THE GOVERNORS

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GR 7/A

Monetary Measures

Assuming that our hand is not immediately forced by exchange market developments, we have until Thursday week to decide how to react to the latest developments. There would in any case be advantage in combining any measures with announcements about the roll-over and the future of the corset. I should like to suggest a rather simple approach.

There are serious difficulties involved in either extending or abandoning the corset. Everyone knows it is largely cosmetic and much weight has been put in public on the increased possibilities of avoidance now that exchange control has gone (the difference in reality is perhaps not all that great but it is the difference in perception that we have to cope with). Such avoidance, as MDKWF has pointed out, has the particular disadvantage that unlike the bill-leak no-one will know how big it is. In these circumstances if we keep the corset, we risk looking as if we have a greater belief in its efficacy than we should. We may be characterised as incompetent and the markets may refuse to take at face value even good money supply figures in the month ahead. On the other hand if we abandon the corset we will see the coming money figures inflated by re-intermediation and we risk criticism for having got rid of all our controls at once, at a time when the situation was far from under control, and having to face the future, as it were, naked.

There are similar dilemmas about any form of roll-over from our present position granted not only the recorded rise in M3 but the public knowledge of the extent of the bill-leak. If we roll forward now without giving ourselves any benefit of "base-drift" the degree of tightness we are already committed to will look very difficult to achieve indeed. On the other hand if by judicious choice of the time period and some degree of consolidation of base-drift we settle for a target that looks reasonably capable of achievement our whole monetary stance is likely to lose credibility.

Neither we nor the Government can in fact afford to lose credibility for our monetary policy. This, together with the fiscal stance, is the major plank in the Government's anti-inflationary policy. As months go by the exigencies of reality are probably going to mean that the PSBR will have to be allowed to rise at least for cyclical reasons. As this happens, it will be more than ever important that we are seen month by month to be maintaining a firm monetary policy.

It seems to me that this implies that we must act toughly now and be prepared to keep on acting toughly. If we do this, and in the light of the probable world conjuncture, we will bring about a significant degree of recession here. This may not mean that bank lending will slow up very much for some time but it is likely to mean that there will be a very good climate for selling gilt-edged. I suggest therefore that provided we can act strongly enough on interest rates we should be able to produce the conditions whereby over the next six months or so money supply growth is drastically reduced. However, since we start from such an excessive point we are unlikely to help ourselves to achieve this result by promising it in advance.

Another factor in the situation is that we genuinely are considering modifications to the methods of monetary control and are going to promulgate them for discussion in due course; and that we do probably intend to get rid of the corset in the not too distant future.

My suggestion therefore is that we go for overkill in interest rate terms. I hope that this means no more than 2% on Thursday week but the essence of the strategy is that whatever it takes we have to achieve the overkill. At the same time as raising MLR we announce that the corset is being allowed to lapse because it has now - particularly with the abolition of exchange control - outlived its usefulness; and that we will in due course be putting forward proposed ideas on modifying our methods of monetary control /or whatever is in fact the proper form of words to make/. We say at the same time that the recent rate of expansion of money supply is quite unacceptable and that our interest rate measures indicate this and are intended to bring it under control. We had intended at this time to roll on the target but it seems particularly inopportune to do so at present. We could actually cite either formally or in background briefing our genuine dilemma over whether or not to incorporate base-drift. In the coming months the figures will be swollen by re-intermediation. We do not want to, therefore, get ourselves on to a false basis. The present targets run in any case until April and in the present circumstances we are concentrating on getting the money supply back under proper control without artificial help from the corset. When we have done so /and perhaps in the light of any announcement we may make on modification of methods of control/ we shall announce new targets.

It seems to me that something along these lines could minimise the presentational difficulties we face and maximise our chance of actually getting the money supply under control while at the same time giving reasonable reassurance to the markets about what we are up to.

C W H

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