREST RATE IS AN IMPORTANE ECONOMIC CONCEPT - BUT IT IS FAR FROM EASY TO QUANTIFY. A RECOMMENDATION TO CHANGE THE STANCE OF MONETARY POLICY ON THE BASIS OF AN ESTIMATE OF THE REAL RATE OF INTEREST RESTS ON VERY FRAGILE FOUNDATIONS INDEED AND A RECOMMENDATION BASED ON MARKET RATES IS WITHOUT ANY FOUNDATION WHATSOEVER.

OR CONSIDER THE EXCHANGE RATE. CAN THE BEHAVIOUR OF THE EXCHANGE RATE TELL ONE ANYTHING ABOUT THE STANCE OF MONETARY POLICY? USUALLY IT CAN. THE EXCHANGE RATE MEASURES THE EXTERNAL VALUE OF A CURRENCY JUST AS THE PRICE LEVEL MEASURES ITS INTERNAL VALUE. IT IS THEREFORE NOT SURPRISING THAT MONETARY GROWTH GENERALLY AFFECTS BOTH THE INTERNAL AND THE EXTERNAL VALUE OF A CURRENCY, AND THAT WHEN A CURRENCY IS STRONG ON THE FOREIGN EXCHANGES MONEY IS USUALLY TIGHT. INDEED, WHEN THERE IS AN UNEXPECTED TIGHTENING OF MONEY THE EXCHANGE RATE WILL JUMP UPWARDS IF THAT TIGHTENING IS EXPECTED TO PERSIST. THE RATE WILL JUMP BECAUSE SOME OF THE EXPECTED CONSEQUENT CHANGE IN THE PRICE LEVEL WILL BE CAPITALISED INTO THE CURRENT EXCHANGE RATE. UNDER THESE CIRCUMSTANCES, THE FORWARD RATE WILL ALSO RISE, PRESERVING INTEREST PARITY.

THERE ARE, HOWEVER, CIRCUMSTANCES - ALBEIT NOT COMMON - WHEN AN EXCHANGE RATE HAS JUMPED WITHOUT ANY CHANGES IN MONETARY POLICY. IF THERE IS A SUDDEN INCREASE IN THE DEMAND FOR ASSETS DENOMINATED IN SOME CURRENCY, THAT CURRENCY'S FOREIGN EXCHANGE VALUE WILL RISE WITHOUT ANY CHANGE IN ITS MONETARY POLICY. THERE IS EVERY REASON TO BELIEVE THAT THAT HAS HAPPENED TO STERLING. THE UK IS NOW SUBSTANTIALLY INSULATED FROM OIL PRICE (OR SUPPLY) SHOCKS. THAT HAS MADE UK ASSETS MORE ATTRACTIVE THAN BEFORE TO INVESTORS, AND THUS RAISED THE DEMAND FOR STERLING ON THE FOREIGN EXCHANGES.

MARKET PRICES, THEREFORE, ARE NOT GOOD INDICATORS OF THE CURRENT THRUST OF MONETARY POLICY BECAUSE OF CHANGING REAL FACTORS IN THE ECONOMY AND BECAUSE OF THE DIFFICULTY OF ESTIMATING THE EXPECTED RATE OF INFLATION. IT IS NOT SURPRISING, THEREFORE, THAT IT IS DIFFICULT TO FIND A GOOD CORRELATION BETWEEN EITHER INTEREST RATES OR THE EXCHANGE RATE AND THE FUTURE GROWTH OF INFLATION.

THE MONEY SUPPLY, HOWEVER, IS FREE FROM BOTH OF THESE DEFICIENCIES. ITS NOMINAL MAGNITUDE IS UNAFFECTED BY EITHER CHANGING REAL FACTORS OR CHANGES IN THE EXPECTED RATE OF INFLATION. THE CHOICE BETWEEN A NARROW AND A BROAD MONEY SUPPLY THEN DEPENDS ON WHICH IS BETTER RELATED TO THE GROWTH OF MONEY INCOME OR INFLATION. IT IS THIS, RATHER THAN THE BEHAVIOUR OF THE REAL ECONOMY, OR THE LEVEL OF INTEREST RATES OR EXCHANGE RATES, WHICH SHOULD DETERMINE THE CHOICE OF MONETARY INDICATOR. THIS ALSO DETERMINES THE ANSWER TO THE SECOND QUESTION. THE PROBLEM WITH THE GOVERNMENT ADOPTING A VARIETY OF MONETARY TARGETS IS THAT IT IS HIGHLY PROBABLE THAT OVER A PARTICULAR TIME PERIOD AT LEAST ONE OF THE INDICATORS WILL HAVE BEHAVED TOLERABLY WELL. BUT THAT IS NOT GOOD ENOUGH. WHAT MATTERS IS THE BEHAVIOUR OF THAT MONETARY VARIABLE MOST CLOSELY ASSOCIATED WITH THE FUTURE RATE OF INFLATION.

SECTION III - WHY HAVE M1 AND STERLING M3 DIVERGED?

TWO TYPES OF EXPLANATION CAN BE OFFERED FOR THE DIVERGENCE BETWEEN THE GROWTH RATE OF THE BROAD MONEY STOCK, STERLING M3, AND THE NARROW MONEY STOCK, M1, IN 1980. FIRST, THE GROWTH OF STERLING M3 HAS BEEN AFFECTED, AFTER JULY, BY THE LIFTING OF THE 'CORSET' RESTRICTIONS ON BANKS ISSUING INTEREST BEARING ELIGIBLE LIABILITIES. SECOND, THE DEMAND FOR THESE INTEREST BEARING TYPES OF MONEY MAY HAVE INCREASED RELATIVE TO THE DEMAND FOR NON-INTEREST-BEARING CHECQUING ACCOUNTS. THIS MAY HAVE HAPPENED SIMPLY BECAUSE OF THE LEVEL OF INTEREST RATES; OR IT MAY HAVE HAPPENED - AS DISCUSSED ABOVE - BECAUSE OF THE PREFERENCES OF PRIVATE SAVERS TO HOLD ANY INCREASES IN THEIR ASSETS IN THE FORM OF INTEREST BEARING DEPOSITS. WE CONSIDER THE IMPACT OF THESE FACTORS IN TURN.

THE EFFECTS OF THE CORSET

THE CORSET ENCOURAGED A DIVERSION OF FUNDS OUT OF THE BANKS BALANCE SHEETS. MUCH OF THE BORROWING AND LENDING ACTIVITY WHICH WOULD HAVE TAKEN PLACE IN THE ABSENCE OF THE CORSET STILL CONTINUED, HOWEVER. IN PART THIS WAS EFFECTED THROUGH AN INCREASE IN BANK ACCEPTANCES OF BILLS DRAWN ON COMMERCIAL BORROWERS. IN PART ALSO THIS EVASION OF THE MONETARY CONTROL MECHANISM WAS EFFECTED, AFTER EXCHANGE CONTROLS WERE ABOLISHED IN NOVEMBER 1979, BY UK BANKS LENDING IN THE EUROSTERLING MARKET.

IT IS HARD TO QUANTIFY THIS LAST SOURCE OF 'DISINTERMEDIATION'. IT IS, HOWEVER, RELATIVELY SIMPLE TO QUANTIFY THE 'BILL LEAK', BY ADDING BANKERS ACCEPTANCES TO THE MONEY STOCK FIGURES. A COMPARISON OF OFFICIAL STERLING M3 GROWTH IN THE PERIOD 1978-80 WITH THE CORRESPONDING GROWTH IN AN ADJUSTED STERLING M3 FIGURE

WHICH INCLUDES BANKERS ACCEPTANCES, IS VERY REVEALING. THE RESULTS ARE SUMMARISED ON TABLE 3. THEY SHOW THAT WHILE 'THE CORSET' APPEARED TO DEPRESS THE MONETARY GROWTH RATE BETWEEN JUNE 1978 AND JUNE 1980, THE EFFECT WAS MORE APPARENT THAN REAL. THE GROWTH RATE OF THE UNDERLYING 'ADJUSTED' MONEY SUPPLY CONTINUED AT A RATE OF 15-16 PER CENT PER ANNUM, AS AGAINST AN 11-12 PER CENT GROWTH IN THE OFFICIAL FIGURES. AFTER THE CORSET WAS REMOVED IN MID-1980, THE DISINTERMEDIATED FUNDS FLOWED BACK, FROM BANKERS ACCEPTANCES, INTO BANK LOANS AND DEPOSITS. THE RESULT WAS A VERY RAPID GROWTH IN THE OFFICIAL DEFINITION OF STERLING M3. IN THIS IMMEDIATE POST-CORSET PHASE, HOWEVER, STERLING M3 IS JUST AS MISLEADING AN INDICATOR OF UNDERLYING MONETARY CONDITIONS AS IT WAS UNDER THE CORSET. THE 'ADJUSTED' STERLING M3 FIGURES SHOW THAT MONETARY GROWTH DID ACCELERATE IN 1980, BUT TO AROUND 16-17 PER CENT, RATHER THAN THE OFFICIALLY RECORDED 19-20 PER CENT PER ANNUM.

THE UNDERLYING GROWTH RATE OF STERLING M3 HAS, THEN, BEEN LESS THAN THE OFFICIAL FIGURES SUGGEST. IT HAS GROWN AT ROUGHLY THE SAME RATE AS THE BROAD INDICATORS PSL1 AND PSL2 SHOWN ON TABLE 2. CONSEQUENTLY WHILE THE CORSET DISTORTION HAS EXAGGERATED TRUE STERLING M3 GROWTH IN 1980, IT DOES LITTLE TO EXPLAIN THE WIDE DIVERGENCE BETWEEN NARROW DEFINITIONS OF MONEY AND BROAD DEFINITIONS OF MONEY.

