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22.11.79

THE GOVERNORS

Copies to: Mr. McMahon o/r
Mr. Dow
The Chief Cashier
Mr. Walker
Mr. Goodhart
Mr. Coleby
Mr. George
Mr. Quinn
Mr. Foot

See 23/11.

REVIEW OF MONETARY CONTROL
(PREPARATION OF A CONSULTATIVE PAPER)

1. As reported at books earlier this week, the Chief Cashier and myself together with Messrs. Goodhart, Coleby, George, Foot and Hewitt have constituted ourselves as a working group in relation to the above subject. As a first step, we have considered an outline structure for the consultative paper and commissioned the first draft of the earlier sections of it. This first draft has been completed and will be considered by the working group early next week. Preliminary drafting of the later sections of the paper, dealing with monetary base control, is also in hand. At an appropriate early stage, perhaps when we have a second draft of the complete paper, we will put it forward to yourselves for discussion.
2. HMT (HF) sent our papers on monetary base control (MBC) to the Financial Secretary last week, without comment. I understand that they have subsequently sent the papers to Permanent Secretaries but not, I think, to the Chancellor. They have been intending, and still intend, to submit to the Chancellor and others a note on the principal issues to which the whole subject is related. They then expect that the Chancellor and/or the Financial Secretary will hold a meeting or meetings, with Treasury officials and ourselves, to discuss the principal issues and indicate what HMG's attitude towards them might or might not be. At a later stage, and probably when the consultative paper has got to an advanced stage of drafting, the whole matter will be referred to the Prime Minister. We await Bridgeman's 'Issues' paper with considerable interest.
3. Littler told me yesterday that they had decided to find out the FST's reactions to the Bank's papers on MBC; and had accordingly had a meeting with him on their own. The FST's preliminary view, as

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reported, was that the papers had convinced him that there was no future in direct controls (or in any MBC variant of them), that we had to rely overwhelmingly on alterations in the price of credit to secure the measure of control needed, and that it was possible (though far from clear) that some sort of MBC of the "variant (c)" type might be helpful in securing appropriate movements in the price of credit. Accordingly, he felt that the consultative paper should be slanted along such lines and should be directed particularly towards consultation with the banking and money market institutions who would have to participate in any MBC scheme.

4. I said that the FST's ideas sounded sensible enough, but probably considerably more sensible to the Treasury than the Bank. However neutral the presentation of the paper, it could hardly avoid giving the impression that the authorities would be prepared to accept the automaticity of a MBC scheme provided it had no intolerable technical snags. The clearing banks and the discount market, for a start, would almost certainly respond to an appearance of official neutrality by asking the Bank, through a whole variety of channels, what it was that we really wanted; and would not take "don't know" for an answer. Moreover, if they thought we were really not keen on MBC they would probably not give it serious consideration and would respond negatively. I added that I would myself expect that the Bank would indeed come to a decision in principle, about what it wanted, before going into consultations. I may have got this wrong but that is the opinion that I gave to Littler. He for his part accepted that the position of the Bank was indeed different from that of the Treasury and the Government and that an appearance of complete open-mindedness would not be easy for us to maintain.

5. I also said to Littler, yet again, that I did not see how HMG could proceed with the consultative paper without first deciding their position on two vital prior issues. There was firstly the question of interest rate automaticity, albeit combined with substantial continuing discretion in the fields of debt management and foreign exchange intervention, and in certain circumstances over MLR. Unless HMG were in principle prepared to accept the substantial degree of automaticity there would be little point in staging elaborate

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consultations about it. Perhaps, in going so far as announcing that a consultative paper would be produced, HMG had already accepted the principle of automaticity. But I was not aware that acceptance of this principle had been agreed by Ministers, nor had it been agreed by the Bank. Secondly, and perhaps even more important, there was the question of perverse automaticity in response to foreign exchange intervention. Nobody had yet denied that such perversity would prevail; and its likelihood could certainly not be concealed in the consultative paper. That being so, its presence as an issue would at once raise questions about HMG's intentions regarding the European Monetary System. If, in the context of a reform of the domestic monetary system, full membership of the EMS had to be treated as a working hypothesis, then it would have to be explained just how one could combine appropriate interest rate automaticity, linked to the domestic money supply, with a fixed exchange rate. At first blush, this would be very difficult. Conversely, it could well be very embarrassing for HMG, ^{in the context of its European policy,} to appear to be consulting about the benefits of a new system of domestic control which assumed a fairly free exchange rate float.

6. Littler accepted that these prior issues were indeed of great importance and said that they would, of course, certainly be included in Bridgeman's paper. He was at first inclined to argue that they could perhaps somehow be skated over, so that a consultative paper on Lawson lines could be published without showing the Government's hand on the prior issues themselves, but was unable to maintain this position with much confidence in the face of repeated arguments on my side.

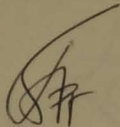
7. I may well be over-reacting to this situation, and under-estimating the freedom with which the monetary authorities can nowadays air ideas in writing, and consult about them, without any prior commitment at all. Also, it may well turn out to be the case that the Government and ourselves can accept the principle of automaticity while retaining plenty of room to disengage from embarking on the practice of it if consultations point us that way. Nonetheless the principle of automaticity requires acceptance by the Prime Minister.

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I am more worried about the problem of external flows and out future full membership of the EMS.

8. Bridgeman's note on 'Issues' will be circulated as soon as it becomes available.

A handwritten signature in dark ink, appearing to be 'SF' with a flourish above the letters.

22nd November 1979.