

G.P.S.

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12. 7.79

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PM's Seminar

The God's name

Review a copy of my ^{final Bk} (draft)

Cover note to the Stearns
brief.

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Perpetually examining these propositions in exhaustive empirical detail, in an attempt to refute so self-evident a truth, becomes either a waste of time or an exercise akin to Potemkin's construction of villages.

2. The price mechanism, at least in the way we use it, seldom works smoothly or quickly. Yet it requires the establishment of politically difficult price levels. This country being what it is, and because of the propositions in 1 above, much further time and technical ingenuity very naturally gets spent in trying to invent a 'reformed' monetary system that will somehow obtain the required results more reliably and promptly, and in a more politically acceptable way, without the need for corsets. 'Monetary base control' is one of the

[Draft]

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The God has seen

PRIME MINISTER'S MONETARY SEMINAR

Participants' desks are already piled high with so much paper for this meeting that it would seem cruel to add any more to your own particular heap. But there are two or three broad platitudes that I feel I must get off my chest, by way of backdrop to the seminar.

1. It is right and helpful to remind ourselves, ahead of a more abstract argument, that we have to conduct our monetary policy within one of the two broadest national wholesale money markets in the world. Round this market, money (and near money) flows like water; and like water it not only seeks to find its own level, but finds its own way round artificial obstructions. Furthermore it is itself directly linked, and the more so as exchange controls are relaxed, to the international 'xenomarkets' in wholesale funds. All this must tell us that economically meaningful central bank control over British monetary expansion, as opposed to the continued fixing of some particular monetary statistic, has to be effected overwhelmingly through the price mechanism - that is to say, interest rates and exchange rates. Consequently, attempts to do so by 'direct' controls on banks, or by such direct controls on inflows of exchange as may be practicable, are inclined to prove foolish and institutionally damaging.

Perpetually examining these propositions in exhaustive empirical detail, in an attempt to refute so self-evident a truth, becomes either a waste of time or an exercise akin to Potemkin's construction of villages.

2. The price mechanism, at least in the way we use it, seldom works smoothly or quickly. Yet it requires the establishment of politically difficult price levels. This country being what it is, and because of the propositions in 1 above, much further time and technical ingenuity very naturally gets spent in trying to invent a 'reformed' monetary system that will somehow obtain the required results more reliably and promptly, and in a more politically acceptable way, without the need for corsets. 'Monetary base control' is one of the

latest in this class, and follows closely on the intensive enquiry made in the Bank into the possibility of arranging matters so that short-term paper, governmental or private, could more easily be placed outside the banking system when required.

Maybe unintentionally, advocacy of monetary base control may be encouraging people to imagine that it would somehow make the banks conform in freedom to the kind of behaviour which direct controls are intended to make them conform by force. Now either base control does nothing of the kind, but instead relies on an even more aggressive use of the price mechanism; or else it really does what people may be encouraged to imagine. But if it does the latter it at once falls foul of propositions about water finding its own level and finding ways round artificial barriers. That much must be clear. So although something that might go by the name of 'base control' could mostly prove to be a modestly improved version of what we have now got, for instance, if the reserve asset ratio were abolished and the existing cash ratio formulated and calculated differently, detailed and prolonged further study of multitudinous variations on the base theme may become a misdirected effort. So it would be useful if we were allowed to get on with our preparation of an improved version of the present system and did not have to wait for studies of base control to reach exhaustion.

3. Next, it is helpful to remind ourselves that British monetary policy relies heavily on debt management conducted within the money markets mentioned above and a bond market of comparable breadth and sophistication. There, the lenders are kept fully at arms length from the borrower, and a completely free market has thereby been preserved despite the strong tendency to corporatism shown in other governmental relationships both in the financial field and elsewhere. But the bulk of debt management is conducted through marketable bonds of a conventional character unindexed against inflation.

It has then to be said that there is no way in which such a bond market can be effectively shielded from sharply fluctuating fears, hopes, and uncertainties concerned with the future pace of inflation, the future rate of monetary growth, the size of public borrowing, etc. etc. But by timely adaptation of tactics and techniques, their effects can be mitigated or softened. Beyond this, there remains either a radical change in market structure or a radical change in the instrument marketed. As to the former, intensive discussion and enquiry over the past few years has failed to convince those who bear

the heavy responsibility for marketing government bonds (i.e. the Bank) that there would be worthwhile gains to set against the inherent risks. Nonetheless we are about to think through a change in structure, in confidential collaboration with the Stock Exchange, in case it were to come about for other reasons, for example as a result of the OFT reference. It would be useful if we were now left to get on with this.

4. As to a change in the instrument marketed, the arguments for and against indexation are familiar enough. 'Narrow' arguments tend to work in favour, so long as inflation remains high and volatile, while 'wider' arguments have hitherto decided against. So plans to introduce an indexed bond have never been brought to an advanced state of readiness, nor have plans to deal with various immediate consequentials. It would be useful if such plans were now made, unless HMG are obviously hostile to the whole idea.

5. By way of conclusion, I suggest it would be helpful if the seminar were to agree:-

- (i) That the Bank should be encouraged to proceed with drafting a consultative paper on the abolition of the reserve asset ratio (and concurrent introduction of a prudential norm), the possible ^{reformulation} representation and recalculation of the existing cash ratio, and the future of corsets.
- (ii) That the Bank and the Treasury should give further thought to base money control of various kinds, in case it might prove opportune to bring one or other variant into experimental use subsequent to abolition of the reserve asset ratio.
- (iii) That the Bank should be encouraged to proceed, in collaboration with the Stock Exchange, with an examination of possible changes in the structure of the securities' market.
- (iv) That the Bank and the Treasury should bring plans for the issue of an indexed bond, and the treatment of consequentials, to an advanced state of readiness.

[J.S.F.]

12th July 1979