THE EFFECTS OF INTEREST RATES AND SAVINGS

THE ALTERNATIVE SET OF EXPLANATIONS FOR THIS PHENOMENON RELIES ON DIFFERENCES IN THE MOTIVES PEOPLE HAVE FOR HOLDING M1 AND, SAY, STERLING M3. THE TRADITIONAL VIEW IS THAT SINCE STERLING M3 INCLUDES INTEREST-BEARING TIME DEPOSITS AND CERTIFICATES OF DEPOSIT, WHEREAS M1 PAYS HOLDERS NO INTEREST, THEN AT TIMES OF HIGH INTEREST RATES THERE WILL BE A SWITCH FROM THE LATTER TO THE FORMER. THE VIEW

TABLE 3 M3 UNDER THE CORSET, 1979-80

M3 MEASURE	GROWTH OVER 12 MONTHS ENDING					
	1978		1979		1980	
	JUNE	DEC	JUNE	DEC	JUNE	DEC
OFFICIAL STERLING M3	16.1	13.3	11.1	11.7	11.6	19.5
		'THE CORSET'				
ADJUSTED STERLING M3	17.8	15.2	14.1	15.1	15.9	16.8

SOURCE : CSO FINANCIAL STATISTICS, CBIF

EXPRESSED BY THE TREASURY AND BY MELTZER IS THAT AS PEOPLE ACCUMULATE MORE AND MORE WEALTH THROUGH SAVING, THEY TEND TO HOLD A LARGER AND LARGER PROPORTION OF THEIR NEW WEALTH IN THE FORM OF INTEREST-BEARING ASSETS LIKE TIME DEPOSITS AND STERLING CERTIFICATES OF DEPOSIT, RATHER THAN SIMPLY HOLDING PROPORTIONATELY MORE NON-INTEREST BEARING MONEY.

WE CAN TEST WHETHER EITHER OF THESE EXPLANATIONS IS CORRECT BY EXAMINING WHETHER, IN THE LIGHT OF PAST MOVEMENTS IN MONEY, INTEREST AND SAVINGS, THE ASSUMPTIONS THAT ARE MADE ABOUT THE RELATIVELY HIGH 'INTEREST ELASTICITY' AND 'SAVINGS ELASTICITY' OF STERLING M3 ARE CORRECT. TO CARRY OUT THESE TESTS THOROUGHLY, IT HELPS TO HAVE A SIMPLE MATHEMATICAL FORMULATION OF THE IDEAS MOOTED ABOVE. THE SIMPLEST POSSIBLE FRAMEWORK IS SET OUT ON PANEL 2. BRIEFLY, EQUATION (1) STATES THAT THE DEMAND FOR STERLING M3 AS A PROPORTION OF TOTAL WEALTH DEPENDS ON TIME (I.E. THERE MAY BE A TREND IN TASTES TOWARDS OR AWAY FROM THIS ASSET), ON THE YIELD ON CERTIFICATES OF DEPOSIT (POSITIVELY, SO $c_3>0$), AND ON THE SCALE OF WEALTH ITSELF (I.E. AT HIGH LEVELS OF WEALTH THE RATIO M3/W MAY BE HIGHER THAN AT LOW LEVELS OF WEALTH). EQUATION (2) IMPUTES SIMILAR BEHAVIOUR TO THE DEMAND FOR M1, EXCEPT THAT IT IS - IF ANYTHING - NEGATIVELY RELATED TO INTEREST RATES ($c_1<0$), AND IS PERHAPS - IF MELTZER'S CONJECTURE IS TRUE - LESS SENSITIVE TO CHANGES IN WEALTH THAN IS STERLING M3.

SIMPLE MANIPULATIONS LEAD TO EQUATION (6), WHICH STATES THAT - IF BOTH THE TRADITIONAL INTEREST-SENSITIVITY HYPOTHESES AND THE MELTZER SAVINGS HYPOTHESIS ARE CORRECT - THE DIFFERENCE BETWEEN THE GROWTH RATES OF STERLING M3 AND M1 SHOULD DEPEND POSITIVELY ON THE CHANGE IN INTEREST RATES AND POSITIVELY ON THE REAL LEVEL OF SAVINGS.

THE ACTUAL SIZES OF THE PARAMETERS B, C AND D CAN BE ESTIMATED BY REGRESSION METHODS, USING DATA ON THE UK IN THE PERIOD 1963-80. THE RESULTS ARE SHOWN ON TABLE 4.

TABLE 4 THE M3 - M1 RELATIONSHIP

DEPENDENT VARIABLE	COEFFICIENT ON: CONSTANT	CHANGE IN C.D.RATE	LEVEL OF SAVINGS RATIO	STATISTICS R^2 S	ρ
	B	C	D		
M3 GROWTH LESS	0.35	3.56	0.54	0.37	0.36
M1 GROWTH	(0.03)	(5.21)	(0.11)	7.60	(3.19)
M3 GROWTH LESS	1.59	3.55		0.37	0.36
M1 GROWTH	(1.13)	(5.26)		7.54	(3.16)
M3 GROWTH LESS	2.22		-3.64	0.12	0.36
M1 GROWTH	(1.31)		(0.75)	8.93	(3.24)

OLS ESTIMATES, QUARTERLY DATA 1963-1980

BENEATH EACH OF THE ESTIMATED COEFFICIENTS B,C AND D THERE IS A FIGURE IN BRACKETS. THIS T-STATISTIC MEASURES WHETHER THE ESTIMATED COEFFICIENT IS SIGNIFICANTLY DIFFERENT FROM ZERO. ROUGHLY, A VALUE ABOUT 1.8 IS NECESSARY. LOOKING AT THE FIRST EQUATION ON TABLE 4, IT IS CLEAR THAT B AND D ARE NOT SIGNIFICANTLY NONZERO BUT THAT C IS VERY SIGNIFICANT. IN PLAIN TERMS, THE REGRESSION TELLS US THREE THINGS :

1. THERE IS NO DIFFERENTIAL TREND IN TASTES TOWARDS EITHER STERLING M3 OR M1.

2. Sterling M3 will grow significantly faster than M1 if interest rates rise. Roughly, a 1 per cent rise in the Sterling CD rate through one year will cause a 3-4 per cent (positive) difference between the growth rates of broad and narrow money in that year.

3. There is no tendency for increases in the savings ratio to cause a relatively fast growth in Sterling M3. Although the coefficient D is positive in the first equation of Table 4, it is not significantly different from zero.

The remaining equations on Table 2 check out what happens when either the savings ratio or the interest rate is dropped from our model of Equation 6. The first shows that the estimate of the interest rate effect remains unchanged, and that the fit of the equation (as measured by the statistic $\bar{R}^2$) does not deteriorate. The second subsidiary regression is interesting since it could be argued that the complete model obscures the savings effect - interest rates might rise as the demand for interest-bearing money rises, and so appear to be causing the M3 growth, whereas the true origin of the growth was the savings ratio rise. Intuitively, this argument is perverse - if the demand for Sterling Certificates of Deposit rises, for example, one would expect to find their yield falling, not rising. Empirically, this turns out to be the case. When relative M3 growth is regressed on savings ratio changes along, the coefficient actually goes negative, though it is still not statistically significant.

SECTION IV - M3 AND M1 AS EARLY WARNING SYSTEMS

ESTABLISHING THE REASON FOR THE DIVERGENT BEHAVIOUR OF STERLING M3 AND M1 DOES NOT, OF COURSE, HELP US CHOOSE WHICH AGGREGATE SHOULD BE TARGETTED. THIS DEPENDS ON THE DEGREE TO WHICH EACH IS HELPFUL IN GIVING AN EARLY INDICATION OF THE FUTURE COURSE OF INFLATION.

TO ASSESS THE RELATIVE MERITS OF THE TWO MONETARY AGGREGATES AS INTERMEDIATE TARGETS WE HAVE CONDUCTED TWO EXPERIMENTS. IN THE FIRST, WE HAVE SIMPLY REGRESSED CURRENT INFLATION ON CURRENT AND PAST MONETARY GROWTH, UP TO A LAG OF 20 QUARTERS, USING EACH DEFINITION OF MONEY IN TURN (SEE PANEL 3, EQUATION 7). WE HAVE ALSO INVESTIGAGED WHETHER INCLUSION OF THE SAVINGS RATIO IMPROVES THIS REGRESSION. IN THE SECOND EXPERIMENT WE HAVE REGRESSED CURRENT INFLATION ON CURRENT AND PAST MONEY GROWTH, AND ON PAST INFLATION ITSELF (PANEL 3, EQUATIONS (9) AND (10)). THE CONTRIBUTION OF THE MONEY GROWTH TERMS IN THIS REGRESSION GIVE US SOME IDEA OF WHETHER MONEY GROWTH IS 'CAUSING' INFLATION, OR WHETHER BOTH ARE THE PRODUCTS OF SOME MORE FUNDAMENTAL FORCES IN THE ECONOMY. THIS EXPERIMENT WAS CONDUCTED ON ALL DEFINITIONS OF MONEY, INCLUDING THE MONETARY BASE AND THE PRIVATE SECTOR LIQUIDITY AGGREGATES. IN ADDITION, THE EXPERIMENT HAS BEEN CONDUCTED IN REVERSE (PANEL 3, EQUATIONS (11) AND (12)); THAT IS, WE HAVE EXAMINED WHETHER PAST INFLATION HAS IN ANY SENSE 'CAUSED' MOVEMENTS IN PARTICULAR DEFINITIONS OF MONEY, SO THAT THESE CANNOT BE CONSIDERED GENUINELY CONTROLLABLE GIVEN THE CURRENT MONEY SUPPLY PROCESS IN THE UNITED KINGDOM.

INFLATION AND PAST MONEY GROWTH

THE RESULTS OF THE FIRST EXPERIMENT ARE SUMMARISED ON TABLE 5. THE ESTIMATED RELATIONS BETWEEN INFLATION AND THE TWO MONEY SUPPLY MEASURES DIFFER IN FOUR RESPECTS: ON ALL COUNTS, THE EQUATION USING

STERLING M3 MUST BE CONSIDERED SUPERIOR TO THAT USING THE NARROW AGGREGATE M1.

