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TREASURY
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NOTE OF A MEETING HELD IN THE CHANCELLOR OF THE EXCHEQUER'S ROOM, H.M. TREASURY ON THURSDAY, 5 FEBRUARY 1981 AT 2.45 P.M.

Present:

Chancellor of the Exchequer (In the Chair)
Chief Secretary
Financial Secretary
Mr Burns
Sir K Couzens
Mr Ryrie
Mr Middleton
Mr Britton
Mr Monck
Mr Unwin
Mrs Lomax
Mr Turnbull
Mr Ridley
Mr Walters - No.10

MONETARY CONTROL

The 3 February discussion was resumed on the basis of Mr Middleton's submission of 4 February and the paper attached to it. The Chancellor said the question to be settled was whether he should announce in the Budget the possibility of an early move to non-mandatory Monetary Base Control (MBC) as an alternative to the evolution of monetary control arrangements foreshadowed in his 24 November statement.

2. Mr Middleton said that, in further discussion with Mr Walters, the alternative course had now been defined rather more precisely. A broad monetary base (M_0) would be targeted over a six month rolling period. Broadly those methods of control which were already being contemplated would be used, with the authorities acting to push interest rates up if M_0 was running above the target range, and reduce interest rates if it was running below the range.

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It seemed likely that the interest rate bands within which the authorities would be working at any particular time would have to be wider than hitherto contemplated. Under this system £M3 could still be retained as a medium term objective. An announcement in the Budget would be essential, given the substantial changes which the discount market, the banking system and the building societies would have to make in the way they do their business in time for the new system to be introduced before the end of 1981. There was no guarantee that an M_0 objective could be achieved over a six month period; considerable uncertainty remained as to whether the manipulation of interest rates would lead the general public to adjust their holdings of cash to the required extent within the time period. The question thus remained whether some other aggregate might not be preferable to M_0.

3. The Chancellor noted that an immediate move to MBC required far-reaching decisions to be taken in a very short time. This was in striking contrast with the procedure whereby future arrangements for mortgage tax relief were to be decided over an eighteen month consultative period. He questioned what were the overwhelming advantages of MBC which made it desirable to take decisions within a very few weeks. Mr Walters said that the advantage of MBC was the very much better control over inflation it would make possible; the excellent Swiss record on monetary control and inflation demonstrated the advantage of the system. Moreover MBC was in effect the UK system from 1840 to 1913, a period when there had been no inflation in the UK. The course he had proposed had been specified so as to fit in closely with the existing UK institutional arrangements; he saw no case for a long adaptation period during which a gradual move was made towards MBC - we should learn little about the demand for monetary base if we sought to change the system by evolution.

4. The Financial Secretary said he had much sympathy for Mr Walters'

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proposals; but he thought there were serious dangers of damaging side effects in present UK circumstances. He doubted whether the Swiss success could be attributed to MBC alone; Switzerland also had the advantage of a balanced budget, and he thought it would be very unwise in the UK situation to abandon setting the monetary objective in terms of a braod aggregate while the present large public sector financial deficit remained. He did not think MBC on its own would do a trick in the UK, and preferred to follow the course already indicated in the Chancellor's November statement, and in particular to see what could be achieved through more flexible arrangements for short term interest rates.

5. Mr Burns suggested that, before looking at MBC, we should choose between a broad and a narrow aggregate for the specification of the Government's monetary objectives. Were we ready to move from total commitment to a broad aggregate to an exclusive emphasis on a narrow one? (He thought the distinction between M_0 and M1 should not be exaggerated - both would have to be targeted in much the same way.) He agreed that considerable importance should be attributed to the narrow aggregates, but felt that a good deal of further analysis and experience was required before any far-reaching commitment to a narrow aggregate was entered into. He pointed out that the recent relatively slow growth of the narrow aggregates made it more difficult for the immediate future to specify the target in terms of them; as interest rates fell, their growth would tend to accelerate, and a low target could well require the downward movement in interest rates to be reversed.

6. The question was raised how precise the tracking of a narrow aggregate over a relatively short period should be, or - to put the question another way - how much interest rate variability would be acceptable in practice. The Chancellor said he was anxious to make monetary control more effective, and to give the markets more say

/in determining interest

in determining interest rates. But in present circumstances the credibility of monetary policy was far from firmly established, and he would be very reluctant to give the impression of indecision which would be implied if the Government were now to announce that they were going to follow a course markedly different from that outlined in his 24 November statement. Mr Walters said the extent of the change in direction should not be exaggerated; he accepted that it might still be necessary in effect to aim at a target range for interest rates, at least for a period, although changes in the monetary base would be closely watched. Mr Britton noted that it might not be easy to determine interest rates by reference to the monetary base; the relationship between M_0 and interest rates was uncertain, and M1 could well prove a better target from this point of view. If a supplementary target to go with a medium term £M3 objective were required, M1 would in his view be better; insofar as M1 was open to objections arising from its misuse in 1974, these applied also to M_0.

7. In further discussion the advantages of evolutionary change were emphasised. There was a risk in the immediate future that we might find relatively rapid growth of both broad and narrow aggregates, associated with upward pressure on the exchange rate. Would we then want to be committed to immediate substantial increases in interest rates? A more gradual movement towards a narrow aggregate would leave us with a safety valve in the meanwhile, and would allow the possibility for further study of the performance of alternative definitions of the monetary base as indicators in the meanwhile. There was no question of a move to MBC, and substantial changes in the operations of the financial institutions, being permanently ruled out; but by contrast an early announcement of a move to MBC, even in a longer time scale, would mean an irreversible commitment to institutional change. Under the course already charted the possibility would be

/open to make more

open to make more use of both M_0 and M1 in the determination of short term interest rates; thus a good part of the changes suggested by Mr Walters could in practice be introduced without any immediate commitment to an eventual move to MBC.

8. Sir Kenneth Couzens emphasised the importance of re-establishing the credibility of monetary policy; in present circumstances it would be undesirable to rush away from £M3 and stake everything on what would be a leap in the dark. It would however be sensible to say now that the authorities would pay more regard to movements in the narrower aggregates; such a step would be credible and evolutionary, and leave adequate room for manoeuvre; such room for manoeuvre could well be required in the light of the Prime Minister's remarks about having regard to the exchange rate in setting interest rates (which would not be possible if interest rates fluctuated markedly according to the requirements of an MBC target). Mr Burns suggested that the authorities might seek to give the £M3 target greater stability by not rolling it forward every six months; at the same time it might be possible to specify ranges for the narrow aggregates which would be consistent with the £M3 target. The Financial Secretary was more doubtful about this; he thought the worst course would be one in which we shifted to a narrow aggregate as the monetary target, and were then obliged by the pressure of events to increase the target. Mr Walters said that he too was worried by the possibility of such pressure; he feared that the £M3 over-run would be monetised - that it would in effect feed into the monetary base. He would himself like to fix a target range of 5-7 per cent for the increase in M_0 over the next year.

9. The Chancellor, summing up the discussion, said that there was still some way to go in getting the necessity of monetary control

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accepted in the UK; but people were now becoming used to looking at £M3, which it would be sensible to retain. Nevertheless we should at the same time pay more attention to the narrow aggregates - M_0, M1, and - when it became available - M2. It would be enough for the time being for the system to evolve, without commitment, towards MBC. He envisaged saying in the Budget Speech that more attention would be paid to the monetary base and other narrow aggregates, and that further study would be made of the properties of these aggregates.

JW

A J WIGGINS
6 February 1981

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