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PRIME MINISTER

"Monetary Seminar", 18th November

The annex to the Treasury's main paper (entitled "Monetary Control: The November Statement") summarises the main points for discussion, with points of agreement and points for decision separately identified. No doubt it will be convenient to build discussion round that summary. There would be something to be said for starting with the last section, on monetary control and monetary base: it would in a sense be more logical to consider the immediate questions of money market operations and debt management once agreement had been reached on the longer-range and more theoretical issues. But tactically it may be more sensible to follow the order in the paper, and deal with the shorter-range operational and debt management issues first: there is less scope for disagreement there, and it is in that area that decisions need to be taken at once.

2. The other decision that needs to be taken directly is that about the roll over of the monetary target, which is in the Chancellor of the Exchequer's separate minute.

Roll Over of Monetary Target

3. As the Chancellor says, this is very much a choice of evils. An announcement now that the target will not be rolled forward until the Budget will be difficult to present, because the existing target is likely to seem increasingly incredible as we come up towards the Budget. But, all things considered, that seems less difficult than any of the alternative possibilities.

Money Market Operations

4. There is agreement between the Treasury and the Bank of England on the introduction of a more flexible system of operations in the money market, including the "operational suppression" of Minimum Lending Rate (MLR) and some consequent change in the operation of discount window facilities. The authorities would not publish an MLR; but they would have in mind a band of interest rates within which money market interest rates would be kept. This should make for

more flexibility and less political impact from transient short-term interest rate movements. The guidelines and interest rate bands would presumably be set by agreement between the Treasury and the Bank of England. The proposal is that they should not be published. Is this sustainable? There would no doubt be great pressure for publication, not only from the markets but from Parliament, including the Treasury Select Committee. Even if it were possible to maintain a decision not to publish the current guidelines and bands, how soon after the event could they be published: would they presumably have to form part of the periodic accounts of monetary events published in the Bank of England Quarterly Bulletin?

Debt Management

5. As is clear from paragraph 8 of the main note, this is one subject on which views differ between the Treasury and the Bank. The Treasury believe that a greater readiness to see the yields on gilts respond to market pressure, and a readiness to adopt new techniques such as auctions, would give greater assurance that a given programme of sales could be achieved within a certain period. The Bank believe that the greater volatility of yields would not necessarily increase the volume of sales outside the banking system, and they believe that the structure of the market and the prospects for selling debt in the longer term would be damaged.

6. Although there remained an area of disagreement, at any rate in theory, the Treasury seem in practice to have narrowed their proposal to the possibility of broadening the market at the short end, including experiments in auctions "at the boundary between the money and capital markets", where the Bank is less resistant.

7. One of the difficulties here is that it is the Bank of England who are responsible for managing Government debt and official market operations; in the last resort, it would be very difficult to force upon them changes which they were reluctant to adopt. This makes the more interesting the agreement between the Treasury and the Bank that a restricted indexed gilt (RIG) available to pension funds would be practicable. One of the decisions needed at this meeting is whether to go ahead with such a stock.

8. It could obviously be attractive to pension funds and the life funds of the insurance companies. Apart from the technical points, there are two presentational issues which you may like to have in your mind:

(a) It is perhaps a superficial point, but it would be a pity if the new stock became known as RIG: the word has the wrong connotations.

(b) In issuing an indexed stock to pension funds, the Government would in effect be providing a partial guarantee against inflation to the beneficiaries of such funds. Is it consistent to be doing this, for understandable reasons of debt management, at a time when the Government is contemplating legislation to de-index tax allowances, social security benefits, public sector pensions, etc.?

9. If we were not announcing a new form of stock, there is not much that could be said in a November statement about debt management. The Chancellor could perhaps indicate that he was looking further into the possibility of borrowing by nationalised industries in their own name for part of their needs; but presumably the Bank would not want him to announce a more aggressive use of partly-paid gilts or greater use of unofficial tap stocks through the National Investment and Loans Office.

Monetary Control and Monetary Base

10. The Treasury's covering note commits itself to some statements which would, if they are accepted, have considerable implications for policy. It states, for example, that "precise short-run control of a broad aggregate like £M3 is not in practice possible", and also that "control of such an aggregate, even over a period of six to twelve months, could sometimes involve costs in terms of other objectives that are unacceptable". The annex says that £M3 is extremely difficult to control, even over longer time periods, and that "a major cause of this difficulty is that interest rate movements do not have a quick or reliable effect on bank lending or £M3".

11. If these statements mean what they say, they appear to call in question a monetary strategy based on targets for £M3 or any other monetary aggregate. If they are right, it would seem that the main purpose of monetary policy is to set a general direction and pace of trends over a period, and it could not be regarded as anything like a fine tuning instrument. On that hypothesis smoothing the PSBR becomes a secondary, though still desirable, objective.

12. You will wish to see whether these propositions in the Treasury's covering note command general assent.

13. There seems to be agreement between the Treasury and the Bank that it is very uncertain whether a mandatory monetary base control system would be workable. The only question for decision here is whether to introduce a statistical series for retail deposits, to replace the old M2 series, on the ground that this would be a necessary precondition of a mandatory monetary base system. It is not clear that the new series would serve any other useful purpose (it was abandoned in 1972); but perhaps the fact that it would be costly for the banks is not in present conditions a very conclusive argument against doing that.

14. Nor is there agreement upon the viability, in the British system, of a non-mandatory monetary base control system. It is argued that the present cash ratio requirement - the requirement on the clearing banks to keep assets averaging $1\frac{1}{2}$ per cent of eligible liabilities as cash and non-interest bearing balances at the Bank of England - prevents us from discovering what cash the banks would hold for their own operational and prudential purposes - which would be relevant to the operation of a non-mandatory monetary base control system - and that, in order to find out how a non-mandatory monetary base control system might work, the cash ratio requirement should be abolished.

15. As the paper says, this would abolish the present source of the Bank of England's income, and it would be necessary to find an alternative source. The Bank of England can be expected to oppose this strenuously. They will be very reluctant indeed to contemplate any system whereby their income and therefore their expenditure are in some sense at the discretion of the Treasury.

16. I am not convinced that this has to be a problem at this stage. The reason why the existing cash ratio requirement conceals the size and variability of the banks' true demand for cash is that the requirement is an average: there is no obligation on the banks to reach a particular target balance on any one day; a degree of averaging is allowed; and the sharp rises in money market rates which have been evident recently in the days before make-up day suggest that the banks allow the ratio to run down in between make-up days. For the purposes of discovering the true demand by the banks for cash, it should be sufficient to make

the existing requirement invariable at all times, so that the banks would be required at all times without exception to keep a minimum $1\frac{1}{2}$ per cent in cash and would be penalised if they went below that figure. The amount by which their actual cash ratio exceeded the minimum would then become some measure of their true demand for cash; and we should not have put the Bank of England's source of income at risk.

Level of Interest Rates

17. If the meeting decides to go for the more flexible method of money market management proposed in these papers, you may also wish to think about the timing. It is implicit in the system that in future there will be no announcements about MLR. It may not be convenient to move straight into this system at the time of a November statement, if the Chancellor's hope and intention is to signal a reduction in interest rates as part of that statement. Thus we might need an MLR change at the time of the statement, and a switch to the new system from, say, 1st January 1981.

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ROBERT ARMSTRONG

17th November, 1980