TABLE 5 M1 AND M3 AS PREDICTORS OF INFLATION

DEPENDENT VARIABLE	MONEY MEASURE	COEFFICIENT ON: CONSTANT	PAST MONEY GROWTH[A]	STATISTICS $\bar{R}^2$	D
RETAIL PRICE INFLATION	M1	5.64 (2.68)	0.78 (3.77)	0.35	1.44
	STERLING M3	1.85 (0.69)	0.92 (3.82)	0.47	1.63

A. COEFFICIENTS SHOWN ARE THE SUMS OF COEFFICIENTS ON MONEY GROWTH IN THE PRECEDING 20 QUARTERS. THE AVERAGE LAG BETWEEN MONEY GROWTH AND INFLATION IS 17 QUARTERS FOR THE M1 EQUATION, AND 10 FOR THE STERLING M3 EQUATION.

OLS ESTIMATES, QUARTERLY DATA 1963-1980.

FIRST, THE STERLING M3 EQUATION EXPLAINS A GREATER PROPORTION (ABOUT ONE HALF) OF THE VARIATIONS IN QUARTER TO QUARTER INFLATION RATES THAN DOES THE M1 EQUATION (ABOUT ONE THIRD). TO BE PRECISE, THE $\bar{R}^2$ FOR THE FORMER IS 0.47; FOR THE LATTER ONLY 0.35. SECOND, THERE ARE SIGNS THAT THERE IS A SYSTEMATIC PATTERN IN THE INFLATION SERIES WHICH IS LEFT LEFT UNEXPLAINED BY MOVEMENTS IN M1, AS EVIDENCED BY THE LOW DURBIN-WATSON D-STATISTIC. THERE IS LESS EVIDENCE OF UNEXPLAINED SYSTEMATIC MOVEMENT IN THE STERLING M3 EQUATION.

ON BOTH FIT AND DYNAMIC SPECIFICATION NEITHER EQUATION PROVIDES A

TOTAL EXPLANATION FOR ALL MOVEMENTS IN INFLATION. BUT THIS IS NOT PART OF THE MONETARIST ARGUMENT. INDEED, THE VERY LACK OF ANY MECHANISTIC CONNECTION BETWEEN MONEY, ACTIVITY, AND PRICES IS PART OF THE ARGUMENT FOR STICKING TO A MONETARY RULE RATHER THAN TRYING TO TAILOR MONEY GROWTH TO SUIT CIRCUMSTANCES. THERE IS LITTLE DOUBT, FOR EXAMPLE, THAT INCOMES POLICIES CAN DRIVE INFLATION TEMPORARILY BELOW THE TRENDS WHICH WOULD BE PREDICTED BY THE ABOVE EQUATIONS, NOR THAT INFLATION IS SUBJECT TO MANY RANDOM SHOCKS DUE TO CHANGES IN DEMAND AND SUPPLY CONDITIONS IN THE ECONOMY. BUT THE EQUATIONS SHOW THAT, FROM THE EXPERIENCE OF THE PAST FIFTEEN YEARS, STERLING M3 CAN BE RELIED ON TO DELIVER A REASONABLE PREDICTION OF THE TREND IN INFLATION TWO TO THREE YEARS INTO THE FUTURE.

THE <u>THIRD</u> POINT TO NOTE IN THE COMPARISON OF THE M1 AND STERLING M3 RELATIONS OF TABLE 4 IS THAT THE CONSTANT TERM OF THE FORMER IS SIGNIFICANTLY POSITIVE, WHEREAS THE CONSTANT TERM IN THE LATTER IS EFFECTIVELY ZERO. THE FIRST SUGGESTS INFLATION HAS A SPONTANEOUS TREND OF OVER 5-6 PER CENT PER ANNUM, IRRESPECTIVE OF THE BEHAVIOUR OF MONEY. THE LATTER SUGGESTS INFLATION HAS NO TREND INDEPENDENT OF THE TREND IN MONEY GROWTH, A MUCH MORE THEORETICALLY PLAUSIBLE STATEMENT. THE <u>FOURTH</u> POINT IS THAT THE RELATION BETWEEN M1 GROWTH AND PRICE INFLATION IS LESS THAN ONE-TO-ONE; A 10 PER CENT GROWTH IN M1 WILL - AFTER A SPECTACULARLY LONG LAG, INCIDENTALLY - DELIVER A 7.8 PER CENT RATE OF INFLATION. FOR STERLING M3, HOWEVER, THE RELATION BETWEEN INFLATION AND MONEY GROWTH IS VIRTUALLY ONE-TO-ONE. THUS NOT ONLY IS THE EQUATION RELATING INFLATION TO PAST STERLING M3 GROWTH STATISTICALLY MORE ROBUST THAN THE EQUATION USING M1, IT ALSO CONTAINS MORE PLAUSIBLE COEFFICIENT ESTIMATES.

THE OFFICIAL STERLING M3 SERIES HAS, HOWEVER, BEEN SERIOUSLY DISTORTED FROM TIME TO TIME, AS THE CORSET SCHEME HAS BEEN ALTERNATELY IMPOSED AND REMOVED IN THE PERIOD 1973-80. IF OUR ARGUMENTS ABOVE ARE CORRECT, WE SHOULD REALLY BE CONDUCTING OUR TESTS OF THE DETERMINANTS OF INFLATION USING AN ADJUSTED SERIES RATHER THAN THE OFFICIAL SERIES. UNFORTUNATELY WE CAN ONLY MAKE ADJUSTMENTS TO THE SERIES FOR A SHORT RUN OF YEARS, AND THIS DOES NOT PROVIDE US WITH ENOUGH DATA TO INVESTIGATE THE RELATIONSHIP BETWEEN INFLATION AND THE ADJUSTED STERLING M3 SERIES, GIVEN THE LAGS INVOLVED. THE BEST WE CAN DO IN THESE CIRCUMSTANCES IS TO EXPLOIT THE FACT THAT THROUGHOUT THE PERIOD 1973-80 THE ADJUSTED STERLING M3 SERIES YIELDS FIGURES FOR MONETARY GROWTH WHICH PARALLEL THOSE IN THE SLIGHTLY BROADER AGGREGATE, PSL1

TABLE 6 OFFICIAL AND ADJUSTED STERLING M3 AS PREDICTORS OF INFLATION

DEPENDENT VARIABLE	MONEY MEASURE	COEFFICIENT ON: CONSTANT	PAST MONEY GROWTH[A]	STATISTICS $\bar{R}^2$	D
RETAIL PRICE	OFFICIAL STERLING M3	1.85 0.69	0.92 (3.82)	0.47	1.63
	PSL1 (ADJUSTED STERLING M3)	1.84 (0.75)	0.95 (4.26)	0.53	1.69

A. COEFFICIENTS SHOWN ARE THE SUMS OF COEFFICIENTS ON MONEY GROWTH IN THE PRECEDING 20 QUARTERS. THE AVERAGE LAG BETWEEN MONEY GROWTH AND INFLATION IS 10 QUARTERS FOR THE OFFICIAL STERLING M3 EQUATION, AND 10 QUARTERS FOR THE ADJUSTED STERLING M3 EQUATION.

OLS ESTIMATES, QUARTERLY DATA, 1971-1980.

On Table 6, we have conducted a regression of inflation on past growth in PSLL over the whole period 1963-80, on the assumption that this is a good proxy for the true behaviour of Sterling M3. On all criteria, PSL1 is a slightly more accurate and better defined predictor of inflation than the official Sterling M3 figure. This suggests that control of Sterling M3 through a device such as the corset is probably not effective as a counterinflationary weapon, even supposing such a policy could be made permanent.

The impact of savings

In any econometric exercise, it is possible to raise doubts over whether the relationships estimated on average over some time period are truly stable over the whole period. In our particular exercise, there is the specific suggestion, made in the 1981 Financial Statment, that changes in the savings ratio modify the way broad money growth affects inflation. If in one year Sterling M3 growth is fast, but savings high, the Treasury argues that subsequent inflation will be lower than the value it would have taken if savings had been low. If we add past levels of the savings ratio as additional explanatory variables (Panel 3, Equation 8), these new variables should if the Treasury hypothesis is correct - significantly improve the level of explanation of inflation, and should appear with negative coefficients. A formal test of whether the unexplained variation in inflation - the 'residual sum of squares' - left after the effects of money growth had been removed could be reduced by including past savings is shown on Table 7. The F-statistics shown in the last column have to be at least 2.3 for any significance to be attached to the savings ratio.

TABLE 7 SAVINGS IN THE INFLATION-MONEY RELATION

DEPENDENT VARIABLE	MONEY MEASURE	RESIDUAL SUM OF SQUARES WITH PAST MONEY GROWTH ONLY	RESIDUAL SUM OF SQUARES WITH PAST MONEY AND PAST SAVINGS	STATISTICS F(6,39)
INFLATION	M1	1535.2	994.9	2.29
	STERLING M3	1242.3	898.7	1.80
	PSLI	1096.0	801.5	1.75

In practice, then, when this sort of regression was performed, the savings ratio only improved the fit of the M1 regression. Moreover in this regression the savings ratio entered with a positive coefficient. That is, if M1 has been growing slowly, but savings growing fast, inflation will be faster than M1 growth would predict. This is precisely the situation in 1980, and our results suggest that hopes for low inflation based on asset accumulation arguments are likely to be fallacious.

The reason for this perverse result is simply that the savings ratio is rising and falling with interest rates, just as Sterling M3 and PSL1 rise and fall relative to M1. So, together, M1 and the savings ratio are proxing the behaviour of the behaviour of more efficient measures of money. This is the only role for the savings ratio in the money-inflation relation, and it is precisely the opposite of that claimed by the Treasury.

