Andrew — I must have a discussion with Nigel and if necessary also with Peter Middleton and Terry Burns. It looks as if we must have another Bank seminar. I had no idea we had let things go to such an extent. MT

4 June 1985

PRIME MINISTER

MONETARY CONTROL

1. I entirely agree with John Redwood's judgement that monetary policy is not too loose. The growth of the monetary base is well down in the target range, and is consistent with a long run inflation rate of circa 5%. With the high interest rates prevailing over the past year, it is likely that the growth rate of the monetary base will decline further, subject to the provisos below, and the longer run inflation rate from 1988 onwards may be pressed below the 5% level.

2. Although the general stance of monetary policy is broadly consistent with your objectives, the operations and procedures of monetary policy are quite different from those which we envisaged in 1981. In short, instead of a market-oriented monetary policy, we have a Bank-controlled and administered policy. (So far as I can see, much of this change has taken place over the last year or two.) This system of administerd interest rates with no penalty rates, together with the influence of the exchange rates, generates considerable instability and removes much of the self-regulating mechanism that, in 1981, we saw as the main desiderata of monetary control.

3. In 1981 we agreed that the Bank would control the 7 day rate within an unpublished band, and that intervention would be restricted to this short end. The term structure of all interest rates would then be determined by the market, and would reflect the expectations of future levels and term structures of rates. This would allow the market to absorb, more or less smoothly, external shocks and changes in government policy.

4. Quite soon the Bank had given up the idea of a flexible short (7 day) rate and the de facto band had shrunk to a point. The market managers at the Bank, rightly, pointed out that the intervention rate was well known and expectations constrained them to one point rate. Such a move did little damage to the substance of the system so, with little reluctance, we went along with this arrangement. More ominously, however, the Bank said it found it necessary to intervene in the higher bands up to and including the market in 3 month bills.

5. The main reason for such intervention in the 1 to 3 month market was the scale of the Bank's bill operations which were required in order to supply the market with sufficient liquidity to hold the level of the 7 day interest rate. Daily shortages of £500 million were common, and occasionally £1 billion or more was required.

6. One of the principal causes of these large liquidity requirements was the overfunding of the PSBR in order to control the growth rate of £M3. (You will recall that in 1982 we took the view that we should not overfund the PSBR, but somehow in 1984-5 this has been ignored.) In effect, the Government borrows long and lends short. In the process, we have raised a mountain of bill assets and a swamp of gilt liabilities. This would not matter very much, although it does look absurd, if it were not for the fact that the bill mountain matures and needs to be rolled over very frequently. Thus the Bank dominates the bill market in its roll-over and liquidity operations.

7. In its desire to promote what it regards as orderly markets, the Bank has arranged its intervention so that there is a downward sloping yield curve in the 7 day to 3 month bill market. The yield curve is controlled with this constant downward slope, as illustrated in Gordon Pepper's paper, whatever the conditions in competitive money markets.

But competitive markets, particularly the interbank, show very large deviations from the yield curve for bills. Thus by creating an administered (and constant) structure of interest rates on bills, the Bank has opened up massive opportunities for arbitrage. It is clear that many banks may find it profitable to borrow in the bill market and lend in the interbank market. It is remarkable that the interbank yield curve, which is recorded by Pepper after such arbitrage, is still so far from the bill yield curve. But this is a measure of the opportunities and the problem. The instability and the effects on £M3 must be very large. (Incidentally I have seen somewhat similar effects of structural monetization recently in Brazil - with the same regulated administrative structure of interest rates associated with a free interbank and overnight market. The effects there have been devastating.)

8. The first question to ask is whether the Bank, under broadly existing conditions, could not allow the market freely to settle the term structure, even though the Bank continued to carry out its massive liquidity operations. I would guess that it would be possible for the Bank to buy (and occasionally sell) a fixed menu of bill maturities, so that the market could determine the yield curve. Once it was clear that this was the Bank's policy, the market would adjust rapidly.

9. However this does not deal with the fundamental problem, which is not per se the growth of credit, as exemplified in £M3, but above all the potential for instant and unstable monetization. The real reason for controlling $M3 and bank credit is the fear that this will become 'spending or transactions money' and so add to inflationary pressure. The point is that many credit instruments are accepted by the Bank as eligible for rediscounting and getting instant access to Bank money. There is no penalty rate. Consequently, there is a potential for immediate and

costless monetization. (As we know, the banks hold virtually no non-mandatory balances at the Bank; they do not need to.) While this situation exists, we have to be concerned about the growth of £M3 - not because of its effect on inflation, but because of the potential for trouble in the future. But the real fault lies in the fact that the Bank operates a no-penalty liquidity machine.

10. I believe that it is time to:

a. Review the experience of monetary control from 1981 to the present.

b. Examine the funding record, and particularly the phenomena of overfunding and the recent issues of long conventionals (again, you will recall our 1981 policy precluded such stocks).

c. Consider introducing the next stage of MBC, namely a penalty rate on bank borrowing from the Bank.

d. Review the future of the bill mountain and the effect on policy.

11. It would be best to keep such a review firmly in the hands of people who are knowledgeable of, but not responsible for, the past 4 years. (A team such as Michael Scholar and Brian Griffiths might be appropriate, with perhaps someone like Petherbridge - lately of Union Discount, but now retired - as a sympathetic and wise City participant.) I would be happy to help if you thought it appropriate.

Linda Rust

pp ALAN WALTERS

SIR ALAN WALTERS

The Prime Minister would be grateful for your assessement of the state of monetary policy in Britain. She would be interested to know your views both on the tightness, or otherwise, of monetary policy, and on the difficulties of monetary control including the problem of the bill mountain. I attach copies of the recent Greenwell Bulletin and of a note by the Policy Unit. Could you prepare a short note, to reach me by close on Tuesday, for discussion when you see the Prime Minister on Wednesday.

AT

3 June, 1985.