TL 27/11 Domestic Monetary Policy

CHANCELLOR'S STATEMENT ON 24 NOVEMBER : MONETARY ISSUES

1. Three major monetary issues were covered in the statement:

   i. MLR was cut by 2% to 14%;

   ii. We shall continue with the present monetary target until the Budget next spring when a new target will be announced;

   iii. Certain changes are to be made to the monetary control system, notably the abolition of the Reserve Asset Ratio.

PA Monetary policy file

2. The MLR cut, which follows the 1 point cut on 3 July, restores MLR to the level of June-November 1979. The cut should help to alleviate some of the problems faced by industry at present. Cutting interest rates should bring forward the time when the debenture market and new issues market come back to life, taking some of the pressure off bank borrowing.

3. It is proposed to maintain the present monetary target range for the rest of the target period. The target was originally announced by the Chancellor in his Budget statement on 26 March 1980. We set a target range for the growth of sterling M3 in the 14 months from mid-February 1980 to mid-April 1981 of 7 to 11 per cent at an annual rate. In the eight banking months since mid-February, sterling M3 has grown by 15.3% or 23.8% at an annual rate. This increase has been inflated by distortions caused by the ending of the Supplementary Special Deposits scheme or 'corset' in June. The underlying rate of growth of sterling M3 over the period from February to October is estimated at around 20% at an annual rate.

4. In the Budget statement in March, the Chancellor said he would review the monetary position and the target in the autumn once the distortions in monetary growth caused by the ending of the corset had worked their way through. Monday's announcement fulfills that commitment.

5. The Treasury and Bank of England have now completed consultations on the Green Paper on Monetary Control. While no firm decision for or against Monetary Base Control (MBC) has been made, a number of changes in the monetary control system have been proposed. One effect of these changes will be to allow us to gather information on the way in which a system of MBC might operate in the UK:

i. As foreshadowed in the Green Paper on Monetary Control, the Reserve Assets Ratio will be phased out and abolished completely as soon as alternative arrangements for prudential control of the banks can be introduced.

ii. Changes will be introduced in the Bank of England's methods of intervention in the money markets.

iii. The Authorities are exploring alternatives to the $1\frac{1}{2}\%$ cash ratio as a basis for financing the Bank.

iv. Statistics are to be collected for "retail" money (akin to the old M2 series).

Supplementaries

MLR

i. Medium Term Financial Strategy. This is not an abandonment of the MTFS. We do not believe, however, that maintaining the current level of interest rates would be an appropriate means of achieving our monetary objectives. An excessive reliance on interest rates would imbalance the economy and might not even have the desired effect on the money supply - in the short run at least. But in any event the strategy is not to be interpreted as slavish and mechanistic concentration to the path of the £M3 statistic. We must look at other aggregates and also what is happening elsewhere in the economy.

ii. <u>Financial Position of Companies.</u> The overshooting of the monetary target so far this year has reflected to a considerable extent the sizeable deficit of the company sector, which has had no option but to borrow, accompanied by a large personal sector surplus. Raising interest rates could make matters worse in this respect because companies would face greater interest charges.

iii. <u>Timing</u>. We reduced MLR by 1 point in July. This was always intended as the first of a series of downward movements. A further move now is appropriate because inflation is falling fash and because companies are being put under increasing pressure by rising real interest rates.

iv. <u>Pressure from the CBI</u>. This is not a response to pressure by the CBI and others. It reflects our considered judgement about the level of interest rates appropriate to achieve the degree of monetary stringency necessary to maintain downward pressure on inflation. It would certainly have been wrong to cut MLR by 4 points as the CBI (and Mr Healey) have suggested.

<u>Monetary Target</u>

v. <u>Suspension of target</u>. There is no question of a suspension of the target. We accept that there will be some overshooting, but the rate of growth in £M3 will slow down appreciably in the remainder of the target period. We shall not be far above the top of the range by April, certainly nothing like as far as the growth so far might be thought to imply.

vi. <u>An interest rate target has replaced a money supply target</u>. No. The commitment remains to a reduction in the rate of growth of the money supply. Interest rates will need to be adjusted from time to time to that end.

vii. <u>Accepting that excess growth has occurred, and will produce inflationary burst in 12-18 months</u>. No. Important not to look at a short period and draw conclusions from that. The latest Greenwell's bulletin, not always supportive of

Government policy, points out the error of this approach. We expect second half-year growth to be much lower. Inflation is coming down sharply and the forecast for the next 12 months is [11 per cent]. It is essential that monetary growth should decelerate sharply to avoid a receleration of inflation as the economy returns to fuller use of capacity.

Monetary Control Techniques

viii. <u>How Will More Flexible Interest Rates Help Monetary Control</u> ? May change the way banks charge for advances and accelerate changes in overdraft system - bank lending will then become more responsive to market interest rates. Will reduce the drama associated with MLR changes. May pave the way for a later decision to set objectives for monetary base instead of interest rates.

ix. <u>How do you Reconcile Cutting MLR at a Time when Money Supply is Out of Control with Moves to More Flexible Market-Determined Interest Rates. Haven't you just Over-Ruled the Market ?</u>

Don't accept cut in MLR is inconsistent with monetary strategy. No question of over-ruling the market : assistance is necessary to prevent inappropriate changes in interest rates. Government will continue to set a range for interest rates (though it will not be announced).