The exogeneity of money

What these statistical results show is that money growth can be used to some degree to predict future inflation, and that a broad aggregate, such as Sterling M3, will be a more accurate and more stable predictor than a narrow aggregate. Thus Sterling M3 is a suitable candidate for an intermediate policy target. It does not, however, follow that money 'causes' inflation, or that control of the money stock is a sensible or feasible policy. The apparent relationships between Sterling M3 and inflation might, for example, be due to the authorities accommodating increases in money demand as a result of expectations of future inflation. Equally, the money stock might prove to be uncontrollable, and be determined partly by the response of the banking system to the demand for money - a belief prevalent among Keynesian economists.

One way to test for these 'causal' relationships is to find out if past money growth can explain <u>unanticipated</u> changes in inflation; if it does then the money growth cannot have been the positive response to expectations of higher inflation. The 'exogeneity' of money - the independence of the money supply from developments in the economy - could be established if past movements in, say, prices played no part in explaining <u>unanticipated</u> movements in the money stock; if they did not, then the current behaviour of the economy does not 'cause' future money growth.

In testing for these relations, we have assumed that expectations about inflation and money are formed in any quarter on the basis of movements of these series over the preceding twenty quarters. These correspond to Equations (9) and (11) in Panel 3. We have then added the past twenty quarters' money growth and inflation to the equations for inflation and money growth respectively - giving equations (8) and (12) - and tested to determine whether these new variables contribute significantly to the explanation of inflation or money supply behaviour. The answers are summarised on Table 8, in the form of F-statistics, based on the reduction in the sum of squared residuals following the introduction of variables other than lagged dependent terms. These F-statistics should exceed 2.3 if any causal significance is to be attached to the relations between inflation and money growth. The results can be summarised simply. Of all the money definitions used only PSL1 (and hence, probably, an adjusted Sterling M3 series) can be construed as 'causing' subsequent inflation. None of the money stock measures, however, is 'caused' by past or current inflation so it is certainly wrong to think of the money stock as responding passively to any demand due to price level changes.

TABLE 8 MONEY AND INFLATION: CAUSALITY TESTS

DEPENDENT VARIABLE	INDEPENDENT VARIABLE	RESIDUAL SUM OF SQUARES WITH		STATISTICS
		LAGGED DEPENDENT	LAGGED DEPENDENT PLUS CURRENT AND LAGGED INDEPENDENT	F(6,39)
INFLATION	M0	1159.5	975.4	1.22
INFLATION	M1	1159.5	1050.2	0.68
INFLATION	STERLING M3	1159.5	965.4	1.31
INFLATION	PSL1	1159.5	775.3	3.23
INFLATION	PSL2	1159.5	1016.0	0.92
M0	INFLATION	2794.3	2285.2	1.44
M1	INFLATION	3026.9	2810.8	0.50
STERLING M3	INFLATION	1299.9	1029.3	1.71
PSL1	INFLATION	1606.4	1267.5	1.74
PSL2	INFLATION	782.9	670.1	1.10

SECTION V - CONCLUSION

THE EVIDENCE OF THE PAST 18 YEARS POINTS TO STERLING M3 BEING A BETTER MONETARY INDICATOR THAN M1. THIS OBSERVATION MEANS, HOWEVER, THAT THE BEHAVIOUR OF THE ECONOMY IN 1980 CANNOT BE EXPLAINED IN A SIMPLE WAY BY CLAIMING THAT MONEY WAS TIGHT. WHY, THEN, IF MONETARY POLICY WAS EASY IN 1980, DID INFLATION FALL, OUTPUT FALL, AND UNEMPLOYMENT RISE? THE ANSWER IS THAT MONEY GROWTH AFFECTS PRICES ONLY WITH A LAG; AND THAT WHILE MONEY GROWTH HAS A SHORT TERM INFLUENCE ON REAL ECONOMIC ACTIVITY, IT IS NOT THE ONLY EXOGENUOUS SHOCK TO WHICH THE U.K. ECONOMY IS SUBJECT.

THE FIRST POINT IS, THEN, THAT IT TAKES A YEAR OR TWO FOR CHANGES IN MONEY GROWTH TO MAKE A SIGNIFICANT IMPACT ON THE RATE OF INFLATION. THE FALL IN THE RATE OF INFLATION IN 1980 REFLECTED, NOT CURRENT MONETARY GROWTH, BUT THE GROWTH THAT HAD OCCURRED IN 1978 AND 1979, WHEN THE RATE OF GROWTH OF AN ADJUSTED STERLING M3 MEASURE FELL FROM 18 PER CENT TO 14 PER CENT. BY THE SAME TOKEN, THE RATE OF INFLATION OVER THE NEXT YEAR OR TWO WILL BE SIGNIFICANTLY AFFECTED BY THE RISE IN MONEY GROWTH IN 1980 - AN AWKWARD FACT WHICH THE BUDGET ARGUMENTS ABOUT THE BEHAVIOUR OF SAVINGS WERE DESIGNED TO OBSCURE.

THE FINAL POINT IS THAT THE OUTPUT RECESSION IN 1980 HAD SEVERAL CAUSES. FIRST, EVEN THE HIGH MONEY GROWTH WAS SLIGHTLY LESS THAN THE AVERAGE RATE OF INFLATION, SO THERE WAS A FALL IN REAL STERLING M3 BALANCES. THIS DID CAUSE INCREASED SAVINGS, AND DEPRESSED DEMAND IN THE ECONOMY. BUT THE SIZE OF THIS 'REAL BALANCE EFFECT' WAS VERY SMALL. SECOND, THE HIGH REAL EXCHANGE RATE AND HIGH REAL INTEREST RATE UNDOUBTEDLY DEPRESSED EXPORT AND INVESTMENT DEMAND. NEITHER WAS DUE TO TIGHT MONEY. THE EXCHANGE RATE ~~WAS~~ INSTEAD BUOYED UP BY ITS ATTRACTIVENESS, AS A PETROCURRENCY, TO FOREIGN INVESTORS HEDGING AGAINST OIL PRICE UNCERTAINTIES; AND

INTEREST RATES WERE SIMPLY DRIVEN UP BY THE WEIGHT OF THE GOVERNMENTS OWN, MASSIVE, BORROWING. AGAIN, HOWEVER, THESE EFFECTS WERE NOT LARGE. EXPORTS STILL ROSE, IMPORTS ACTUALLY FELL, AND PRIVATE INVESTMENT FELL ONLY 1.5 PER CENT.

THE REAL PROBLEM IN 1980 WAS THAT ALL OF THE NEW DEMAND GROWTH IN THE ECONOMY, AND MORE, WAS MET FROM STOCKS, AND NOT FROM CURRENT PRODUCTION. THESE STOCKS HAD, IN TURN, BEEN BUILT UP IN 1978 AND 1979, WHEN MONEY GROWTH WAS HIGH, AND PRODUCERS THOUGHT THEY WERE FACING A GROWING REAL DEMAND FOR THEIR GOODS. IN FACT, THE DECEPTION WROUGHT BY THE IRRESPONSIBLE MONETARY AND PRICES POLICIES OF THE LAST GOVERNMENT DID IN A VERY REAL SENSE CAUSE THE RECESSION WHICH MANY COMMENTATORS ARE ATTRIBUTING TO THIS GOVERNMENT, BY INDUCING A MASSIVE STOCK CYCLE. IT WOULD INDEED BE IRONIC IF THE LESSONS OF HISTORY WERE NOT LEARNT, IF THE OFFICIAL EXPLANATION FOR 1980 GAINED CURRENCY, AND THE EXPERIENCE OF THE PAST YEAR WERE USED AS AN EXCUSE FOR A RETURN TO MONETARY INDISCIPLINE.

PANEL 1 DEFINITIONS OF MONEY

DATA	DEFINITION	SOURCE
Monetary Base (M0)	M0 = notes and coin in circulation with the public and Bankers deposits at the Bank of England	Statistical Abstract and Bank of England Quarterly Bulletin
Money Supply (M1)	M1 = notes and coin in circulation with public and UK private sector sterling sight deposits.	"
Money supply (£M3)	£M3 = M1 and UK private sector sterling time deposits and UK public sector sterling deposits.	"
PSL1	PSL1 = £M3 and other money market instruments (Treasury bills, Bank bills, Deposits with Finance houses) and Total (gross) certificates of tax deposit.	Financial Statistics
PSL2	PSL2 = PSL1 and Net Savings deposits and securities, and total (net) certificates of tax deposit.	Financial Statistics

PANEL 2 : MONEYS, INTEREST AND SAVINGS

SYMBOLS

$M1$ = Money Stock, M1 definition
$M3$ = Money Stock, M3 definition
W = Total Wealth
Y = Income Flow = Change in wealth
S = Savings flow
R = Interest rate on 3-month Sterling Certificates of deposit
T = Time in quarters

PORTFOLIO BEHAVIOUR

$$\frac{M3}{W} = A_3 \mathrm{EXP}(B_3 T)\mathrm{EXP}(C_3 R)\, W^{D3} \qquad (1)$$

$$\frac{M1}{W} = A_1 \mathrm{EXP}(B_1 T)\mathrm{EXP}(C_1 R)\, W^{D1} \qquad (2)$$

$$C_3 > 0 > C_1$$

$$D_3 > D_1$$

ESTIMATING EQUATION

From (1) and (2)

$$\frac{M3}{M1} = \frac{A_3}{A_1} \mathrm{EXP}\{(B_3 - B_1)T\}\mathrm{EXP}\{(C_3 - C_1)R\} W^{D_3 - D_1}$$

HENCE

$$\mathrm{LOG}(M3) - \mathrm{LOG}(M1) = \mathrm{LOG}\ (A_3/A_1) + (B_3 - B_1)T + (C_3 - C_2)R + (D_3 - D_2)\mathrm{LOG}W \qquad (4)$$

DIFFERENTIATING WITH RESPECT TO TIME

$$M_{3T} - M_{1T} = B + C(R_T - R_{T-1}) + D(W_T - W_{T-1}) \qquad (5)$$

ECON POL

30.3.81.

