CAEG I have read this Sterling stuff and made various marginal comments

SECRET 11.9.80

MR FFORDE

Copies to The Deputy Governor
Mr George

MBC

A DRAFT LETTER TO THE PRIME MINISTER

You asked me yesterday to try to set down a draft letter which the Governor might think of sending to the Prime Minister now, setting out the Bank's case as we see it. I attach a first draft of such a paper. I shall arrange for the supporting statistics, currently left blank in the draft, to be obtained as soon as possible.

Having completed the draft, it seems doubtful to me whether this, or any other letter, would probably be helpful to send to the Prime Minister at this juncture. Clearly a paper will have to be written after the 29 September conference and before the October seminar, but I have doubts whether the present letter would serve a useful purpose just now. However, despite these doubts, you may find that the letter serves as a useful base both for clarifying our own position and for future work of this kind. At the moment I am restricting the circulation extremely narrowly to yourselves.

In general I thought the first few pages pretty good. I then thought that the ~~emphasis~~ objections to monetary base control were perhaps not quite made forcibly enough. There seemed to be a tendency to fall a bit between 2 stools. There are the objections to having MBC at all, in U.K circumstances, and there are the objections to ~~having at~~ having higher interest rates at the present time. I thought that the latter tended in your draft to overshadow the former; but I may be wrong. P.T.O.

CAEG

11 September 1980

C A E Goodhart (HO-G)

JSFf 10/9 12

I think the arguments later in the draft about why higher interest rates w'd be a bad thing could be shortened a great deal. I think the PM is (or was) only interested in a temporary rise in rates associated with a change to m.b.c of some sort which she thinks would work wonders on the behaviour of banks and their customers.

Lastly I thought that the concluding passages, inviting a decision on m.b.c, implied that the Bank w'd after all accept a change to m.b.c without too much fuss and could in practice put it into operation over a matter of weeks. I think given this implication may be unwise (!)

DRAFT (10.9.80)

SECRET

September 1980

/Dear Prime Minister/

I have become increasingly concerned in the course of recent discussions that there has not been a full meeting of minds between us. I feel, unhappily, that I have not been able to present before you in full the position as I see it. Moreover, I am worried that certain interpretations of past events, which I believe to be incorrect, may become entrenched. However, while I should like to put the record, as I see it, straight, my main concern relates to the future, both in relation to likely conjunctural developments, and with respect to the wider question of monetary strategy to cope with that conjuncture.

In the letter sent by your Private Secretary to Mr Wiggins at the Treasury of 9 September, it was said that you would like to hold a further meeting on this subject in the first week of October. You will appreciate that I also believe that a further meeting, or perhaps several meetings, on this matter, are indeed necessary: I would hope that I would also have in this process an opportunity for a private audience with you and the Chancellor on these matters, either instead of, or in addition to, such meeting(s).

Recent Monetary Developments

In Lankester's letter of 9 September to Wiggins, which served also as the record of the meeting with yourself on Monday afternoon, it was stated that you felt "that the Bank had been pursuing an interest rate policy rather than a policy to control the money supply". Not having been present, I cannot judge the nuances of the discussion. Certainly, since February last winter the level of MLR has been consciously set by administrative choice, rather than allowed to vary in response to the fluctuating pattern of liquidity pressures falling on the market, for example as a result of massive movements from week to week and month to month in the PSBR. This may be all that you meant. Nevertheless I would like to emphasise two points. First, the decision both to act in this way and with respect to the particular level of MLR to maintain, was not taken by the Bank alone, but was a policy decision taken with the Chancellor and yourself. Whether right or wrong with the benefit of hindsight, it was not just the Bank's policy. Second, the choice of interest rate has continually been made with the overriding purpose, above all, of setting rates at a level that would achieve the target rate for £M3.

If you will permit me a short historical résumé, market pressures last winter, especially in February, were such as to lead to an increase in interest rates, at a time when monetary growth was still above the then target. Partly because those pressures arose from a very sharply reduced PSBR, which in turn was helping to bring down the then rate of monetary growth, we forecast at that time that no increase in interest rates was necessary in order to achieve the monetary target for 1979/80. As you will recall, monetary growth during the
but
disinterm?
winter did subside and the target was met. Shortly thereafter, with this reduction in monetary growth having become public knowledge, many commentators were arguing specifically that interest rates should come down further. We opposed that at the time, in the early spring, because again our forecasts showed a very sharp rise in the PSBR, together with continuing high

bank lending, which was likely to bring about a renewed acceleration in monetary growth.

