CONFIDENTIAL

MR. FLEMMING 8.1.80

MR. FFORDE

Copies to Mr. Dow
The Chief Cashier
Mr. Walker
Mr. George
Mr. Foot

A CREDO OF MONETARY BELIEFS

1. You reported that the Governor had asked for a short paper to be prepared, setting out in annotated form the key views held within the Bank on monetary policy against the background of the present draft Consultative Document. I have tried to do so, though time was short and the drafting has had to be hurried.

2. The attached paper, entitled "A Digest of Monetary Tenets", sets out a small number (7) of theses on key aspects of monetary policy and monetary control mechanisms. In addition, in relation to all these tenets, a commentary, or short exegesis, is also appended, commenting on the relationship between the views of the Bank, as set out in the tenet, and the views of the Government, HMT, and other outside commentators, particularly as these differing views relate to the discussions, present or prospective, on the Consultative Document.

3. I have not put the attached document in draft form, in case you find it acceptable for putting forward to the Governor, in order to meet his desire for a short credo. If you feel that any revisions are necessary, or that it does not meet the objective at all, you might want to reconsider the drafting, in part or in whole.

CAEG

8th January 1980.

C.A.E.Goodhart

Please pass copies to:
Mr Flemming
Mr Holland

JSF 10/1

A DIGEST OF MONETARY TENETS

A. The Meaning of Money

1. There is a stable medium and longer term relationship between the rate of growth of nominal incomes and of the money stock, so that a faster rate of growth of the money stock over this time horizon will be accompanied by a faster rate of price inflation and, if the rate of monetary growth can be reduced, so also over this time horizon will be the rate of price inflation.

/This is central to both the Government's and the Bank's position. It runs, of course, into the Keynesian criticism that the short run costs, in terms of lost output, of pursuing a longer term contra-inflationary policy through 'tight' monetary policy may be unbearable. Acceptance of the above tenet is the main justification for having a monetary target; it is, however, worth noting that other financial-type targets, e.g. maintaining a fixed exchange rate, could also serve to constrain policies and with them monetary growth in the longer term./

2. There is no single 'objective' method of measuring monetary growth, which has to be assessed judgmentally. In the short run, the various indicators can diverge quite markedly, e.g. in response to changing interest rate differentials, while in the longer term structural changes, e.g. the growth of new institutions, new forms of asset, new markets, new technologies (e.g. EFTS, credit cards), can alter previous relationships. Nevertheless for control and presentational reasons it is best to have only one published target aggregate, and the arguments for sticking with the present target, £M3, remain on balance persuasive.

/The above is intellectually common ground between us and HMT. However, the step from the admitted need for judgmental assessment to having a single £M3 target is not logically very solid. Because HMT are much more committed to the maintenance of £M3, and perhaps because of some Ministers' sympathy for medium-term targetry, they are keen to brush the problem of 'choice of aggregate' under the carpet, as not being a matter for public dispute. In contrast, in the Bank draft the issue is fairly fully explored./

3. In particular, any direct control which penalises, or prevents, some channel of intermediation will distort the relationship between the controlled indicator and both other monetary indicators and the economy. This will be especially so in a highly developed financial system, as in the UK, where other substitute channels are easily available. Such substitution possibilities have been even further enhanced by the abolition of exchange controls, opening up off-shore banking. Direct controls will, therefore, both tend to reduce financial efficiency and to discredit targetry without achieving much 'real' result on the economy.

/While the above is again common ground between the Bank and HMT in relation to any prolonged or intensive application of direct controls, HMT hanker after the possibility of some occasional, partly cosmetic, possibility of access to some form of direct control to smooth away 'awkward corners'. Experience, however, shows (with ceilings in the 60s and the 'corset' in the 70s) that direct controls tend to get used in a more prolonged and intensive way than initially planned. In any case, although perhaps a change of degree rather than kind, the abolition of exchange control has made it practically much harder to devise a practicable, sustainable direct control./

B. Policies Affecting Monetary Growth

/Having rejected direct controls, tenet 3, monetary growth is affected by the standard instruments of government policy, exchange rate policy, fiscal policy, interest rate policy./

4. Exchange rate policy. In order to maintain any desired exchange rate, domestic policy changes, e.g. fiscal and interest rate changes, will have to be made that will help to determine the rate of monetary growth: per contra, the attainment of a monetary target will require policy changes that will influence the exchange rate. Although there may be some leeway, it is not generally possible to set targets independently for both the exchange rate and domestic monetary growth. Moreover, in the short run the attempt to do so would often lead to inconsistent and incompatible policy response. Thus, if the authorities were intervening in the exchange market, say to prevent an appreciation of £, the resulting inflow would tend to raise monetary growth. To check the monetary growth, the authorities would resort to restrictive

domestic policies, e.g. raising interest rates, which would stimulate then further inflows over the exchanges.

[The draft Consultative Paper is addressed to the question of achieving better control over domestic monetary growth. Yet the Government is also considering policies, joining the EMS, that would involve giving greater priority to exchange rate policy. It is not possible for the authorities to have both simultaneously, at least in a relatively small country such as the UK. At some stage a strategic choice will have to be made. Until that choice has been made, any exercise to alter domestic monetary control mechanisms and institutions stands the risk of being made invalid at a stroke.]

5. Fiscal policy. The appropriate size of the PSBR has to be assessed against the background of economic developments, cyclical and structural. There is no very close relationship between the PSBR and monetary growth. Moreover an increase in the PSBR, which tends to increase the money stock, will lead to developments, e.g. a larger investible surplus in the personal sector, lesser need for bank borrowing among companies, which in some part lead to offsetting reductions in the money stock. Nevertheless, in any given economic situation with a given monetary target, the larger the PSBR the more restrictive pressure via higher interest rates will have to be placed on the private sector in order to achieve that monetary target. The less the efficacy or the desirability of using high interest rates to constrain monetary growth, the greater the necessity for having a cautionary bias in setting the PSBR consistent with the chosen monetary target.