GOVERNMENT VIEWS ON THE STATEMENT BY 364 ACADEMIC ECONOMISTS

MS

The Government has read with interest the four points to which these 364 economists subscribe. The Government, however, agree with the substantial school of economists which do believe that there is a strong connection between monetary growth and the rate of inflation, and has itself set out its thinking on this in evidence to the Treasury Select Committee. So far as output and employment are concerned, the Government's supply side policies have been designed with the objective of raising both output and employment specifically in mind. But experience has shown that injections of monetary demand can at best have a limited effect, and are ultimately counter-productive.

For these reasons, the Government totally disagrees with the assertion that present policies will deepen the depression and weaken the UK's industrial base. Countries pursuing policies broadly of the kind being implemented here are those with the strongest industrial base.

It is conspicuous that although the 364 economists assert that there are alternative policies, they are unable to specify any such agreed alternatives.

H M TREASURY
PARLIAMENT STREET
LONDON SW1P 3AG
01-233 3415

/81

→ T.L. Thanks — I had in fact seen this in draft some weeks ago

INQUIRY MARCH

THE BATTLE OF BRITAIN

Mr Hoskyns —

to see

TL

Maggie Thatcher is fighting an undeclared war against her own economic philosophy, and the British people are the losers.

By JOHN O'SULLIVAN

AFTER ALMOST TWO years of Tory government in Britain, the question that must now be asked is: Will Margaret Thatcher ever attempt to carry out her announced policies of reducing public expenditure, cutting taxes, slimming down subsidies to both nationalized and private industry, and reforming the unique legal privileges of the trade unions? This question must surprise those who innocently assume that Thatcher, in the fearsome guise of Attila the Hen, has been ruthlessly imposing these policies on a nervous country, a cowed civil service, and a queasy cabinet. Indeed, most Americans must by now believe that these policies have not only been tried but been proven a spectacular failure, entangling in their collapse Professor Milton Friedman, the *Wall Street Journal* editorial page, President Ronald Reagan, and assorted enemies of social justice around the globe.

The appropriate conclusion to draw from this is that most reports in the American press about the "Thatcher experiment" are inaccurate to the point of fiction. A typical example—Anthony Holden pronounced confidently in the *New Republic* that "Thatcher's election promises in 1978–1979 were very similar to those of the Republican candidate in 1979–1980: reduce government spending, eliminate waste, cut back the bureaucracy, tighten control of the money supply. For all of Thatcher's patent sincerity in applying what she thought appropriate, if painful, remedies, none of them have worked."

If this passage means that Thatcher actually did reduce state spending, tighten control of the money supply, and the like, then it is simply false. As we shall see, since May 1979, government spending has increased and control of the money supply has been loosened. This makes nonsense of Holden's claim that "none of them have worked." None of what—the rhetorical pledges or the actual policies? The great flaw in U.S. reporting has been to concentrate on the speeches of Tory ministers in praise of free enterprise and "monetarism" without peeking behind their words.

When once the grim statistics are inspected, a very different picture emerges. Let us first examine what critics are pleased to call "Mrs. Thatcher's dogmatic adherence to monetarism." It is certainly true that both Thatcher and the chancellor of the exchequer, Sir Geoffrey Howe, came into office convinced that inflation was a monetary phenomenon and determined to reduce it by gradually winding down the rate of increase of the money supply. It is also true that in March 1980 the chancellor set target growth rates for the money supply for the next four years. But there the dogmatic adherence ended.

Target rates and good intentions notwithstanding, the money supply has lunged wildly out of control. Last year, for instance, the target was an increase within the range of 7 to 11 percent. The actual increase was a horrifying 20 percent. This is higher than in most of the Labour years—but Denis Healey, the former Labour chancellor, still denounces "punk monetarism."

The reasons for this failure are interesting and undermine the widespread contention that Friedmanite monetarism is at the bottom of Britain's economic troubles. Of the various techniques of monetary control, the one most favored by orthodox monetarists is control of the monetary base, that is, the amount of loanable funds available to banks. This method was firmly opposed both by Treasury civil servants, who have always been skeptics about monetarism of any kind and regard monetary base control as the most extreme form of that heresy, and by the governor of the Bank of England, who is a closet Keynesian. Under such pressures the government selected instead the much more complex technique of controlling five different determinants of credit, most notably the public sector borrowing requirement (PSBR), which is Mandarin English for the government deficit.

Of this method Professor Friedman told a committee of MPs last June: "I could hardly believe my eyes when I read the first paragraph of the summary chapter [of the government's Green Paper on monetary policy, published in March 1980]: 'the principal means of controlling the growth of the money

JOHN O'SULLIVAN is the editor of Policy Review. *He formerly wrote editorials and a column on Parliament for the London* Daily Telegraph.

supply must be fiscal policy—both public expenditure and tax policy—and in-[illegible]t rates.' Interpreted literally, this sentence is simply wrong. Only a Rip Van Winkle, who has not read any of the flood of literature during the past decade and more on the money supply process, could possibly have written that sentence." Of the many difficulties with the government's approach, perhaps the most important is that, as the Green Paper itself admitted, "it is impossible to forecast the PSBR . . . and very difficult to control it closely."

That has turned out to be a vast understatement. The original March 1980 forecast of the deficit, on which the monetary target was in part based, was \$20.4 billion (all dollar figures reflect an exchange rate of £1 = \$2.40). By November of 1980 it had been revised to \$27.6 billion, or about 5 percent of Britain's gross domestic product (GDP). And in a recent speech to Zurich bankers, the financial secretary to the Treasury, Nigel Lawson, hinted that the final figure was likely to be higher still. Economic commentators now seem to expect it to be about \$30 billion. In short, the government deficit, which is the centerpiece of the strategy for controlling the money and thereby gradually diminishing inflation, has gone wild, throwing the entire monetary strategy out of kilter—as orthodox monetarists had long warned.

And why has the government deficit bolted out of control? Most commentators (and even some ministers) now agree that the government's most serious economic error has been its failure, despite four bites at the cherry since May 1979, to cut state spending. What, then, is one to make of those heart-rending stories of nursery schools being shut down for lack of staff? One clue is that in the vocabulary of long-term planning of public expenditures, a "cut" may be simply a reduction in the allocation for some future program. Such cuts are merely disappointed aspirations. And since Labour's spending plans were inordinately optimistic, conceived with the 1979 election in mind, savage cuts could be made without touching any existing programs whatsoever.

That is not, however, a firm guarantee against nursery-school closings or the abandonment of half-built municipal swimming pools. Bureaucrats in town halls and in Whitehall are quick to ensure that, whatever else is sacrificed to economy, it will not be their jobs or the size of their staffs. Hence, in the series of public spending cuts since 1975, overall government expenditure remained static while capital spending was cut by 50 percent. This has meant, ironically, that the jobs axed were largely in the private sector, among construction and manufacturing companies supplying the government, leaving proportionately more civil servants to administer worse and worse services.

Even so, the government leashed its savagery, proposing merely to "stabilize" public spending for the years 1979–81, and then to reduce it year by year to achieve a 4 percent real reduction in public spending by 1984. What made this project dubious was the convenient arrangement of the cuts: piffling cuts timidly proposed for the here and now; large reductions confidently forecast for the hereafter of 1983–84. Worse yet, even the immediate spending reductions sought by Thatcher ran into a deadly political crossfire within her own cabinet. In July 1979 Thatcher and Howe asked for spending reductions amounting to \$19.2 billion; the compromise that emerged from the cabinet was a mere \$8.4 billion. Still more significant was the episode in November 1980 when the Treasury, with the full backing of the prime minister, demanded \$4.8 billion worth of cuts. The cabinet responded with a stinging rebuke and cuts of only half that figure, a real rebuff to Thatcher's power to direct economic policy.

If cuts were small, however, unanticipated rises in current government costs were large. The most striking example in 1979–80 was the sharp increase in the public sector wage bill. This reflected the lavish pay awards determined by a special commission chaired by Hugh Clegg, which was set up by the Labour government on its deathbed. The awards reflected the assumption that public sector workers should be paid on the basis of "comparability" with the private sector, ignoring the unique job security and indexed pensions enjoyed by public employees. According to official estimates, these pay rises added \$4.8 billion to public spending in a full year. But this was a case of a very large chicken flapping home to roost. Thatcher herself had promised in Opposition to honor the commission's awards on the straightforward political calculation that to do otherwise might lose the votes of public sector workers.

In the present financial year, 1980–81, public spending has been sharply increased by the larger than expected rise in unemployment. Every loss of 100,000 jobs in the private sector adds approximately \$1.2 billion to the government deficit as income tax receipts fall and social benefits are paid out. (Public sector unemployment creates a slight surplus in the exchequer—but there hasn't been much of that.)

The net result is that by every possible test—in constant prices, in money terms, in volume, as a percentage of national income—*public spending has increased under the Tories*. The increase in real terms may be modest, between 1 and 2 percent, but throughout this period national income has been falling, so public spending comprises a significantly larger share of it. According to the official *Economic Trends* (December 1980), public spending as a percentage of national income rose from 45 percent under Labour to 49 percent in the second quarter of 1980.

Ironically, the jobs axed under Thatcher have been largely in the private sector, leaving proportionately more civil servants to administer worse services.

SINCE THATCHER IS not a supply-sider, this failure to control public spending produced a cautious policy of increases in the tax rate. Tax revenues, as a result, continue to rise. At the time of the budget the total tax take in 1980–81 was estimated to be approximately \$149 billion, up from \$120 billion for the financial year 1979–80. But that was before the November mini-budget, which added in a full year another \$2.4 billion in national insurance contributions (a euphemism for taxation), with an additional \$2.4 billion extracted from the oil companies in petroleum revenue tax. As a percentage of national income, state revenue (taxes plus charges for state services) rose from 41.3 percent under Labour to 43.3 percent in the first six months of 1980. The November measures mean it has risen still further.