By July, with the benefit of extremely large gilt sales, we hoped that we had overcome the worst of this rise in the PSBR and in bank lending in the early summer and, despite the foreseen short-term surge in bank lending as the corset distortions were run off, we believed that there was a good chance that the underlying rate of monetary growth would fall back again shortly thereafter to a lower level. History will no doubt now say that this was premature. Nevertheless our best forecasts still point to a reduction in the underlying rate of monetary growth in the last half year. As the economic situation was then developing, The risks seemed worth taking.

Cut to 16% [illegible]

Although the main cause of the exceptional rise in the money stock in banking July was the massive increase in bank lending, following the ending of the corset, the rise in bank lending to the private sector over the first half year has not, in practice, been greatly in excess of that forecast at the time of the summer NIF: meanwhile the PSBR seems to be running at a rate considerably above that then foreseen, indeed almost twice as fast, while sales of other central government debt, particularly National Savings, have languished. In relation to the latter, I would like to have it put on the record that the Bank has been pressing for a widened programme of sales of indexed Granny Bonds of the kind now undertaken, ever since /June/, and that I wrote to ask for this myself in my letter to the Chancellor of /‾ _/August.

I was glad that you asked the Treasury, at our meeting on Wednesday, 3 September, to send to you a regular account of their projections for the CGBR and PSBR, so that you will appreciate more clearly the

Too wide?

uncertain nature of the projections of the borrowing requirement, which we need to fund in order to maintain monetary control. Although I recognise my lack of expertise in this respect, I have to say that I am distinctly sceptical about the extent of downturn that would have to be achieved in the CGBR and the PSBR in the final part of this year, if the Budget forecast is to be achieved. Assuming that the CGBR in banking September turns out to be [£1,050] the CGBR, over the first six banking months of the year, will be [£]. This is running some [£] above the level last year. While there certainly must be some reduction in the pace of the CGBR and the PSBR in the latter half of the year, certainly in the first calendar quarter of 1981, it seems to be inherently implausible that the extent of such a change-around would be even greater than last year. My personal view is that there is a very good chance that the PSBR will end up over £10 bn., and it could well be higher.

In any case in the immediate future we look likely to be faced with borrowing requirements during the coming banking months of the fourth quarter which will, in some months at least, continue to be high. While I share the view that bank lending should moderate in future, we have been looking for just such moderation in vain for over a year. The pressures on company profits remain intense; the capital markets have not recovered to a state yet to which companies could obtain access on any much larger scale; in order to finance their deficits, and to remain afloat, companies are likely to continue seeking bank loans on a large scale. Although one clearing bank recently suggested there were signs of a lower trend in such borrowing, this was not supported by the other clearing banks, who reckon that recent bank lending trends remained unchanged.

For the immediate future, therefore, at least over the next few months, I do not see our present monetary problems simply disappearing on their own. The upwards pressures on £M3 of the PSBR and bank lending could well continue. Against this background the National Savings package will be of great help, and we must continue in the immediate future to press forward with our funding in the gilt market, even though in the longer term, when the PSBR eventually does come down towards the levels that we would all like to see and the National Savings drive picks up momentum, we would hope and intend to shift the balance of funding decisively away from gilts. /We have, therefore, announced the introduction of a new tap./

System of Control

Monetary Strategy

While you will, I hope, agree that these latter measures are both necessary and desirable, I am aware that they do not meet the main thrust of your concern and arguments that the whole basis of our monetary operations has been wrong. I hope, and feel sure, that you will accept that the interest rates adopted early this year were set for the purpose of trying to achieve the £M3 target. On that basis, recent developments in banking July and banking August would seem to underline the charge that, with the best will in the world, the monetary authorities cannot forecast developments accurately enough, or know the interrelationships within the financial system clearly enough, in order to set a level of interest rates actually to achieve the desired £M3 ~~monetary~~ target. And I must in turn admit that there is considerable force in the argument that our knowledge is not sufficient to set interest rates in such a way as to provide a reliable assurance of achieving the desired monetary target within ~~, at least within~~ a desired & a short time span.

Possibly a good idea to spike this gun earlier i.e. somewhere on p.2 say that the issues of control will be coming later in the letter?

These people also say that this w'd cause change in banks' behaviour such that availability will be restricted And .... with lower interest rates

As an alternative to this, there are many who advocate an apparently simpler procedure of fixing a controlling monetary or liquidity base, and then letting interest rates, including of course MLR, vary in line with the resulting market pressures. I can see the attractions of this proposal, but I have to say firstly that its apparent simplicity is greatly exaggerated. There are quite a number of differing versions of monetary base control, as was noted in the Green Paper, all with their varying attendant characteristics and problems. In some cases, as with most versions of mandatory base control, the adoption of such a system still in practice requires the authorities to determine the interest rate, or at any rate some maximum interest rate, at which they will ultimately provide the required monetary base to the system. And in those cases where the authorities can withdraw from setting interest rates, because the system allows more flexibility, as with a non-mandatory base system, there is very considerable uncertainty whether the relationship between the base and the money stock, ie the money multiplier, would not be so uncertain and variable, as to cause just as much difficulty and uncertainty in controlling £M3 as exists at present.