[While the above would be common ground among the financial side in the Bank and HMT, the aim to limit the PSBR in support of the achievement of monetary targetry runs into Keynesian criticism, also mentioned under tenet 1.]

6. Interest Rate Policy. In practice the response of the monetary aggregates, especially so £M3, to interest rate variations has been slow and uncertain. This is partly because bank lending to the private sector has been notably unresponsive to the interest rate variations that have been experienced, and partly because debt sales respond more to expectations about future interest rate developments than to their actual current level. In large part because of this slow and uncertain response, there has been considerable volatility in both interest rates

and in the pace of monetary growth. Nevertheless if interest rates are varied with sufficient vigour, they can serve to achieve desired monetary growth paths over the medium term.

While the volatility of both interest rates and monetary growth is in some large part inevitable, given the slow and uncertain response of markets to interest rate changes, both the authorities and 'monetarist' market commentators accuse the other side of making the situation worse. The authorities tend to accuse the market of panicking at short-term monetary fluctuations, which have really little significance, and thereby exaggerating both the monetary fluctuation and the necessary interest rate response. The market commentators claim that the authorities are too slow and reluctant to vary interest rates to control monetary growth - and anyway do not and cannot have the knowledge to choose the appropriate rate - and thereby allow undesirable monetary trends to emerge that subsequently require substantially larger interest rate variations to control.

[There are, perhaps, two separable issues here. The first, to which much of the discussion on monetary base control has related, concerns the method by which interest variations are made. The second, which several of us consider fundamentally more important, concerns possibilities for trying to make the response of the monetary aggregates to interest rate variations quicker and more certain. Among 'monetarist' market commentators, this latter issue leads them to query present methods of debt management. It is possible that the question of whether anything further, beyond the BEQB June 1979 article on Debt Management, needs to be said on this latter subject in the Consultative Document could be a subject of debate. The position in the Bank's draft, which could perhaps be expanded, is that the proposals therein are evolutionary, and, while perhaps of limited scope, do not preclude further steps towards changes in debt management techniques or in a closer adoption of a monetary base system, should that be so desired later, as experience of the revised system accrues.]

C. Monetary Base Control

7. As already noted, tenet 6, discussions about the desirability of monetary base control have essentially concerned the issue of how interest rate variations (for the agreed purpose of maintaining monetary control) were to be made. This is certainly the case in the US. In the UK, however, some commentators and academics have raised the possibility of using a variant of base control as a form of direct control over the banking system. This is examined in the Consultative Document in the section on Negotiable Entitlements in Annex 3, and rejected on grounds of tenet 3. There has also been a strand of thinking, exemplified by Swiss experience (and argued on occasions by the IMF), that the movements in the monetary base could become a useful leading indicator of subsequent monetary developments. Again this has been examined in Annex 3, and sufficient doubt cast on this hypothesis to make it undesirable to change the institutional structure for this purpose.

Abstracting from these other possible objectives of monetary base control, the purpose of the exercise is to remove the fixing of interest rates from the discretionary control of the authorities. The reason for advocating this was noted in tenet 6, (the authorities react too slowly and do not have sufficient knowledge to set interest rates appropriately). In its purest form (B.Griffiths), it is argued that, with the authorities setting the monetary base, interest rates should be purely and completely 'market determined'. In the Consultative Document, the Bank has argued that it is not feasible for the authorities to withdraw altogether from the process of interest rate determination, /nor, of course, has the Fed so withdrawn in the operation of its new monetary control system/. In the first place, so long as there is a mandatory reserve requirement, and the need for such is agreed by HMT and ourselves, the banks have to be enabled to meet it In practice only lagged (or conceivably current) accounting is really practicable, and under these circumstances the banks cannot meet their mandatory requirement for reserves by their own unaided actions, e.g. selling assets or bidding for funds. There is no practicable alternative to the Central Bank ultimately having to provide the requisite reserves. The choice is at what rate such reserves are to be made available.

A second, more general argument, leading to the same conclusion is that the lagged, slow response of the monetary system to interest rate changes would tend to make any system enforcing day to day, or week to week, control of monetary (base) quantities subject to excessive volatility in interest rates. While this latter is partly accepted by monetarists, they tend to argue that a combination of structural changes that could be made to the system and various forms of built-in flexibility could reduce the extent of such excessive short-term interest rate volatility.

/The Bank's position in the Consultative Document is that it is not practically or technically feasible for the Central Bank to withdraw altogether from the process of determining the level of market interest rates. Instead, it is argued that the authorities could move some way towards the position of the monetarist critics, by committing themselves to adjust interest rates to monetary divergences in a pre-determined manner, subject to over-ride.

On this important technical issue (i.e. whether, or not, the Central Bank can withdraw from interest rate determination) we have not yet been fully able to convince HMT, despite a number of discussions, and it will certainly be an important area for public discussion. Nevertheless we expect to be able, ultimately at least, to convince others that the Central Bank has to have the ability to maintain an upper limit on interest rates. Once that fundamental point is accepted, the discussion then becomes one of the modalities whereby interest rates are varied, subject to the upper limit, as monetary developments diverge from the desired path. The issues here are, perforce, somewhat narrowly technical, but we have some confidence that we could reach at least an understanding of positions, if not a full agreement, with the main monetarist commentators.

The more important strategic question, however, is whether the Government really understands and approves the basic direction of this proposal, which is directly to remove the determination of interest rates from its discretion./

8th January 1980.