CONFIDENTIAL until 11.30 a.m. on 20.3.80, then unclassified

FINANCIAL SECRETARY

cc Chancellor
Chief Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Mr Burns
Mr Ryrie
Mr Middleton
Mr Bridgeman
Mr Britton
Mr Unwin
Mr Riley
Mrs Gilmore
Mr P Davies
Mr Bottrill
Mrs Lomax
Mr Peretz
Mr Browning
Mr Grice o.r.
Mr Shields (+ 1 for UKTSD)
Mr Ingham
Mr Folger
Mr Bell
Mr Page
Mr Ridley
Mr Cropper
Mr Cardona

Mr Quinn, Bank
Mr Lankester, No 10
PS/PMG

cc Mr Ingham

MONETARY CONTROL

I attach the background brief for the publication of the Green Paper tomorrow. Please could I ask Mr Quinn to distribute copies in the Bank as necessary.

M L Williams

M L WILLIAMS
19 March 1980

MONETARY CONTROL TECHNIQUES

BACKGROUND BRIEF FOR CONSULTATION PAPER TO BE PUBLISHED ON 20.3.80
(References throughout are to Green Paper, Cmnd 7858).

Main Points

1. Monetary policy objective: to control monetary growth over the medium term, in order to bring down trend. Progressive reduction in rate of growth essential to achieving reduction in inflation.

2. Main instruments of monetary control are fiscal policy and interest rates.

3. Paper considers ways of moderating short term fluctuations in monetary growth. Specifically, it:

(i) examines scope for improvement in existing instruments (and proposes some changes, e.g. to reserve assets ratio);

(ii) considers role of direct controls, and alternatives to SSD scheme, including monetary base control.

Positive

1. Fiscal policy and interest rates must continue to be main instruments. Sufficient to control money supply growth in medium term, say over a year or more. Government intends to bring down over time PSBR as a proportion of national output.

2. Fluctuations in monthly figures do not destroy monetary control. Relation between monetary growth and prices and nominal incomes is medium term. But some advantages from smoother path, including reduced uncertainty and less volatile expectations.

3. Monetary target gives guidance to markets and industry on which to assess direction of policy and to formulate expectations. £M3 most suitable as target, but account taken of other aggregates, and policy directed to a reduction in growth rate of all.

4. Direct controls not an alternative to fiscal policy and interest rates. To the extent that they leave interest rates unchanged they simply divert and change forms of liquidity and credit, rather than affect underlying conditions.

5. Recommendations on existing control arrangements summarised in para 6.3. (Phase out SSD scheme, end 12½% reserve assets ratio, extend cash requirement to all banks, retain special deposits scheme. Bank issuing a separate consultative document on future prudential requirements, and will issue paper on cash requirement).

6. Monetary base system presents difficulties; there are practical problems and it might not produce desired results. Paper discusses possibility of more automatic system of adjusting Bank's lending rate in response to divergence of money supply from target. Bank and Treasury would welcome comments on whether the difficulties with monetary base control could be overcome and whether there is on balance anything to be gained from more automatic interest rate adjustments.

7. Consultation period. The consultations will take place over the next six months, but written comments should be made preferably within the next two months. Throughout consultation period Bank and Treasury will be inviting individuals and organisations to discuss further.

8. Recent monetary growth. Clear that measures already taken bringing monetary growth under control. Some deceleration in £M3 growth, and other measures growing more slowly. M1 falling.

Elaboration

1. Present instruments. Main instruments can achieve control over medium term. But time lags mean it can take up to a year or so to correct a divergence from target with present techniques. Smoother control would require substantial interest rate fluctuations. But some advantage from smoother path, hence consultation paper.

2. Fiscal policy. No simple relationship between fiscal policy

and monetary growth; affected by economic cycle, inflation and structure of tax and expenditure flows. In long run, unless there are to be steadily increasing interest rates, monetary restraint requires firm fiscal control.

3. <u>Gilt sales</u>. Substantial sales of gilts have helped to finance PSBR outside banking system. But sales irregular. Bank article (BEQB June 1979) discussed proposals for securing flow of sales more closely related to requirements of shorter term monetary control. Comments on paper welcome.

4. <u>Interest rates</u>. Interest rate changes affect bank lending, sales of public sector debt, exchange rate and/or external flows, although bank lending responds slowly. Can have immediate impact on expectations in financial markets and hence gilt sales. But not an exact control in short run.

5. <u>Ratio controls (Chapter 3)</u>. Reserve assets ratio not designed as monetary base, but as element in control of short term interest rates. Separate consultative document on prudential liquidity requirements. Special Deposits scheme to be retained to guard against adverse effects of excess liquidity. Cash requirement is effective fulcrum for Bank's money market operations; propose to apply it to all banks, not only clearers (Bank to issue detailed paper).

6. <u>Monetary base control (Chapter 4)</u>. See Annex B for full description of alternative systems and possible problems. In summary:

(i) Non-mandatory system: to secure sufficiently stable base assets/deposits ratio would require significant institutional changes, resulting in less flexible money markets (since only banks' balances at Bank would count as primary liquidity, there would be less role for money brokers and other intermediaries who help to transmit interest rate changes through markets).

