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NOTE FOR RECORD

Mr. ~~Foot~~
You may like to note
for future reference
CMB 15/11

Copies to: Mr.Fforde o/r
Mr.Walker
Mr.M.J.Balfour
Mr.Goodhart
Mr.D.E.Thomson
Mr.Foot
Mr.Green
Group 7/2
Group 6,
Overseas

Miss Balfour
Very interesting. As I've now taken over Alan Porter's job in O'seas on these countries I'd be grateful to have a copy of your notes reporting future meetings. RJM ?Macdonald 14/11

59A

Meeting of Group of Four, Zürich, 1st-2nd November

The greater part of the meeting was taken up with the "tour d'horizon" of individual countries' problems and prospects, though there was some discussion of forms of monetary control, with particular reference to the UK's difficulties.

The Swiss were currently working to a monetary base target rather than one for M1, though developments were much influenced by the intervention in the foreign exchange market necessitated by the weakness of the dollar. Because of this unstable situation, the monetary target had not been published. Growth of M1 had dropped significantly this year and the 1979 average was likely to be only some 9% above the 1978 figure. They had not yet decided whether to adopt and announce a monetary target for 1980.

One of the problems with working to a monetary base target was that the Swiss monetary base was subject to erratic fluctuations which could not be eliminated by seasonal adjustment, as they were partly due to end-month window dressing by the banks. Prior to 1976, such window dressing could be identified via observable swaps with the National Bank, but these swaps were now used as a regular instrument of monetary policy. Thus although some distinction could be made internally between window-dressing and other lending, this was not secure enough to be used publicly to justify an "adjusted" monetary base series. An alternative was to set a target from November 1979 to November 1980.

An M1 target would be derived from a forecast money multiplier from the monetary base. The forecast error for M1 had been fairly stable from 1974 to 1978, but had fluctuated since then, with quite substantial underprediction in 1978. This may have come from increased

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foreign demand, which the banks responded to by cutting their reserve ratios. For this reason a monetary base target might be preferable. This could be set in the light of a goal for M1 which would take account of a shift from Swiss francs into dollars. Expected inflation of 5% in 1980 together with real growth of only 1% would suggest desired growth of M1 of 6%; however taking into account a 4% overshoot in 1978 and one of 2% in 1979 (which allowed for the 2% oil price rise), growth came down to zero. The growth in monetary base believed to be consistent with this would be growth of 4% from November to November; this was likely to be expressed as a range of 3-5%, as it would not be possible to announce a zero growth for M1 or a negative figure for the monetary base (which was the year-on-year figure expected). Although, given the need to contain wage demands, this represented a restrictive monetary policy, the National Bank did not feel it would be over-restrictive in view of the world recession they expected.

The unexpected buoyancy in the German economy - with growth of over 4% and falling unemployment - had not been matched in monetary growth, with a more restrictive policy being followed, so that central bank money had shifted towards the lower end of the target range, without any allowance for the oil price rise. Policy had become tighter since the summer with increases in official rates and management of the money market designed to keep conditions tight. The exchange inflows had been largely sterilised so that they did not increase money. However, the reduction in the growth of central bank money partly reflected a stock shift of deposits from M1 into M2 and hence into longer-term savings deposits and bank bonds. This enabled bank lending to the private sector to continue to grow at a more rapid rate (over 10%), reflecting the buoyant conditions in the economy. Market rates had continued to rise relative to official rates and one reason for the rate increases announced on 31st October was to bring them back into line. In addition although the current downward sloping yield curve might suggest a belief that a peak in interest rates had been reached, the Bundesbank wanted to curb possible over-optimistic price expectations, particularly given the latest figures for the rise in wage rates (of 6½%). A further problem was the rate of interest on small savings which was below all other comparable rates notably the 8% bond rate; this savings rate was set by a cartel and was related to the Bundesbank's discount rate.

The monetary target for 1980 was due to be published at the end of November. With potential growth likely to be around 2½% (which included a ½% reduction for the effects of oil price rises) and prices forecast to rise by some 4 to 4½%, monetary growth of some 7% might be suggested. However, there was room for doubt as to how far the 4½% inflation forecast was really "unavoidable"; moreover there was also the question of how far overshooting of targets in earlier years should be taken into consideration. It appeared that the Bundesbank were thinking in terms of a range of 6-8% or 5-8%, compared with outside recommendations of 7-8%. Mr.Goodhart has commented separately on the changes in the Bundesbank's techniques in the money markets which they feel will help them to meet the target.

In the Netherlands there had only been a moderate growth in output this year and this would be lower in 1980. The balance of payments had been in deficit though there were signs of improvement. With no prospect of a reduction in the public sector borrowing requirement in 1980, it was important that the stance of monetary policy be such as not to accommodate any further increase in inflation. Consideration had been given as to whether direct controls could be relaxed after three years' use, but it was felt that this would be difficult at this stage. The Bank were not confident that the banks would reduce short-term funds; long-term funds raised in the capital markets by the banks in order to finance lending competed with the government's needs, thereby putting responsibility on the government to reduce the PSBR.

Questioning from both ourselves and the Germans failed to provoke any reaction to the proposition that their direct control was by this time having merely a cosmetic effect on the target aggregate, given the large increase in long-term liabilities. The Dutch maintained that the credit ceiling did ultimately work through interest rates, with the bidding up of rates for longer-term deposits being reflected in the rates charged to borrowers. Given that pressure was passed on via the market, they did not believe that portfolio choice would change, at the current level of interest rates, if the controls were removed. Although it was admitted that there was some arbitrariness over the definition, the aim of their policy had been to reduce excess liquidity of households thereby removing a potential threat; they did not want to reduce current spending. With the shift into longer-term assets which had occurred, they were confident that they had reduced potential excess liquidity.

There was a good deal of interest in our problems of monetary control, particularly as they related to the criteria used for interestrate changes. It was suggested that there might be some middle way between reliance only on interest rate changes and direct controls; Schlesinger (Deutsche Bundesbank) pointed out that some forms of monetary base control could lead to rationing but mainly worked through inducing interest rate changes. It was also noted that in the US, some banks had responded by asset management, though as this was largely a result of uncertainty, the effects were likely to be transitory. It seemed to be generally felt that the "auto-pilot" approach, whereby there was an automatic interest rate response to deviations from a desired path for monetary base, would be unhelpful as underlying monetary growth was subject to erratic movements over short periods. The Germans pointed out that their new approach, while giving "automaticity" over the longer term, allowed them a good deal of discretion on a day-to-day basis over the form and timing of assistance and the rate at which it would be given.

Economic Intelligence Department,
Monetary Policy Group,
8th November 1979.

Miss C.M.Balfour (4332)