If however, a control over the monetary or liquidity base of the banking system was in practice set in such a way as to constrain the cash or liquidity below that which the banks require, the result would be that banks would bid for funds, thereby raising interest rates. There are hopes sometimes expressed that the knowledge that the availability of cash or liquid assets would be strictly limited would make the banks, or their customers, behave in such a different manner, that the resulting rise in interest rates, necessary to bring the money stock under control, would be much reduced. I have to warn you

Maybe a new subheading, to mark the change of gear, from arguments about MBC generally to questions of immediate policy?

that I, and my main officials, do not share that hope. Although banks and their customers would have to become accustomed to much more volatile interest rates, I see no reason why banks, as free market operators pursuing their own profit maximisation, as would any other company, would turn away creditworthy borrowers who wish to raise money from them. On the other hand, under certain forms of monetary base control, ie those which impose a form of tax penalty on banks, and under certain circumstances, ie when interest rates were threatening to rise very sharply, banks might simply prefer to direct creditworthy borrowers through channels outside their own business, thus leading to disintermediation, not unlike that which occurred under the "corset". [See AHC response to Gee Paper]

Straw man?

In the main, however, I would expect the result of holding the rate of growth of the cash, or liquidity, base below that consistent with meeting the credit and monetary demands of the system to be a sharp upwards movement in market interest rates. Until a decision was taken on the precise form of monetary base control to be adopted, it would be difficult to estimate how sharp the movement in interest rates might be. One cannot rule out the likelihood that, for example, refusing to continue to provide assistance, eg in the form of gilt repos to the banking system, at present would lead to a very sharp rise in interest rates, very likely above 20%, and indeed there is a possibility that the rise would continue without limit, until at some time there would have to be an administrative decision to provide the required cash at some chosen higher interest rate level. All this ~~would~~ might ~~no doubt~~ be acceptable in principle, perhaps even desirable, if there ~~were there~~ to be confidence that the sharp upwards movement in interest rates could shortly be decisively reversed, if monetary growth were then to be significantly and genuinely lower.

} or the R-A-R liquidity requirement broken

The analogy with developments in the USA earlier this year is seductive, but I have to say that the analogy is far from exact, and very different results could well take place in the UK. In the United States last winter the recession had hardly begun, outside the housing and car industries. The economy was being buoyed up by consumption (other than cars), spurred on by inflationary psychology, which showed up in the monetary figures in the form of very heavy bank borrowing by persons. Meanwhile companies, with labour costs growing at a far lower rate than in the UK, were in a much better profit position than in this country, and also were in far less need of external funds. Under those circumstances a credit squeeze aimed mainly at personal consumers (for borrowing other than for car purchase and housing, which were specifically excluded),was suitable and successful.

In the UK bank borrowing that can be identified, in part as a residual, as being for personal consumption (including for car purchase) has grown by £ mn., or % over the last year. This is considerably less than the total bank borrowing of the personal sector, because the latter includes the sharply rising borrowing by farmers and other unincorporated businesses as well as bridging loans for housing finance, etc. The total growth in bank lending for personal consumption can be compared with the growth in bank lending in sterling to the private sector overall, which during the same period has grown by £ mn., or %. Whether or not a case can be made out for further restrictions on bank lending to persons, and with consumption having fallen so sharply recently, I feel that such a case would be difficult to make now, such restrictions would only help marginally in reducing the overall rate of bank lending, since the bulk of that is now going to companies.

SE 124

In aggregate the company sector is very squeezed for funds, with a cash flow under extreme pressure. It is impossible to ascertain what proportion of bank lending takes the form of distress borrowing for companies who have no other viable source of funds to keep going. No doubt quite a proportion of bank lending is to companies who could obtain funds from elsewhere, but we believe that the proportion of distress borrowing is unusually high and rising. If further pressures are put on ~~the banks, either in the form of direct~~ their corporate customers, through controls or rising interest rates, the~~ir~~ response of the banks could well be to concentrate their funds on those borrowers who have the greatest chance of survival.

Give too much away?

Both experience and all our research studies suggest that increases in interest rates have a very uncertain and unreliable effect in dampening down bank lending to the private sector. This is likely to be especially so in circumstances such as at present, when so many companies have no alternative source of funds. Unlike the case in the US, where consumer bank borrowing could relatively easily be cut off, there is much less chance of a significant reduction in bank borrowing by companies as a result of increases in interest rates. Indeed the addition to bank borrowing arising from the higher interest bill could well match the reduction in borrowing from others who could turn to alternative source of funds.

