



10 DOWNING STREET

MR. MIDDLETON

I attach some notes on  
Monetary Control - The Next  
Steps.



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cc Mr. Burns  
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## NOTES ON MONETARY CONTROL - THE NEXT STEPS

### Paragraph 3(b)

Is it not important to state what is penal in relation to those established by the market? Should we not say that funds will be supplied at say 3%, or maybe 2%, above the market rate of the day that the funds are borrowed? We might have to define this even more precisely in terms of time, etc. Secondly, should not the rate apply to all borrowers? I would be reluctant to think that the Bank will supply funds at one rate for one borrower and another rate for a different borrower. But perhaps I am being pernickety there because presumably the Bank should operate a system where they do not discriminate between borrowers.

### Paragraph 4

I find this part of the new system the most unsatisfactory. I don't think anyone will imagine that we are going to set interest rates at all by reference to M3. After all we haven't done so in the past and we are unlikely to change now. In its present formulation this suggests a whole rag-bag of factors and we really have not got agreement here at all. In my view it would be best to state unequivocally that the objective would be to have a constrained growth of a monetary base over moving six to twelve months periods of 5% per annum this year, and thereafter declining to virtually zero per cent per annum in 1985. This does not mean that in the interim period one couldn't use liquidity considerations, exchange rates and even real interest rates to vary the open market operations of the Bank at this short end. But there is a considerable distinction between varying interest rates to secure a long-run target of the growth of  $M_0$  and day-to-day operations which may take into account all the factors you list, such as the exchange rate, the behaviour of other variables, such as liquidity considerations in the banking system, other interest rates, etc. I think in its present state the crucial problem is to distinguish between the long-run objectives and short-run accommodations. This doesn't appear in the present note. It is, however, relatively simple to argue

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that, in the long-run, the movements of the monetary base and  $M_3$  are fairly highly correlated. This then gives us an argument for using the monetary base as an intermediate target for the control of  $M_3$  and PSL aggregates. This is then consistent with the medium term financial strategy.

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## NOTES ON MONETARY BASE CONTROL - THE PRESENT SITUATION

1. Since November 1980 there has been no rule for interest rate control and open market operations. The general procedure has been to sell as many gilts as the market will take, but this is at prevailing interest rates. We are not moving interest rates in order to control any monetary magnitude. In short there is no monetary control. We are responding to the demand for money and not determining its supply.

### Monetary Base Control

2. There is no reason why we should not attempt to control the monetary base of the system. Since  $M_3$  is influenced, but certainly not determined by, the sales of gilts to the non Bank private sector, there is no reason why this policy should not continue alongside the system of monetary base control. In this control system we are only concerned with the liabilities of the Bank of England in the form of cash held by the public, cash in bank tills and bankers' deposits. There does not seem to be any marked inconsistency between controlling these liabilities to some specified 5% growth rate, on the one hand, and pursuing existing policy of selling gilts in order to influence the path of  $M_3$  on the other. Thus monetary base control is entirely consistent with the present control mechanisms used in medium term financial strategy.

### The Disadvantages

3. It is thought that the main disadvantage would be the fact that interest rates will oscillate more than under present conditions. But this depends very much on the monetary base policy pursuit. If we try to keep a growth path day-in day-out of 5%, there certainly will be marked oscillation, but if instead we are concerned with growth over much longer periods, say six months to one year, then there is no reason why there should be induced liquidity crises of this nature.

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In fact we should make it clear that the day-to-day operations of the system are concerned with supplying adequate liquidity to the banking system. The control of growth rate at 5% per annum would be over a period longer than six months and probably about a year in duration.

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