Also at Flag J is a long paper from the Governor

R.

10 DOWNING STREET

Prime Minister

This is a mass of paper on a whole complex of interrelated issues. (I haven't yet seen several of them). But I think you should try to read through them - starting with the background note attached to this minute, and then working your way through from Flags A (You don't need to read F on nationalised industry prices) to ~~H~~ I. I will be at home if you want to discuss, and we have the briefing meeting at 7pm on Sunday.

R 10/10

SECRET

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Prime Minister

Ref. A03202

MR. LANKESTER

TL 10/10

Monetary Policy

Prime Minister's Meeting on 13th October

There is a formidable volume of paper for this meeting. What follows is an attempt to suggest how the Prime Minister might set about organising the discussion of it.

2. I think that there are three main issues, which should be separated for the purposes of the discussion:

(1) History

What went wrong with the money supply this summer; why we failed to prevent it in time to consider correcting it.

(2) Economic and monetary prospects and policies

What is the prospect for the money supply in the rest of this financial year and next? If it looks as if it will not come back into line with the path of the MTFS, should action be taken to bring it back? If so, what action?

(3) Techniques of monetary control

Should we stick to the existing principles of control and try to improve it, by improved forecasting and the adoption of different techniques for the management of open market debt sales? Or should we move to a system of monetary base control?

3. I suggest that the issues should be taken in this order, because, even if we decided in principle to change to a monetary base control, the control could not be in place in time to help us with the immediate problems of confronting the money supply. And it can be argued that differences of technique are marginal in relation to the problem of management which we face.

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History

4. The Treasury papers make the case that the path of money supply was seen but not the magnitudes. In particular the rates of increases in wages and prices and the level of the exchange rate were considerably higher than those forecast. Great efforts are being made to improve the forecasting system; but the papers warn that it will never be easy to forecast the month-by-month movement of the monetary aggregates. I suggest that the meeting should not spend too much time on this, but should move fairly quickly to the second and main item of business.

Economic and monetary prospects and policies

5. Here the questions seem to be:

(1) What are the prospects for £M3 and the PSBR over the coming months?

(2) If it looks as if they are not going to come back within the MTFS path, do we accept failure to reach the target, on the ground that further tightening would deepen the recession and strangle the corporate sector? Or do we take action to bring £M3 and the PSBR back nearer to the MTFS path, by such means as will least damage the corporate sector?

(3) If so, what action?

(a) Monetary action - in effect, pushing sales of public sector debt harder (possibly with new techniques)? What would be the effects of that upon interest rates and the exchange rate? Would those effects be acceptable, given the underlying economic and industrial situation?

(b) Fiscal action:

(i) Public expenditure - public sector pay is an important element here, but can we expect to get more out of that than keeping it in line with the rate of increase of £M3 predicated in the MTFS? Is there any possibility of reducing public expenditure sufficiently to affect the PSBR by the amount we need to effect it in the necessary timescale?

(ii) Taxation - presumably no increase in corporate taxation or in VAT. It would not be possible to increase direct taxation until next April, but an increase from next April could be

The Chancellor is considering increasing the 'health stamp' as an alternative to raising income tax

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announced ahead of the Budget (Mr. Healey did that once). But would such an increase make economic sense or be politically practicable? The remaining possibility is increased indirect taxation on alcohol, tobacco and petrol; these would have an unwelcome effect on the RPI, but perhaps less effect on pay settlements in present circumstances than might have been the case at earlier times.

(c) Direct controls on bank credit to non-manufacturing borrowers - only tolerable as a temporary measure in a near-emergency, because it would tend to increase disintermediation, and would be likely to add to problems of small businesses; but a possible source of temporary relief to the pressure on interest rates at the centre of the system?

(d) Do we want to be able to finance a given PSBR at lower interest rates, in order to diminish the pressures keeping the exchange rate and ease the squeeze on the corporate sector? If so, do we need to consider a system of two-tier interest rates, even if that means introducing inflow controls (two-tier interest rates would not be sustainable without them), either on their own or in addition to other monetary or fiscal action? If that is not thought likely to be practicable or effective, do we have to consider monetary or fiscal action for this purpose, even if it is not required to bring £M3 and the PSBR down?

Or should we try to talk the rate down, and would joining the EMS help?

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6. All these questions have to be considered in the context of the prospects for and the effects of possible measures on the underlying level of economic activity. What are those prospects? Earlier forecasts suggested that we might begin to move out of recession by the end of 1981. Is it the case that recent forecasts are more pessimistic, and see the recession continuing and even deepening into 1982? The output of manufacturing industry is expected to fall by about $7\frac{1}{2}$ per cent in 1980 and a further 5 per cent in 1981. This must imply rising unemployment and liquidations. Can we afford to risk intensifying these tendencies?

Techniques of monetary control

7. The papers tell us that several months' more work would be needed before it would be possible to start to introduce a system of monetary base control (MBC), and that its introduction would have to be gradual thereafter. So the introduction would presumably be phased over the second half of 1981 and 1982. The papers seem to favour a mandatory system.

8. A final decision to move to MBC does not need to be taken yet. But it may be possible to begin to define attitudes on it, as a basis for further work.

9. The fundamental point that seems to me to emerge from these papers is that whatever technique we adopt for smoothing the growth of money supply - whether new techniques of debt sales within the existing system, or moving to a system of MBC - implies greater volatility of interest rates. Using debt sales would imply greater volatility at the medium and long-term end; MBC would mean greater volatility at the short end. The ability of the authorities to enforce a judgment about the appropriate level of interest rates at any given time would be impaired. Are we prepared to give up, or at least significantly diminish, the capacity to manage interest rates?

10. An MBC system would involve institutional changes: changes to, probably the end of, the overdraft system in favour of fixed loans, the loss of the discount market's present role. The first would be a loss of flexibility for borrowers, and people would believe that it meant higher costs of borrowing, because they would have to pay interest on the full amount of the loan incurred, not on a day-to-day balance (they might be wrong, but it would never be possible to prove it). The loss of the discount market's present role would not matter much; but the discount houses would be looking for other business, and that brings me to the risk of disintermediation.

11. What is the risk of disintermediation with an MBC? At the extreme end of the spectrum, one could imagine the financial system developing forms of "para-money" which were not dependent upon or much affected by the monetary base. How real is that risk? What would be its consequences for monetary control, for the monetary system, and for the economy? What part would Eurocurrencies play in defeating the objectives of MBC? Are there exchange rate implications?

12. If the decision were eventually to go against MBC, what improvements can be made in existing techniques, particularly techniques of market management? The papers do not carry us much further forward on this. Should the Bank of England now be asked to do a thorough study, and report with recommendations by Christmas?

Conclusions

13. It seems unlikely that the meeting will lead to definite or final decisions. It may, however, help to narrow the choice of options, and lead to at least provisional judgments which will

(i) enable further work, both on monetary policies and on techniques, to be concentrated on the most likely ~~starters~~ starters;

(ii) colour the discussion of cash limits, EFLs and public expenditure which will dominate the meetings of the Cabinet and the Ministerial Committee on Economic Strategy in the next few weeks.

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ROBERT ARMSTRONG

9th October, 1980