As I emphasised earlier, I would certainly myself advise an increase in interest rates if I thought that that would now help to bring the rate of monetary growth significantly under control. Frankly, under present circumstances, I am sceptical whether it would do much, if anything, to bring monetary growth, in the form of £M3, under closer control, while at the same time it would have damaging effects on the economy. For the above reasons, I have serious doubts whether an increase in interest rates at the moment would serve to reduce bank borrowing by the private sector. It would have a perverse effect in increasing the PSBR through higher debt interest and a perverse effect in encouraging inflows over the exchanges still further, many of which inflows could not be prevented by such exchange controls over inflows as could feasibly be put in place. Equally it is highly doubtful, in my view, whether any increase in interest rates at the present juncture would be either necessary or desirable in order to increase private sector debt sales to the non-bank private sector. Indeed, although it would be obviously a risky, and presentationally exceedingly difficult, route, I would not entirely dismiss the corollary that a reduction in interest rates at the present moment could be consistent with encouraging a fall in £M3.

Thus I have grave doubts whether the effect of adopting a form of monetary base control and, in the current circumstances, thereby pushing interest rates sharply up, would actually, at any rate for a number of months, have a beneficial effect in reducing £M3.

The section in the Green Paper on Monetary Control, which I now regret, is paragraph 1.9, in which it was suggested that "Using the basic weapons of fiscal policy, gilt-edged funding and short-term interest rates, the monetary authorities can achieve the first requisite of control of the money supply - control, say, over a year or more". The evidence of the last six months shows pretty clearly first of all that the Treasury can neither predict nor control the PSBR within a range of at least £2-3 bn. over a period as long as six months, and I would note that an error of this size amounts to some 4 or 5% of £M3, or up to 10% over six months at an annual rate. Equally, I have increasing scepticism over our ability to control £M3 by varying short-term interest rates. Under these circumstances you may well reply that if I am unhappy about the present degree of control over £M3, as I am, then this should make me all the more willing to try the alternative approach of monetary base control. Again I must reply that monetary base control works primarily through forcing changes in interest rates via the market. If the extent, and indeed the direction, of change in interest rates to achieve £M3 control cannot be discerned by officials, I see no reason for faith that holding to a monetary base and allowing interest rates to be much more determined by market forces would necessarily bring any better result.

Conclusions

The monetary target will have to be rolled on in the next month or so. This provides both an opportunity and a need to take a number of difficult and important decisions. First, in the adoption of £M3 as the sole monetary target, we have chosen a target which is particularly difficult to control, and I believe that this difficulty will persist whether we stick with our present control techniques or seek to move towards some form of monetary base control. There is at least a case for examining whether a revised form of target might be adopted, not necessarily M1, but something more on the lines, say, of the German or Dutch target aggregates, which would offer us more chance of maintaining steady control.

Second, whether or not any change is made to the target aggregate itself, we shall clearly have to review our control strategy, whether to move to a form of monetary base control, or to remain broadly with our present techniques. It is, no doubt, right to wait until after the forthcoming conferences on monetary base control. But those conferences are unlikely to conclude anything finally. The chance of everyone suddenly agreeing either for or against monetary base control is minimal. Those who have firm views, either for or against, are likely simply to continue presenting them, though I would expect recent events to shift some uncommitted opinion more towards the experiment of trying monetary base control. In general, the bulk of the written responses that we have received about the Green Paper, particularly from financial institutions, remain sceptical and broadly opposed to a shift to monetary base control, while a sizeable number of academics, expert in the monetary field, remain committed to it. This is not likely to change as a result of the conferences. Accordingly the authorities will have to take a decision themselves. If you feel that, in the circumstances that I have outlined, you are going to want us to adopt monetary base control, despite the reservations that I have expressed above, then there is a case for wondering whether we should not plan for such a move as early as possible, without waiting for further discussion. ?

Finally, if you wish to retain £M3 as the sole target, but do not want, at any rate for the time being, to move to monetary base control, then we must indeed re-examine further, yet again, whether there are any movements that we can make to strengthen what I have admitted to be an unsatisfactory control system for £M3. In this respect I do have hopes that we may be able to make more use of National Savings

Gives impression of a majority?

as an additional weapon for controlling the volume and timing of public sector debt sales. However, whether or not any additional form of monetary control is introduced, problems and difficulties of monetary control are likely to recur so long as the PSBR remains so high in nominal terms and so long as bank lending remains the most attractive, and frequently the only, source of funds to the company sector in severe and persistent deficit.

/Yours sincerely/

~~D.6.P.~~ Ch

Rebuwanan

Is this so please?

PRB

GPS

I imagine this has been overtaken by events

Crom