So much for the macroeconomic legends, but what of other aspects of economic and industrial policy? After all, inflation and runaway government spending are relatively recent (post-1972) complications of the British disease. The most pronounced and persistent symptom has been simple industrial inefficiency, i.e., the same size workforce producing half as much as in the United States. Postwar British government policy has seriously aggravated this in a number of important ways. State influence over the direction of public and private investment—to subsidize inefficient nationalized industries, to save "lame duck" companies from bankruptcy, to preserve jobs in failing industries, to assist regions with below-average income levels—has led to a massive misallocation of scarce investment capital. Britain's uniquely permissive laws on labor unions, which allow almost no legal redress to employers, union members, or members of the general public who are harmed by union action, have encouraged industrial overmanning and restrictive labor practices. And the British economy, like the American, is littered with boards, commissions, licensing agencies, and regulations that keep new competitors out of the market.

HERE AT LEAST THE Thatcher government can boast some modest achievements. It abolished the commission that had administered price controls since 1972, through the period of the largest rise in prices in British history. It has taken a few tentative and nervous steps in the direction of returning some of the nationalized industries to more efficient private hands: selling the hotel subsidiaries of British Rail and making provision for the sale of shares in British Airways (though not yet putting the shares on the market). "Lakerization" of the long-haul bus routes has brought fares tumbling down as minibus owners rush to compete with established operators. And one economic reform should especially appeal to advocates of economic freedom: Sir Geoffrey Howe abolished at a stroke the system of exchange control that since 1939 had placed severe restrictions on the right of British citizens to invest abroad or even to take out money when emigrating.

The British economy, like the American, is littered with boards, commissions, and licensing agencies that obstruct the entry of new competitors into markets.

Against these modest successes, however, must be set a major failure of nerve, associated, oddly enough, with the government's most controversial minister—Sir Keith Joseph in the Industry Department. Joseph entered office with a reputation as a born-again monetarist who had publicly repented his statist and Keynesian sins in past public office. He announced that, although a Tory politician for over twenty years, he had "only recently become a Conservative." In Opposition, he had ranged up and down the country preaching the gospel of sound money, private enterprise, the signaling function of prices, the folly of state control of investment, the futility of job subsidies and aid to "lame duck" companies, and the like. For every unprofitable job temporarily shored up by subsidies, he argued, a worthwhile job is destroyed through the burden of the extra taxation or borrowing needed to finance the subsidy. He called this process "Dracula economics."

But in office Joseph has been born yet again, this time as a statist tycoon. In the words of one disillusioned Tory MP, "he wrings his hands and pays out." There was some early talk, for instance, of gradually withdrawing subsidies to nationalized industries to force them to compete. But the figures (at constant prices) for external financing of nationalized industry show a spectacular increase. In Labour's last full year, 1978–79, expenditures under this heading were $5.7 billion; in the first year of Joseph's tutelage, the sum rose to $6.3 billion. At the time of the March budget it was planned that the figures for 1980–81 would be almost stabilized at just over $6.3 billion. But during the year, various nationalized industries got into such dire financial straits that the "cash limits" on their borrowing had to be raised by $1.4 billion—an increase of almost a fourth of Labour's total.

British Steel is a dramatic illustration of how the problems of nationalized industries gradually draw ministers from the path of financial virtue. In 1979–80, subsidies to the British Steel Corporation amounted to $1.7 billion. The target figure of $1.08 billion was laid down for 1980–81. Indeed, the government fought a steel strike to resist union demands for easing these financial constraints. But faced with the prospect of the BSC being unable to pay its bills, Joseph has since added another $1 billion in subsidies—to make a grand total of $2.3 billion for 1980–81. As Thatcher wisely observed in Opposition, "We don't own the nationalized industries; the nationalized industries own us."

This economic truth may soon be reaffirmed in a big way. Leaks from Whitehall suggest that, in response to a request from Ian MacGregor, the chairman of British Steel, the government is considering fresh financial assistance for the "MacGregor Plan" of reorganization. It is proposed that the government should "write off" previous capital debts to the tune of $6.5 billion and provide new loans of $1.8 billion. In addition there is now talk in government circles of "redrawing the line between the public and private sectors in Steel." This is again discreet Mandarin English for subsidizing the private sector. Private steel firms are in trouble because of the recession and, ironically, because of underpricing by the subsidized BSC.

But we must not ignore the large and growing subsidies to private industry. In 1980–81, subsidies for regional development alone were set at $1.3 billion. In fact, the total is now expected to be considerably higher because some regions have been "upgraded" into aid recipients as a result of the recession. Such policies represent a vast waste of scarce investable resources. And the burden that they impose on the economy is higher today than it was under Labour. This largesse also makes nonsense of, for instance, Leonard Downie's claim in the *Washington Post* (February 1, 1981) that Thatcher's policies represent "the survival of the fittest."

We must seek the explanation in politics rather than economics. It is politically very difficult to resist the clamor for subsidies in time of recession. The claim is that denial of a subsidy means the bankruptcy of the company—interpreted as not merely the reallocation of its assets, but as its disappearance into thin air, leaving all its employees (and *every* employee of *any* firm that *ever* provided it with goods and services) permanently unemployed. If the government ventures to contest this logic, marches are held, Joseph is hanged in effigy or personally splattered with tomatoes, parliamentary debates are suspended following disorders (Labour cries of "Shame," "Resign," "Butcher," "Suez"), and Tory "Wets" (an old Tory term, originally meaning weak or appeasing, now signifying moderate opposition to Thatcher's supposed hard line) worry publicly about the dangers of social unrest. Eventually the money is paid out.

As the minister concerned, Joseph must accept the principal responsibility for the runaway rise in subsidy costs. Yet the political reality is, as President Carter might have put it, more complex. Behind the scenes, Joseph bitterly opposed a recent vast award to British Leyland, the nationalized auto firm. It was Thatcher who insisted on the authorization. In the words of the *Economist*'s fictitious but shrewdly observed *Diary of A Wet*: "The nationalized industries are much older hands at this game than we are: they force a confrontation with their unions, cover themselves in right-wing virility to get M purring appreciatively, and then, bang, in comes the bill. Michael Edwardes (chairman of British Leyland) is brilliant at it. . . ." And so, apparently, it ran on this occasion. For this installment comes close on the heels of a strike at one of the Leyland factories, which Edwardes strongly opposed; it ended well for him when the workers voted to return to work in defiance of their shop stewards' advice.

AND WHAT OF THE actual economic consequences of Thatcher? Is there a similar chasm between report and reality? Here the answer must be that although Britain's economy is in serious recession and the suffering is real, there is not the unrelieved economic disaster that some critics report. What is wrong can be easily stated. Production is down and falling; bankruptcies are at record levels; unemployment has reached a postwar high of 10 percent of the labor force; and most forecasters predict that these conditions will worsen in 1981.

But unmistakable shoots of economic improvement are thrusting up through the gloom. The most heartening is the rate of inflation. After reaching a peak of almost 22 percent in May 1980, the year-on-year rate is now 15.1 percent. When Labour left power the inflation rate was rising rapidly; today it is falling fast. In the last six months, for instance, prices rose a mere 4 percent, for an annual rate of 8.4 percent.

The second encouraging sign is that, without benefit of a formal incomes policy, late in 1980 unions began settling for much smaller wage increases. British Leyland workers accepted a 6.8 percent boost; two million engineering workers settled for a rise of 8.2 percent; even the much-feared miners agreed to a formula yielding something around 12 percent—about 3 percent below the year-on-year inflation rate. This self-restraint on pay is only one of several indications of greater economic realism on the shop-floor. During 1980 there was also a reduction by two-thirds in the number of man-hours lost in strikes and industrial stoppages. And throughout industry workers accepted layoffs in order to keep their factories in business.

> *When Labour left power the inflation rate was rising rapidly; today it is falling fast. In the last six months, for instance, prices rose just 4 percent.*

Despite the recession, furthermore, real living standards in Britain reached what the *Economist* called "an all-time high in 1980"; prices rose by 16 percent and wages by 22 percent. Indeed, between 1977 and 1980, real disposable income rose by an astonishing 20 percent. This makes nonsense of assertions that Britain is characterized by a "stagnant economy and falling living standards" and that "the windfall of oil revenues only prevents living standards falling more rapidly," as Barbara Goodwin wrote recently in *Dissent*. Nor is this rise in real incomes diverted unfairly from the unemployed and the old. Both pensions and unemployment payments have more than kept pace with inflation.

It is easier to recite these facts and figures than to explain them. But both the strengths and weaknesses of the British economy at present seem to result from the clash of a strong currency (itself the result of North Sea oil and high interest rates) and the high wage settlements of last year. The strong pound, for instance, has lowered the price of imports, sharply increasing the competitive pressures on British companies. In order to retain their markets at home and abroad, they have in turn cut their prices, depleted their stocks, and looked for every possible method of reducing their costs and improving productivity—a shakeout that will stand them in good stead when general economic conditions improve. In the present cold economic climate, however, this survivalism has taken a big bite out of company profits, in effect diverting income to workers in the form of the high wage settlements of last year and to consumers through the prices kept low by competition. Hence the rise in real disposable income and the rapid fall in the inflation rate.

On the other side of the coin, the high wage settlements and falling profits meant higher unemployment. Workers literally priced themselves out of their jobs. (And firms that were scarcely making a profit in the first place were priced out of business altogether and into bankruptcy.) Furthermore, the social benefits that make life more tolerable for the unemployed also tend to increase the rate of unemployment. These benefits are financed by what is in effect a tax, levied on each employed person and collected from the employer. This makes labor more expensive. Recent increases in the tax to pay for increased benefits in turn contribute to the rise in unemployment. And generous and effectively indexed benefits allow unemployed workers to be more choosy in selecting their next job, which necessarily adds to the rate of transitional unemployment.