(ii) Mandatory systems: with lead accounting, banks' could meet requirements only by disintermediation, i.e. with no effect on underlying liquidity. Under lagged accounting, severe practical difficulties, including insulating base from fluctuations in Exchequer's daily cash flow. No reason to suppose right interest rates would be generated, and could still have disintermediation problems if penalties imposed on banks.

7. Indicator Systems (Chapter 5). Uses changes in base from desired path to trigger interest rate changes. Alternatively, and more direct, use divergences in £M3 from desired path to trigger changes (e.g. using weekly figures). Greater automaticity may be advantageous. But although system could reduce policy delays, it could also mean more variability of interest rates and possibly even the money stock. Welcome views.

8. Bibliography and Glossary. See press release.

9. Impact on "Ordinary" Man. Fundamental reliance on fiscal policy and interest rates mean that proposal for smoother monetary growth will have little impact on general level of interest rates. But could mean greater interest rate fluctuation; individuals and institutions have to accommodate to this.

Defensive

1. Direct controls (Paras 1.12 - 1.17). Tend to reduce competition, involve loss of efficiency, and give rise to prudential risks. If permanent, funds move out of controlled sector; monetary statistics distorted (as is £M3 by SSD scheme), and impact on underlying growth weakened. If short term, problems of anticipation by controlled institutions, and removal of control can mean problems. New techniques must not provide significant incentive to development of financial channels outside controlled sector (disintermediation).

2. PSBR/£M3 Relationship. /e.g. Lord Kaldor in New Stateman of 14.3.80 argued that PSBR and £M3 growth are unrelated./ Many

factors affect relationship between PSBR and monetary growth. Close relationship not observable from published figures partly because of Government action to offset monetary impact of PSBR. Precise relationship will depend on structure of tax and expenditure flows, as well as interest rates. In long run, tight target will require ever higher interest rates unless fiscal policy is under control.

3. SSD Scheme (Chapter 2). Government aware of limitations and scheme should be phased out as soon as convenient (further announcement in Budget on future of scheme beyond mid-June when present guideline ends).

4. Adequacy of control techniques if SSD scheme not replaced. Fiscal and interest rate policies adequate for control over medium term. Advantage in shorter term control; hence paper. Consultation process will explore alternatives.

5. Phasing out SSD scheme and £M3 growth. Development of credit channels outside the banking system (e.g. bill leak) means £M3 under-recording. Ending SSD scheme would mean process would in part be reversed, thereby increasing £M3. Would need to take account of this is interpreting figures.

6. Exchange control abolition undermined SSD scheme. Decision to phase out scheme would have been made even without abolition. Disadvantages of SSD independent of exchange controls and apparent well before abolition. Switching transactions offshore only one form of disintermediation.

7. Exchange control abolition disruptive: Abolition justified on its own merits. Strength of sterling and markets' confidence in Government's policies means abolition well timed, not disruptive. Monetary impact hard to assess, but probably small.

8. Other aggregates. £M3 adopted as target aggregate as well understood, and indicates links with other policies (especially fiscal policy). But substitutability between forms of liquidity

means authorities must have regard to other measures (both narrow, e.g. M1 and wide, such as measures of private sector liquidity; and also DCE). Fiscal and interest rate policies directed to any one aggregate will tend to control others over a period.

9. Current interest rates and monetary control. In recent months short term interest rates under upward pressure as a result of liquidity shortages in money markets. Not a reflection of fears about monetary control. Bank has taken technical measures to relieve pressure; do not reflect a weakening of monetary resolve. Relieving excessive money market pressure not inconsistent with more automatic interest rate adjustments for monetary control purposes.

10. Liability management (para 3.3). Likely to occur, particularly in short run, with most systems of control, including present one. Could be avoided only by some forms of direct control, but disadvantages of direct controls make such a solution unacceptable.

11. EMS (para 1.19). Some changes in control methods inconsistent with EMS; this is a consideration in assessing alternatives.

12. Cash requirement and monetary base control: Cash requirement to be extended to all banks for reasons of equity (all benefit from services of Bank). Monetary base system would possibly also require a uniform requirement, but that is not why change is now being proposed.

13. Liquidity requirements: Enquiries about Bank's consultative document to Bank: 601-4444 Ext 3275.

14. US System: Comparisons complicated by different institutional structure. October 1979 measures interesting experiment. Apparently only partial move to monetary base control as Fed has continued to supply reserves to the banks to prevent extreme short term movements in interest rates. Banks' reserves continued to grow rapidly in subsequent months; money supply growth slowed, but continued concern over total credit growth led to further restrictive measure on 14 March. (Direct control element of package largely "moral suasion",

Fed mainly relying on reserve ratios and interest rates.)

15. Timetable for consultation. Inevitably imprecise. Difficult subject. Implementation of RAR, etc. changes depends on reactions to Bank's papers. On monetary base hope to receive written comments within next two months. Any subsequent changes, and timing of implementation, will depend on how consultations develop.

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