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SECRET

Monetary Control dose

THE GOVERNORS

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REVIEW OF MONETARY CONTROL

(Preparation of Consultative Paper:
a further progress report)

1. Bridgeman's long-awaited paper finally appeared on Monday of this week and was sent to the Chancellor together with a dossier of background papers. A copy of the paper is attached. ? It is to be expected that Treasury Ministers will in due course hold a meeting with their officials and with ourselves to discuss the issues raised. A further meeting of the Littler/Fforde group is also indicated. The meeting with Ministers has not yet been arranged and we do not yet know when it is likely to be held.

2. Bridgeman's paper omits any reference to the problem of external flows and in particular to the implications for our possible full entry into the EMS. This omission was accidental and will be repaired in a postscript which will also emphasise our own close interest in this point.

3. My own view of JMB's paper, with postscript, is that it is a clear and thorough sketch both of the 'issues' themselves and of the complexity of the whole subject. But I would draw your attention in particular to paragraph 39 which foresees some further discussion with ourselves about objections to the more extreme versions of monetary base control. We do not at present think that these discussions will cause us great difficulty or weaken our view, which we hold in common with, e.g. the Federal Reserve and the Bundesbank, that while a central bank can dictate the price at which cash is supplied to the banking system it cannot simply refuse to supply in full the cash that is needed to meet a mandatory requirement.

CC 5/12 39.

4. As to the preparation of the consultative paper(s), we hav[e] had several meetings and a great deal of drafting has been done. The present state of play is as follows:-

(a) We have concluded that it would be inappropriate to go for a long single paper covering the whole ground. The subject is too complex and a single paper would be too long for ready assimilation by Ministers, Clearing Bank Chairmen, etc. A better plan seemed to be to go for a short main paper of about 15 pages with a long supporting Annex divided into three chapters covering, firstly, the reserve asset ratio and primary liquidity, secondly the choice of target aggregate, and thirdly monetary base control together with greater flexibility/automaticity of the interest rates at which our money market operations are conducted.

(b) We hope to have the first two chapters of the Annex in a form fit for wider circulation by the end of the week. The first half of the third chapter is in presentable form but the second half requires reconstruction which will not be complete until the middle of next week.

(c) A draft of about one-third of the short main paper has been prepared by EAJG, who hopes to finish a full draft by early next week. We will hope to discuss this in the working group next Tuesday with a view to amendment and wider circulation later in that week.

5. We have been working on monetary base control for some 18 months now and it would not be surprising if we were getting a little jaded with the whole subject. But our present view, arising from further examinations of 'Variant (c)' set out in our paper of October 25th (and my draft cover note thereon of the same date) is that an element of automaticity in the Bank's lending rate, in response to untoward movements in the target aggregate, might best be obtained by directly linking our operational lending rate to a moving average of weekly money figures rather than linking it indirectly through a monetary base structured for the purpose. The latter part of Chapter 3 of the Annex is therefore being recast so that it becomes in large part a discussion of the pros and cons of the direct versus the indirect link. It is noteworthy in this context, that Ministers are reportedly taking some interest in the idea of a floating MLR.

6. It would be premature to suggest that, at the level of the working group, we are likely to come down strongly in favour of the 'direct link' suggested in the preceding paragraph. Technical difficulties would remain and there are in any case the unresolved prior issues concerning the advantages of automaticity itself and its compatibility with alternative exchange rate régimes. But the direct link arrangement would at least be fairly easy to understand; and a set of proposals which abolished the reserve ratio, substituted the liquidity norm, and directly linked our lending rate (subject to limits) to a moving average of weekly money figures, would be relatively straightforward and would not immediately involve us in a major institutional upheaval. The trouble with monetary base control, in all its manifestations, is that it is too difficult and complex a subject. It can be made to look persuasive and attractive at first sight but quickly becomes almost unmanageable in detailed discussion; and I fear that talks with Ministers, let alone the Prime Minister, may get hopelessly bogged down in technical confusion. A much more simple way of imparting automaticity to our lending rates might then have a good deal in its favour, at least as an option for meaningful discussion and decision.

GF.

5th December 1979