But, again, the picture is not as gloomy as it seems. Britain's economic statistics are likely to be unduly dismal at present because of the growth of the "black" or underground economy. Sir William Pile, the head of the Inland Revenue, estimated last year that "unrecorded income" might be as high as 7.5 percent of the GNP. If the universal anecdotes about plumbers and electricians who offer a discount on bills paid in cash are accurate, then the total must be even larger. And a high level of economic activity outside the "official" economy would explain otherwise mysterious events like the record Christmas spending in supposedly distressed areas and the local conjunction of numerous job vacancies and high rates of unemployment. The Salvation Army recently opened a soup kitchen in a northern town with an official jobless rate of almost 20 percent. National newspapers on the following morning showed the two volunteer workers drinking their own soup after entertaining only one unemployed visitor the entire day.

We therefore have grounds for qualified optimism about the "Thatcher experiment." At the end of 1980, *Incomes Data* estimated that wage settlements were running between 2.5 percent and 4 percent "below the perceived rate of inflation." As inflation continues its predicted decline throughout this year and perceptions catch up with that reality, wage settlements are likely to follow downward. Indeed, this is already happening. Eventually this will reduce and then reverse the rise in unemployment. Workers will start pricing themselves *into* jobs. In short, there is the possibility in these circumstances of a "virtuous circle," in which lower inflation leads to lower money wage settlements which in turn lead to greater employment and higher real output.

To keep this from becoming a brief illusion before another burst of inflation, the government must achieve two clear objectives: reduce inflationary expectations and get proper control of the public sector. The first objective is not being achieved at present because the Bank of England continues to resist the application of clear guidelines for monetary growth and the methods that would contain monetary growth within them.

But there are signs that the government is moving to correct this. Among the chancellor's measures in November were certain reforms of the banking system that are preconditions for monetary base control. These reforms were opposed by the Bank of England and enforced only through the direct intervention of the prime minister. Still more encouraging is the arrival in Downing Street of Alan Walters, the leading British monetarist, as Thatcher's personal economic adviser. Not only does Walters have the technical expertise that is needed in internal battles with the Treasury and the Bank; he is also a man of great independence of mind, who will not hesitate to resign and return to the easier life of the World Bank and Johns Hopkins University if his prescriptions are steadily ignored. His bargaining position in government is a strong one since the financial markets would regard his resignation as an admission that inflation would never be controlled.

There are mixed signals, however, about the second objective—controlling the public sector. The main cause for pessimism has already been mentioned: Thatcher's failure to obtain her full roster of spending cuts last November. On the positive side, the Clegg commission has been abolished and the government recently went to court to deny to civil service unions even the *findings* of the Pay Research Unit that were the basis for "comparability" pay awards. Yet, if Thatcher is to control the money supply and in time reduce taxes, she must first control the size, pay, perquisites, and prices of the public sector.

WHICH BRINGS US, finally, to politics and power. To begin with, once Thatcher enters the cabinet room, she ceases to be a free woman and becomes in part a prisoner of the consensus of ministers. Had she chosen the cabinet, that might be of little moment. But no party leader chooses his or her own cabinet colleagues for the first decade or so. They are inherited from one's predecessor and can be replaced only following resignations or deaths—thus the immortal remark that in British politics, where there's death, there's hope.

Margaret Thatcher is not the Joan of Arc of free market capitalism that the more innocent American conservatives take her for—she's a politician.

Thatcher's cabinet was in the main chosen for her by predecessor Edward Heath, and its majority still bears his philosophical stamp. It is uninterested in economics, skeptical about monetarism, relatively content with the social and bureaucratic status quo (provided that the right chaps are running the show), not especially concerned about cutting public spending, and passionate only about winning the next election.

This attitude is known as pragmatism. Most ministers believe in it for the engagingly simple reasons that it justifies their spending large sums of public money, earns them newspaper headlines like "Minister Announces Massive Ten-Year Hospital Building Strategy," avoids trouble and abuse from the Labour Party and the public sector unions, spares them from painful rows with their civil servants, and seems to be a tried-and-tested way of winning elections by buying votes with the voters' own money. They are strengthened in these lazy convictions by a small group of ministers like Sir Ian Gilmour (minister of state at the Foreign Office) who have become, in effect, dogmatists of pragmatism, burrowing through Burke to find quotations hostile to economic theory per se and indeed to reasoned argument of any kind.

There was thus little prospect that Thatcher would, like Ludwig Erhard in Germany, sweep away long-accumulated economic controls and errors in a single morning. Nor was her intention anything like that. Thatcher is not the Joan of Arc of free market capitalism that the more innocent American conservatives take her for. As minister for education in the free-spending Heath government, she was one of the most extravagant. As prime minister she has carried out policies of subsidy and intervention that are supposedly anathema to the free market principles. In short, she is a politician. In the year leading up to the election, her private conversation dwelt much on the virtues of the Churchill government of 1951–55, which abolished rationing, cut taxes, denationalized the steel and trucking industries, did away with food subsidies, and steadily reduced the proportion of national income spent by the state. And it had racked up these achievements, she mused, with no major clash with the trade unions or great social polarization.

In the harsher economic climate of recent years, Thatcher could not hope to achieve her economic revolution entirely on the sly. Fierce trade union and Labour opposition had to be anticipated. But she did believe that by such political compromises as subcontracting foreign policy to the cabinet pragmatists she would be able to carry out her economic policy in a spirit of Tory unity. Indeed, the full cabinet barely discussed the broad economic strategy in the first year of her government. But the resistance of the cabinet to her plans for public sector cuts has exposed that belief as an illusion. She faces a choice between the success of her economic policy and the unity of the government.

Like the U.S. Fifth Cavalry, however, the Labour Party is riding to her rescue. The strongest argument of the cabinet pragmatists has been that the economic strategy will lose the next election; Thatcher's strongest motive for placing party unity above economic realism is to counter the Labour attack on her policies. The present chaos in the Labour Party, with left-wingers of a particularly militant and unpopular variety apparently triumphant and right-wingers threatening to split the Labour vote at the next election, reduces the force of both argument and motive. It is now politically possible for Thatcher to risk short-term party disunity in order to achieve at least the prospect of long-term economic success. We are about to learn if Thatcher really is the Iron Lady of legend. ❏

CHANCELLOR

PA

cc Chief Secretary
Financial Secretary
Sir D Wass
Mr Burns
Mr Ryrie
Mr Middleton
Mr Cassell
Mr H P Evans
Mr Unwin
Mrs Gilmore
Mr Williams

V MS

STATEMENT OF 364 ACADEMIC ECONOMISTS

I understand that the Financial Secretary may be making a short radio appearance this lunchtime to respond to the statement by 364 academic economists critical of Government policies, widely reported in today's press.

2. Sam Brittan's response to the statement (today's FT Lombard) I think strikes just the right tone. Points to make would be:

- Exercises of this sort have a long history. I recall a similar academic round-robin some ten years ago on the question of EEC membership (on which the economics profession were divided 50=50).

- As Sam Brittan notes, the statement does more to discredit the economics profession than Government policies. In fact the lack of professional consensus in regard to inflation and unemployment is nothing new.

- The list of signatories (with possible exception of Professor Meade) is predictable, with a heavy Cambridge bias.

- The statement itself is extremely short and is couched in terms of vague generalities. It says "there are alternative policies" but not what these are.

- The statement is ill-timed given the growing evidence that policies <u>are</u> reducing inflation and that the recession may be bottoming out.

- Treasury Committee Report on Monetary Policy, which drew on a wide range of academic evidence, gave support for the general thrust of Government policy, through criticising specific elements of policy.

A Williams

pp. R I G ALLEN
EB

30 March 1981

TIM LANKESTER

cc ALAN WALTERS

A. DUGUID

I cleared this with John Hoskyns last week. However, I thought I ought to send you an advanced copy so that you knew what was happening.

DOUGLAS HAGUE
30th March 1981.

PLEASE EMBARGO UNTIL 11-00 HOURS ON THURSDAY 2ND APRIL 1981

Professor D.C. Hague, Deputy Director of Manchester Business School and Adviser to the Prime Minister's Policy Unit at 10 Downing Street, spoke in Birmingham today to the Society of Chief Personnel Officers in Local Government.

He said that the economic situation in Britain today was very much like that faced by Edward Heath 10 years ago. As today, there was severe recession and high unemployment. As today, there was clamour for a complete change of policy. In the face of this clamour, it was only too easy to sympathise with Mr. Heath's decision to change course, silencing the critics. Life became so much quieter. But Mr. Heath's U-turn had been disastrous. So would one be today. This was why the government had to stand firm.

Today, the 'idiots' called for demand reflation. Heath's reflation, with Labour's help, had led to price increases of well over 20% in 1974 and 1975 and to more unemployment. Demand reflation today would lead to even bigger price increases. We understood what was going on better and responded more quickly.

Giving in to the 'idiots' would also throw away one clear benefit from the recent pressures on business. There was now greater potential for increased productivity and greater competitiveness than at any time since 1971 when the position had been similar, after a period of recession. Yet, by 1973, Heath's dash for growth had more than cancelled out the earlier gains. Productivity performance had been torn to shreds. The 'idiots' would have us do the same today. We must not.

More-refined idiots recognised the perils of excessive demand reflation, but recommended increased government investment. They urged us to repeat another error of the 1970s.

In 1970-74 (in 1975 money) British Steel had invested little short of £2 billion, and in 1975-79 a similar amount, in new plants etc. The result was not an efficient steel industry. This year, for example, we should be spending little short of another £1 billion in bailing out British Steel.

We were financing British Steel twice over. Having spent to over-expand it in the 1970s, we were spending again to slim it down, depriving private industry of funds in the process.

Professor Hague continued: 'With nationalised industries, it is all too often a case of: Pay now and pay later. Like electricity in the 1960s, steel in the 1970s provided a bottomless pit for state money - that is, our money. The railways are now being nominated as the bottomless pit of the 1980s.'

This was why the government had to scrutinise proposals for nationalised industry investment with scepticism. There was no general case against increasing public investment in recession. There were public investment projects that would give good returns. The problem was that they were rarely those that the public investment lobby had in mind. Because human beings lacked foresight, lobbies usually backed yesterday's industries, not tomorrow's. The problem with most economists and civil servants when they dealt with issues like this was not that they did not understand economics, but that they did not understand business. Britain did not need more public investment for its own sake. It needed more profitable public investment.

