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SECRET AND PERSONAL

1.10.80

THE GOVERNOR

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See 6.10.80

MONETARY CONTROL

Certain things have become rather clear as a result of the consultations, the two seminars and long discussions in the Bank.

First, nobody is now happy with £M3 (or M3 for that matter). The foreign monetarists regard it as a bastard concept with no special validity. Moreover, they do not believe we can control it. The British monetarists are beginning to desert it (eg notably Griffiths, who has gone over to M1). Treasury officials - even those who were keenest to enshrine it in the MTFS are noticeably weakening, largely again because of the manifest difficulty of controlling it over the short run - especially because of its insensitivity to interest rates. The same feeling is fairly widespread within the Bank.

Moreover, if one were to go for a mandatory base system, nobody likes M3 as a denominator because of the extreme danger of disintermediation (the resemblance to the corset would be striking) and because in any case there are reasons to doubt the stability of any relationship between the monetary base and M3 (wholesale banks might need no base at all).

There is, therefore, general agreement that at the least we should begin dethroning M3, though nobody has yet come up with anything more specific and constructive than "looking at everything else - other aggregates and the target variables".

Specifically, very few people are urging a move to M1 (Griffiths seems to be an exception). One practical reason is that if we were to get interest rates down significantly, we might be in for a period when M3 growth, at last, slows right down while M1 growth takes off. More specifically, there is a general feeling that the interest sensitivity of M1 which makes it, within limits, controllable by interest rate policy, makes it by the same token a less significant variable to control. (I am not wholly persuaded of this myself; and in any case, at this stage of the game I have some preference for a variable which is meaningless but can be controlled over one which is potentially meaningful but cannot be controlled at all. As will be seen below, others tend to share this preference when it comes to monetary base.)

M1 has some importance in relation to a mandatory base control; indeed it is perhaps the only aggregate which could be plausibly related to a mandatory base - though the Treasury are believed to be exploring the possibility of a new M2 which would effectively be "retail deposits".

For all its disadvantages, a mandatory base related to M1 might have some attractions as a basis for moving to something like the present US system: ie the main change would be to float our short-term interest rates within a relatively wide band. This might appear an attractive "half-way house" because a fundamental theme of all the monetarists is that we must stop pegging interest rates and let them fluctuate freely. Some of the British monetarists might indeed accept this half loaf with a good grace. But Brunner and Co would denounce it as worse than useless as they denounced the Fed.

Apart from these presentational cum political points, there is the point that a greater fluctuation in the interest rate at which we supply or drain cash to or from the market is thought by many (including, I think, yourself) to offer the possibility of importantly influencing the banks' behaviour. The argument goes that by making it uncertain at what price the banks could get their needed cash, some form of direct quantitative rationing effect could be achieved on their lending. Friedman appears to believe this as does Professor Mervyn Lewis but most others (including myself) find it hard to understand how this could come about. The banking system is nothing if not competitive and I cannot see why an individual bank would be constrained from simply paying the price necessary for its money by anything other than the demand for its corresponding variable price loans. In other words, there would certainly be a price elasticity effect from the demand side but it is hard to see a quantitative effect. We pressed the foreign monetarists and a number of people at the domestic seminar and nobody was disposed to argue for a "rationing" effect.

The academics appear almost unanimous in their advocacy of a non-mandatory base system. This has two components: (a) you take the economys' own demand for monetary base as given; and (b) you target the base itself not one of the wider aggregates through some assumed relationship to base.

There is fair unanimity among the academics that if one kept the growth of MO at a steady, slow rate over time none of the other aggregates nor indeed the final target variables could go widely wrong - at least in the medium term.

It seems to us that something along these lines might be workable. It would in fact be much more difficult, particularly in the short-run, to control the base than many academics think (it is their creed that the base is totally under our control and is the only thing that is). But the difficulty is how we would know what was the level of base that the desired growth rate should relate to and; what should be the desired rate of growth and what kind of relationship there would be in the short term with the wider variables and the economy as a whole.

All the academics freely admit that there would be transitional problems and that the transition would take quite a while. Phrases are used like "after a couple of years you will be able to find from the data which were the stable and appropriate relationships". One cannot use the evidence of the past or even an intermediate future regime of mandatory base control because these systems are fundamentally different from the non-mandatory base and cannot yield, therefore, useful information about the demand for base in an unconstrained system.

Switzerland has the only central bank in the world which really uses monetary base control and its circumstances are very special: just a few banks who are required to hold with the central bank prudential as well as regulatory balances; very little government debt and very few alternative monetary market instruments etc. It would be quixotic to decide that this was the model we were to follow for our highly complex system. Central banks with economies anything like ours have not been seduced by the monetary base. The German system of control, for example, is basically similar to ours.

But all this said there is some interest on the monetary side here for some kind of movement towards an MO system. EAJG and ALC are working out some details but the essential feature (which is also the main attraction) is that the Bank of England would have to be given wide discretion to move interest rates up and down in the transition period to feel our way towards an appropriate level and rate of growth of base. Pre-judging the result of their efforts, I find it hard to see our being able to justify and maintain a wide degree of discretion of this kind when it would be very difficult to articulate the precise criteria for the movements we were making.

There is a different but important point about MO. Taken literally - ie it is just what the banking system wants to hold as cash and balances - it carries no guarantee for our income.

All this is very difficult. In crude terms one is telling the Prime Minister that she ought to abandon, or at least downgrade with such speed she can, the centrepiece of her existing policy; and at the same time telling her that the ideal system suggested to her by her foreign advisers would be a complete leap into the unknown and take a couple of years at least before one could have any idea, not only whether it worked, but whether we were working it properly. These two propositions would, I believe, broadly be assented to by her foreign advisers. Unfortunately, however, they have not put them to her.

Cwm

1 October 1980