10 DOWNING STREET

Prime Minister

Here is the promised brief from Alan Walters.

I think it should be sufficient for you to read this and the covering note from the Treasury at Flag B.

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PRIME MINISTER

Notes for the Monetary Seminar: 31 July 1981

The ultimate objective is to switch from a system of control through interest rates to a system whereby interest rates are determined by market forces and the Bank controls the money supply quantitatively using open market operations.

The medium term objective was to have "new arrangements" which allow markets to have greater influence in determining short interest rates within a moving band. The movement of the band would be determined basically, but not solely, by quantitative money supply targets. The new arrangements envisaged in the November seminar and reaffirmed in the March budget are now substantially in place.

You may feel it right to congratulate the Bank and the Treasury on getting the basic "new arrangements" working so efficiently.

- the discount window is now used only very infrequently

- interest rates (up to 14 days) have moved with market pressures within the band (2 percentage points wide)

- MLR is now otiose

- the cash ratio and RAR have been reformed

These changes have been achieved in very difficult market situations (with the fall of sterling and record high US interest rates) yet with the money supply apparently remaining under control. All the interim objectives, which you set out in the November seminar and reiterated in your minute of 4 June to the Chancellor have been achieved.

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Although the Bank was rather reluctant to give up their "signal" of the MLR (at least until the strike is over) there is now full agreement that MLR be abolished on 20 August. This move is widely expected by the markets and should cause no problems. The Bank wishes to retain some power to lead money markets by announcing the rate at which it will supply cash. Again there is agreement that, although such occasions should be rare, the Bank ought to have such residual powers.

There is no agreement, however, about the criteria which should be used for moving the unpublished interest rate bands. The Bank is not happy with the use of quantity-of-money targets, whether M3 or M1. The Bank would clearly like maximum discretion to determine the band in accordance with its view about credit conditions and sterling, etc. For the most part, the Treasury (especially Peter Middleton) would like to move the band so that it is consistent with a quantity target - and I suspect that Middleton and his group would prefer M1 as the target.

Although there is apparently inconsistency between the Bank and Treasury views, there is a possibility of reconciliation. For the quantitative targets the stress is that they be achieved in the long run (i.e. over more than a 12 month period). Within this period, in the day to day, month to month, or quarter to quarter management of the bands, there could be considerable discretion. The Bank could respond to transitory credit demands, "shortages", and to erratic movements in sterling, provided that it delivered the appropriate quantitative targets over the long period. The combination of short period discretion with long period targetting is entirely consistent with the Government's strategy.

This still leaves the issue whether primacy be accorded to M3 or M1 as the long run target for movements of the band. At present, and for at least six months ahead, this is not a live issue.

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The M3 and M1 figures have been obscured by the strike. And even if the strike is settled in August, it will take some 5-6 months to unwind the effects. Meanwhile, only the monetary base is known with certainty. This shows a modest expansion of about 5% and is again consistent with the MTFS. Thus as far as we know interest rates over the past 6 months or so have been appropriate for domestic purposes. Monetary expansion seems to have been contained.

Choosing £M3 for a primary long run target would be attractive mainly in so far as it can be represented as directly consistent with the MTFS. But in view of the policy on MLR from November 1980 onwards, it is doubtful if such a policy announcement would carry much conviction. And the structural changes in credit markets (such as for example the recent incursion of banks into housing mortgages) suggest that £M3 may again provide, as during 1980, only a rather biased guide to monetary conditions.

Choosing M1 as a primary target would be better in the sense that short term interest rates have more influence on M1 than on £M3. Thus, a statement that interest rates are to be determined largely by reference to the trend in M1 would carry some conviction. (It would be very similar to the United States M1B criterion.) (But there would be the risk that £M3 and M1 would follow markedly different paths for a while, as in 1980, and this would require close monitoring and appropriate interpretation. Using M1 as a target for the band would also be a step nearer to a form of MBC. (My preference is for a long run primary target for M1. However, since all aggregate other than M_0 are likely to be very obscure until the end of the year, I believe that we should watch closely M_0 the wide monetary base - the only monetary aggregate on which we can rely.)

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The ultimate transition to MBC can be achieved by widening the bands and relying on operations in money markets to control the base. In the Treasury papers there is no recommendation for a timetable for widening the bands nor for a decision for proceeding to MBC. It should be possible and useful to review the "new arrangements", and in particular the width of the bands later in the year (November, say). I believe that by February, 1982, the banking system will have had time to adapt their reserve policies and we shall have sufficient experience of the new arrangements, so that we can take a firm view of the next steps. Decisions should then be made on a timetable for the adoption of MBC or some clear alternative policy. The Bank may not find this palatable, but will probably agree that it is feasible provided that it has considerable short term discretion.

ALAN WALTERS

30 July, 1981