This explained the strategy of the Budget. Rather than giving direct subsidies to business investment, it sought to bring down interest rates and so encourage business to finance its own investment. Private business, backing its own judgment with its own money, was being encouraged, as it must be, to take the main burden in establishing the industries of the future. We must ensure that public investment did not gobble up the seed corn that private business needed.

The final legacy of the Heath era was a permanent, and unfortunate, shift in the traditional pattern of government finance. Until 1970, the central government had traditionally run a big enough surplus to finance its own expenditure and also part of the deficit of local government. During the 1960s, for example, the central government surplus covered more than 80% of the deficit of local government. Only the remaining 20%, plus the deficit of the nationalised industries, had to be borrowed.

Between 1970 and 1974, the Heath government turned a central government surplus of nearly £3 billion into a small deficit. Under Labour, the deficit grew,by 1976, to about £4 billion. Far from helping to finance local authority deficit, central government has, since then, run a huge deficit of its own. Hence today's enormous public sector borrowing. The 'idiots' had their way.

Against this background, it was sad to see a lobby, with The Guardian to the fore, seeking to legitimise huge public sector borrowing. Two points must be made.

First, in the 1960s, the public sector borrowed less than 4% of GDP. Since 1974, it had borrowed more than 8%. Worse, we had increasingly borrowed to meet current, not capital, spending. To argue that the increase in public borrowing was the sole cause of our economic difficulties would be foolish. Yet the fact was that under the traditional arrangement the economy had prospered reasonably well. Since 1974 it had not. The onus of proof was on those who supported higher public sector borrowing. Could they convince us that bigger public borrowing and poorer general economic performance were not linked?

Second, if it was now argued that a PSBR of £15 billion was quite acceptable, why not one of £25 billion? Or of £50 billion? There must be a limit somehwere. Those who were so enthusiastic about public borrowing should explain where that limit was, and why.

Professor Hague concluded: 'We have become accustomed to speak of the British disease. Its symptoms are high government spending and borrowing, high interest rates, high pay rises, high inflation and poor industrial performance. Similar symptoms are now appearing in other European countries. In Sweden the disease is chronic. In truth, this is not a British disease. It is a social democrats' disease.'

Econ Pol

PRIME MINISTER

c.c. Mr. Wolfson
Mr. Walters
Mr. Duguid

These papers suggest that we are likely to lose £150 m of receipts due to Civil Service industrial action in the March banking month, and £800 m by the end of the calendar month.

The banking figures for March are therefore likely to be little affected - particularly since the CGBR is in any case some £½ b lower for the month than was forecast only a month ago. However, I understand that bank lending to the private sector has been running at quite a high level - partly because of round tripping due to high short-term interest rates in the money markets; consequently, we cannot be certain that the banking figures for March will be good.

The estimated loss of £800 m by the end of calendar March, and presumably continuing losses in April, will put the April banking figures at risk. They will of course also mean that the PSBR for the financial year 1980/81 will be higher than would otherwise be the case. However, this has a brighter side: the delayed payment will make it easier to meet the £10½ b forecast for 1981/82.

Finally, the letter refers to large-scale assistance provided by the Bank to ease the clearers' liquidity (pressure arose because of the strong debt sales immediately after the Budget): the Governor mentioned this to you at the Mansion House.

T. P. LANKESTER

20 March, 1981.

2.

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

20th March 1981

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

Dear Tim,

I enclose the report requested about the effects of the Civil Service industrial action on the central government borrowing requirement.

You will see that the sums at risk are significant and that, if the efforts of the Revenue Departments to maintain the flow of receipts are only partly successful, the effect on the 1980-81 central government borrowing requirement will be to increase it by a large sum.

Inevitably, a substantial proportion, though a good deal less than all of the loss of receipts, will be reflected in the monetary statistics. It is, however, necessary to put these developments in the context of the general monetary picture. In the absence of any disruptive action, we would have expected the rather moderate growth of £M3 seen in the last three months to have continued.

Banking March, which ended on Wednesday, 18 March may show a seasonally adjusted deficit for the CGBR of around £900 million, some £½ billion better than we had expected a month ago. This is despite a loss of receipts of around £150 million from industrial action. In addition to a good performance of the CGBR, gilt sales and National Savings inflows have been very strong. These indicate the possibility of a low growth rate for £M3 in the month, although there is some threat to this from bank lending, which could have been inflated by round-tripping, produced by high short term interest rates in the money markets.

In the absence of industrial action, we would have expected the April CGBR, seasonally adjusted, to have been small. At the same time substantial gilt sales (including the

/indexed

indexed gilt) have already been arranged and National Savings should continue to provide strong inflows. In addition the slower growth of bank lending seen in recent months would be expected to continue.

As you may be aware, the combination in March of a good CGBR and strong debt sales produced conditions of exceptional tightness in the money markets. In response to this the reserve asset ratio was put down again to 8 per cent and the Bank had to provide a large amount of assistance, mainly through purchases of bills. Underlying conditions are likely to remain tight for most of April, making it difficult to unwind the assistance before the end of the month. It is an ironic side effect of the industrial action that the more successful it is, the more it would contribute to normalising money market conditions.

Nevertheless, the action could produce a temporary resurgence in the recorded money supply and it will make it more difficult to interpret precisely what is happening in the monetary field, as we will never be entirely sure just how much revenue is being delayed. We have gone to considerable lengths to stress the dangers in assessing the underlying growth of the money supply in relation to movements in £M3 over relatively short periods. We will keep the situation under very close review and we shall need to take great care in presenting the effects of this industrial action on the monetary position. But at present there is no reason to expect that the monetary effects will be such as to cause difficulties in a policy sense or to disrupt markets.

Yours

John

A.J. WIGGINS

EFFECT OF THE CIVIL SERVICE INDUSTRIAL ACTION ON THE CENTRAL GOVERNMENT BORROWING REQUIREMENT

1. In those Departments where there was a high response to the one day strike call on 9 March, processing of receipts and payments was delayed. However, apart from the collection offices of the Inland Revenue and Customs and Excise which have been selected for longer term action, the arrears have now been processed and there are no lasting effects.

2. Inland Revenue. After 9 March, there was no significant effect on collection of Inland Revenue until Friday 13 March. From that date, however, selective strike action has been taken at the collection offices at Shipley and Cumbernauld, the main centres for the processing of PAYE receipts and the associated national insurance contributions and surcharge receipts. In terms of receipts into the Exchequer, there was no effect until Tuesday of this week, when receipts were about £20 million less than we would normally have expected.

3. PAYE etc deducted by employers in February is due to be paid to the Inland Revenue today, 19 March. We were expecting the two centres to have processed about £1 billion of receipts in the period 18-31 March inclusive. However, some months ago, contingency plans were made under which large payers were invited to remit PAYE etc via Inland Revenue, Bush House. These arrangements seem to be working despite the pressure of pickets at Bush House. The staff associations have sought the cooperation of the banking staff associations in preventing these arrangements from working. The arrangements involve using an alternative method of payment but of a sort which already exists. They are therefore unlikely to be seen as provocative. So although the situation is delicate, the Bank of England are hopeful that the Bush House receipts will continue to be processed. And there are no signs of interruption from the clearing banks. Revenue is coming in today from the contingency arrangements but it is too early to form a clear judgement about how much we shall get.

4. Customs and Excise. Strike action commenced at the VAT Centre at Southened on 9 March. We would normally expect to receive £400 million from here in the period 18-31 March, in Consolidated

Fund terms. From Thursday 12 March, daily receipts have been up to £30 million less than expected. Shortfalls in receipts are being offset by reducing weekly VAT repayments. And receipts are also being kept up by contingency plans made by Customs and Excise on similar lines to those of Inland Revenue.

5. Total Effects in 1980-81. Up to and including yesterday, total receipts appear to be about £150 million short of the figures expected. In the rest of March receipts through the three centres affected by the selective action would have amounted to about £1,400 million. We really cannot make any firm assessment of the effectiveness of the contingency plans at this stage. With luck about half the expected receipts might be obtained. This would leave a cumulative shortfall of £800 million by the end of the month and the central government borrowing requirement for 1980-81 would be higher by that sum. We should have better information and will report again, by the middle of next week when we can assess the effectiveness of the arrangements for getting in Inland Revenue receipts.

6. 1981-82. If the action continues into April, the VAT effects may be considerably more severe. Total VAT receipts in the first month of a quarter are normally about twice the total receipts in either the second or third month. April PAYE and related receipts are usually of the same order as March receipts, with similar peaking after the 19th of the month.

7. Once the dispute is settled, any shortfall as at 31 March will be recovered in 1981-82, reducing the CGBR for that year. The delay will, however, result in a minimally higher total for the two years taken together; because interest will have to be paid for the relevant period on any extra borrowings.

19.3.81

With the Compliments
of the
Chancellor of the Exchequer's
Private Secretary

Treasury Chambers,
Parliament Street,
S.W.1.

c. Mr T P Lankester, No 10
Is the PM now content for this to be published?
JW 19/3

Mr Ridley

cc Principal Private Secretary
PS/Financial Secretary
Sir Kenneth Couzens
Mr Burns
Mr Britton
Mrs Lomax
Mr Walters) No 10
Mr Wolfson)

NIEHANS

You were asking when the Niehans study was likely to be published. I have had a word with Alfred Sherman. He said that he now had a more or less satisfactory text, but there were still some points to be resolved. He expected to be distributing the study sometime in the next 3-4 weeks, but he could not be more precise than that. He will let us have a copy of the final version, but in substance it is said to be very little different from the earlier draft.

PEM

P E MIDDLETON
18 March 1981

Spoke to W. [illegible]

PART 7 ends:-

12.3.87

PART 8 begins:-

18.3.87