



10 DOWNING STREET

Mr Lamberts

MBC PL

This was a record
of my attempt to
"ginger up" the
Chancellor in April.

You may think that
the PM should at
least know about it

ALW

AW - Where do we get from here?

Copies to [initials]
JW



cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Mr Burns
Sir K Couzens
Mr Ryrie
Mr Middleton
Mr Monck
Mr Unwin
Mr Turnbull
Mr Ridley
Mr A Walters
Mr T Lankester) No.10

NOTE FOR THE RECORD

MONETARY BASE CONTROL

Mr Allan Walters called on the Chancellor this morning at 10.00 a.m. Mr Burns, Mr Middleton and Mr Ridley were also present.

2. Mr Walters said he felt that now the Budget was out of the way, the Government should take the decision to move to Monetary Base Control (MBC). He had no objection to the use of £M3 as an aggregate to be monitored, and he thought it appropriate that £M3 should be the focus of the MTFs. However, in the short run he thought the monetary base should be the control variable. His concern was to de-politicise decisions on interest rate movements, at present it appeared that MLR movements were very substantially affected by the requirements of the political situation. MBC by contrast would allow interest rates to be set by reference to an objective rule. In establishing such a rule, the move to MBC would fill a clear gap in the Government's current policy stance. There should be no particular difficulty about choosing numbers for a monetary base target, although a decision would be needed about the time period over which the authorities would aim to hit a target. Decisions would be needed about the future of the discount market, and perhaps also about the operation of building societies.

3. The Chancellor noted that Professor Griffiths, who had been an advocate of MBC, had recently produced a paper which argued for the retention of £M3 as the target variable. Given the extent of the Government's commitment to £M3, it would be very difficult to move away from this without a major change in the presentation

/of policy.



of policy. At the least it would seem sensible to wait until the next Budget, for the current year the £M3 target would have to remain. Although the movement of £M3 during the course of 1980 had given rise to serious problems, £M3 had proved a more reliable current policy in the circumstances of the earlier 1970s. There were reasons for thinking that last year's experience was likely to prove wholly exceptional; the 1979 switch from direct to indirect taxation, coupled with the removal of exchange, price and dividend controls could be seen as having resulted in a once-for-all shift in the demand for money. Mr Walters noted that the monetary base would in practice have given the right signals about interest rate movements in the latter part of 1980, while movements in £M3 gave no support to the interest rate reductions implemented by the authorities, the very slow growth of the monetary base would have provided a clear explanation for them.

4. In further discussion, Mr Burns and Mr Middleton said they thought the substance of the issue was how far the Government wanted to move now towards a situation in which the monetary base was the sole determinant of short-term interest rates. It was questionable how far it would be sensible at this stage to emphasise the monetary base to the exclusion of other factors. So far policy had been cautious and pragmatic, with the authorities seeking to learn from the market's response to each step towards a greater role for them in the determination of interest rates. Given the very slow growth of the monetary base and other narrow aggregates over the last eighteen months, it was questionable how far the authorities should now limit the flexibility within which they would operate; it seemed likely that it would continue to be necessary to take some account of movements other aggregates and in the exchange rate.

5. Meanwhile it seemed undesirable for the authorities to commit themselves too deeply to the early introduction of MBC. Further

/work still needed to



work still needed to be done on the relationships between the monetary base and the various monetary aggregates. In these circumstances it would be better to concentrate for the time being on the further steps already outlined by the Chancellor for improving short-run monetary management: the introduction of the (unpublished) band within which interest rates would fluctuate, and the suspension of MLR. While it now seemed likely that the cash ratio would have to remain, although transformed into a minimum applicable to all banks instead of an average applicable only to the clearers, the Bank had introduced a useful measure of flexibility into the reserve asset ratio. The best course seemed to be to work towards the successful implementation of these further changes, while at the same time paying close attention to movements in the monetary base and the narrower monetary aggregates. In this way the authorities might hope to learn more about controlling the base and M1 by regarding them as in a sense "shadow targets", without any commitment to a move away from £M3. It was noted that the monetary base seemed to have moved fairly closely in line with M1, and that operating by reference to a six month average of the monetary base might not be very different from using M1 as the target variable. As well as moves to enhance the role of the markets and setting short-term interest rates, further attention should be given to possible funding initiatives in the fields of indexed debt and national savings.

6. It was agreed in the light of the discussion that it would be appropriate to stick to the programme of monetary control changes already outlined by the Chancellor. At Mr Walters' suggestion, Mr Middleton undertook to provide a note setting out a possible timetable for the work needed to reach the necessary further decisions in this field, which could then form the basis for a discussion with the Bank. Mr Walters would thus be associated with the Treasury in keeping up the pressure on the Bank to ensure that they made the promised changes.

JW

A J WIGGINS

28 April 1981