

Blind cc:- Mr Hoskyns, Mr Wolfson

Mr Ingham, Sir R Armstrong

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NOTE OF A MEETING BETWEEN THE PRIME MINISTER AND FOREIGN
PARTICIPANTS IN A SEMINAR ON MONETARY BASE CONTROL: 1430 HOURS
30 SEPTEMBER AT 10 DOWNING STREET

Present

Prime Minister
Mr. P. Middleton
Mr. T. Lankester

Professor Karl Brunner
Professor Allan Meltzer
Dr. Hermann-Josef Dudler
Dr. Kurt Schiltnknecht
Professor Mario Monti
Professor James Pierce

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Mr. Middleton summarised very briefly the discussion in the Seminar on MBC which had been held for UK participants the previous day. They had first discussed the period over which it was possible and desirable to control the monetary base, and had concluded that the shortest period possible was three months. They had then discussed how the clearers would react to an MBC system. They had concluded that the overdraft system in its present form would have to go. In addition, it was clear that the discount houses would no longer function as they did at present. Finally, they had discussed the issue of mandatory versus non-mandatory forms of MBC. There would be problems with both forms: for example, with a non-mandatory system, there would be a tendency to disintermediation; with a mandatory system, there was great uncertainty as to what would happen. But although there would be problems with both methods, the distinction between them was less important than

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the decision of whether or not to adopt MBC in any form.

As for the second Seminar with the foreign experts earlier that day, there had been a general consensus that the existing instruments were inadequate to control the monetary aggregates in the way the Government desired, and that reforms were needed. Most of the participants were strong advocates of MBC, but they were concerned about the transitional arrangements in moving from the present system. It was clear that it was not possible to combine control of the monetary base with short-term control of sterling M3. This posed a political problem insofar as the Government was committed to a M3 target. But from an economic standpoint, the majority view was that controlling the monetary base was more important in the fight against inflation than controlling M3, and therefore converting to a monetary base target would be desirable.

Dr. Brunner said that the issue was essentially simple. Either, the Bank would continue with its present instruments, and M3 would continue to be out of control, or we should move over to MBC. In designing the present monetary strategy, the authorities had virtually made it certain that the strategy would fail. The only viable way forward was for the authorities to set a target for the monetary base; he was confident that over a period the other monetary aggregates would follow a similar path. In any case, he believed that there was a good relationship between M_0 and inflation. Having announced a target for M_0 , the Bank would have the job of both achieving it - that should not be difficult, given the will - but also of communicating to the public what it was trying to do. By influencing expectations, the cost of getting inflation down in terms of lost output and jobs would be that much less.

Dr. Pierce said that at present M3 was planned by the authorities by fixing interest rates, and too often the interest rate judgement was wrong. To the extent that errors occurred, they lost control of the money supply. By contrast, if they were to control the monetary base, they would have effective control over credit creation.

Dr. Schiltknecht said that in Switzerland the authorities had dispensed with any targetting of the exchange rate or interest rates, and instead they simply had a target for the monetary base. By experience, they knew that inflation would not break out if the monetary base was controlled.

Professor Meltzer said that the UK Government was on target for meeting its inflation objective. But the recent jump in sterling M3, even though some of it was due to the end of the corset, underlined the difficulties which the authorities had in controlling the money supply. Under the present control arrangements, there was a tendency to "procyclicality": the Bank was slow to respond to changes in monetary conditions in its manipulation of interest rates, and this simply made the cycle worse. The Government should free interest rates right away, and move over to controlling the monetary base. The M3 target should be dispensed with, and replaced by a new target. For M_0 it was particularly important to move quickly so as to get the monetary aggregates under control before the recovery appeared. He admitted, however, that there would be a problem of political credibility in moving from one target definition to another: somehow it would have to be explained that the new target was a continuation of existing strategy.

Dr. Dudler said that he was less confident than some about the speed with which economic agents would respond to monetary targets, even if they were achieved. For example, in Germany after a monetary base target was adopted in 1974, wage settlements had continued at an excessive rate. But over time tight control of the monetary base did seem to have the desired effect: and agents were likely to respond more quickly with the penalties which were implicit in an MBC system than under the UK's present arrangements.

Professor Monti said that he too would support a move by the UK authorities to MBC. The Italian authorities had used MBC for some time. Although Italy's monetary performance had been less than satisfactory this was not because of inadequate instruments; rather, it was because the Government had not been prepared to take

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interest rate consequences of the monetary base targets. In other words, they had the right levers but not the political will.

R.

1 October, 1980