

COVERING SECRET

11. 7.79

See 6 7 79
13 7 79

MR. FFORDE

*Draft first
half of steering brief
second half, on debt
management, to come from
Cashiers.*

Copies to: The Chief Cashier
Mr. Walker
Mr. George
Mr. Goodhart

THE PRIME MINISTER'S SEMINAR

I attach a draft, which CAEG has seen, of the overview on monetary base control requested yesterday.

M.D.K.W. Foot (4315) *MF*
Economic Intelligence Department,
11th July 1979.

WFF 11/77

support of this note, there is also a brief summary (following very much the lines of the recent Bulletin article which those at the seminar will have had the chance to read) of what the base is and what the controversy is about. *These* could serve as speaking notes. In addition, there are the other rather weighty papers that have been circulated to the members of the seminar, together with our comments on them. Finally, there is a *separate* *setting out* short note on the case for abolishing the present reserve asset ratio, the relevance of which will be noted below.

Possible Ministerial Misconceptions

2. The attached papers by Pepper, Griffiths and Wood all favour some form of monetary base control. Middleton's paper recommends further study of a number of possible schemes. Given this, it is *desirable* that Ministers should not think that the Bank's mind is closed on the subject. The recent Bulletin article went out of its way to leave discussion open on schemes which did not envisage some (unworkable or unacceptable) rigid short-term control of the base.

THE GOVERNOR

THE PRIME MINISTER'S SEMINAR ON MONETARY POLICY:
THE OPPORTUNITIES AND THE RISKS

Introduction

1. Attendance at this seminar on Wednesday, July 18th is restricted (we understand) to Ministers and yourself. It will last for up to 2 hours and consider two main topics:

(a) monetary base control, and

(b) operations in, and the structure of, the gilt market.

This note deals with (a) and with topics of close relevance which you may wish to bring into the discussion. It seeks to summarise the main points on base control of which Ministers should be reminded and also points a possible way ahead for the period after the seminar. In support of this note, there is also a brief summary (following very much the lines of the recent Bulletin article which those at the seminar will have had the chance to read) of what the base is and what the controversy is about. These could serve as speaking notes. In addition, there are the other rather weighty papers that have been circulated to the members of the seminar, together with our comments on them. Finally, there is a short note on the case for abolishing the present reserve asset ratio, the relevance of which will be noted below.

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3. Nevertheless, it would also be wrong for Ministers to think that we find the present system of monetary control inherently defective. The strains of recent years have owed their origin primarily to the serious inflationary and fiscal position of the economy and to Government's repeated unwillingness to take adequate monetary steps, notably on short-term interest rates, soon enough.

4. Control of the base does not offer any magic new weapon. Indeed, it implies dropping any direct control such as the 'corset' and relying solely upon the interest rate weapon. But the private sector's demand for bank credit will remain as little affected in the short run by changes in short-term interest rates; ^{and} the effects of a rise in such rates on the sales of long-term gilts will remain as uncertain as they are now. ^(perhaps much greater) Only through greater short-run volatility of interest rates than in the past or through the development of more 'cosmetics' (for example, keeping EM3 down only through engineering sales of Treasury bills by banks to non-banks and thus - like the present bill leak - achieving control at the price of unregulated growth in a slightly broader aggregate) can base control 'improve' on the present system.

5. If Ministers find the prospect of sharp interest rate changes unpalatable, then the ^{other} only option open is some form of direct control. The present version - the corset - very adequately demonstrates the strengths and weaknesses of such an option and also the fact that the longer the control is in place the more glaring are the weaknesses. If it is accepted, however, that the ^{locker} should always contain some direct control for an emergency, the question is whether the present form could be improved upon. This is a subject to which the Bank and HMT have given much thought and will wish to give more. It would be unwise to continue only with development of possible forms of monetary base control.

6. Another area of the present controls to which the Bank have

passing
→ *reference has to Middleton's Super-corset?*

given thought is the reserve asset ratio. In our view it is superfluous, for the reasons set out in the separate paper mentioned in paragraph 1. With the Banking Act about to come into force, now would in any case be a good time to discuss the future of the ratio before licensed deposit takers have to take on an obligation the monetary control value of which is so doubtful and the prudential value of which is less than it could be. But the present discussions make the time more opportune still, because to those who favour base control, the present ratio has the critical flaw that the supply of reserve assets is outside the control of the monetary authorities. An essential feature of their preferred solutions is that the reserve base of the banking system be defined to cover only assets over which the authorities have complete control. The abolition of the present ratio would therefore clear the way for any future experiments with base control without in any way affecting the efficiency of the present controls. As explained in the separate note, this step would be accompanied by action by BMMSS to establish relevant prudential norms (which incidentally, because funds with discount houses undoubtedly rank as primary liquidity, would mean that the houses would not face the uncertain future ^{that might otherwise seen} implicit in schemes for base control).⁽¹⁾

7. It would be valuable then if Ministers would endorse in principle a Bank initiative on the present reserve asset ratio. It remains then to ask what else can be hoped for from the seminar.

(1) There is a further reason why it would be valuable for BMMSS' action on the prudential front in the context of the Banking Act to be raised. The various papers favouring base control tend to argue that the reserve requirement they suggest would also have prudential value. But limiting the definition of primary liquidity solely to cash and bankers' balances (the generally preferred definition of the base) is a wholly unnecessary and unhelpful view of what should constitute liquidity for the banking system.

8. Clearly, the conclusion of Middleton's paper - that certain schemes for base control should be examined further - will be hard to resist, albeit that enough is already known for the general merits and demerits to be apparent. Such further study will have the benefit of throwing up the tricky institutional problems they are likely to pose and of disabusing Ministers of any idea that the theoretical simplicity of base control ~~on paper~~ carries through to the real world.⁽¹⁾

9. However, it would seem appropriate for the Bank to institute such studies, consulting others as appropriate, with the aim of producing a consultative paper which could open the way to experimentation if thought appropriate. Two points on such a line of action are, however, worth making. The first is that it would be difficult to consult outsiders - and we suggest impossible to hold any worthwhile general discussion - until a decision on the reserve asset ratio had been made and announced. Otherwise our hands would be needlessly tied. Secondly, given the complexity of the issues involved it would be optimistic to look for a speedy move to a consultative document.

Economic Intelligence Department,
11th July 1979.

M.D.K.W.Foot (4315)

(1) One problem of particular relevance to the Bank is the question of our future income. A form of base control which required all banks to hold non-interest-bearing deposits with the Bank would provide income in the way that the clearers' balances do now. However, some schemes - such as that introduced into the discussion by Middleton - would not have such a requirement and would put even greater pressures on the clearers to end their present agreement with us.