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NOTE OF A MEETING AT No.11 DOWNING STREET ON FRIDAY 7 JUNE 1985 AT 11.45am

Present: Chancellor
Economic Secretary
Sir P Middleton

Mr E George - Bank of England
Professor Sir Alan Walters

MONETARY POLICY

The Chancellor said the Prime Minister had a number of concerns, some of which he shared. While he did not accept that monetary conditions were out of control, he did have some worries about the system of monetary control. He hoped it would be possible to define some practical options for improving the situation.

2. Sir Alan Walters agreed that monetary conditions were not too loose. His concern stemmed from the way in which the 1981 arrangements had been amended both deliberately and under force of circumstance:-

(i) in 1981 the Bank had originally intended to operate only at the short end of the money market, keeping the seven day rate within an undisclosed band. Since 1983 the band had disappeared, and the Bank had been forced by the growth of the bill mountain to operate all along the yield curve. A bill mountain of the present proportions had certainly not been envisaged in 1981 and while it was not a major economic problem, it did have damaging effects on credibility;

(ii) the size of the Bank's daily operations in the money market had frustrated the aim of achieving greater automaticity in interest rate movements, and allowing more market influence on the structure of interest rates. Political anxiety about base rate movements had also played a part;

(iii) since 1981 more attention had been paid to the exchange rate in determining interest rates;

(iv) sales of long term conventional gilts had been resumed;

(v) contrary to his understanding in 1982, there had been continued over-funding.

3. A more welcome shift of emphasis had been the prominent role assigned to M0, always his preferred monetary indicator. The 1981 arrangements had been intended as an interim step on the way to monetary base control. Targetting MO was a step in that direction. But there had been no progress towards introducing a quantitive element into money market operations.

4. His judgment was that the monetary stance had been broadly correct since about 1980; this was borne out by the success in bringing inflation down to around 5 per cent, which he guessed was still the current underlying rate. But he was concerned that the system of monetary control contained no automatic mechanism to prevent a switch from broad money into cash. This was a potential danger.

5. The Chancellor noted that the 1981 arrangements had never worked as envisaged almost from the start. He shared Sir Alan Walters concern about over-funding and this had been reflected in his Mansion House speech in November 1983. There was nothing new about over-funding; what had happened in the last few years was that it had cumulatively reached absurd proportions and this was reflected in the present size of the bill mountain.

But we had been driven into over-funding as a result of our attempts to control sterling M3. As it had become apparent that sterling M3 was a highly imperfect measure of monetary conditions, so the justification for over-funding had become weaker. Conversely, de-emphasising sterling M3 was a necessary condition for ending the over-funding/bill mountain "merry-go-round".

6. Mr George was more concerned about current monetary conditions. He doubted whether policy was on track for re-establishing a downward trend in inflation (to around 3 per cent in 1988). The slowdown in wage settlements had come to an end and the prospect was for an increase in unit labour costs of around 5 per cent or more. This concern underlay his worries about the behaviour of broad money. While he could accept the idea that there had been some upward shift in the demand for sterling M3 as a result of financial innovation, the buoyancy of the economy and the behaviour of unit labour costs suggested that the performance of sterling M3 was less misleading than it had been in 1980.

7. The monetary policy instruments available to control sterling M3 were short term interest rates and over-funding. He would be happier with more emphasis on higher short term interest rates since these would help to control demand for credit. But over funding was a perfectly rational second best approach. It helped to restrain the aggregate demand for credit from both public and private sectors. The objections to it were presentational. The bill mountain was an even more severe presentational problem. In economic terms it was not important; it was a technical inconvenience, the scale of which had been much exaggerated by commentators like Gordon Pepper.

8. The ways of reducing reliance on over funding and checking the rise in the bill mountain had been much discussed in recent

years. They included steps to improve PWLB facilities to reduce bank lending by local authorities and changes to encourage companies to borrow from the capital markets rather than the banks. The impact of the bill mountain on money market operations could be sharply reduced by lengthening the maturity of "hard core" assistance, either by placing long term deposits with the banking system or buying-in fixed rate export credit paper currently held by commercial banks.

9. Sir Peter Middleton felt that inflation would come down further. His principal worry concerned public expenditure and the fiscal side. This underlined the need for a credible monetary policy. The present policy lacked clarity; the time might have come to make a decisive move to restore credibility. His own preference would be to drop sterling M3 as a target and rely on M0 and the PSBR. Practical and political realities meant that the exchange rate also had to be taken into account.

10. Sir Alan Walters supported Sir Peter Middleton's proposal. He saw it as the *sine qua non* for getting rid of over funding and the logical next step in the evolution of policy.

11. The Economic Secretary thought that overfunding was less worrying than the reason for it: the rapid growth in bank lending. No change in the emphasis of policy could afford to leave this problem to one side.

12. Mr George commented that the merits of Sir Peter Middleton's proposal clearly hinged on the importance attached to bank credit and broad money. He would be uncomfortable with any set of monetary indicators that left them out of account. Nor would the credibility of policy be improved by going in this direction.

13. The Chancellor took the view that Sir Peter's suggestion was less radical than it sounded; policy had been moving in

this direction for some time. The time might have come for more clarity. He would not propose disregarding sterling M3 entirely, but there could be a case for dropping it as a target. But any such step depended critically on the performance of other indicators: it would probably require a continuation of current levels of interest rates, some further deceleration in the growth of M0 and, above all, a firm exchange rate. Such a combination of circumstances, in his judgment, would be sufficient to put downward pressure on inflation.

14. Sir Alan Walters agreed that if interest rates remained at current levels, it was reasonable to expect some deceleration in both M0 and inflation. Any worries he might have voiced about monetary conditions had been based on the implicit assumption that the present level of interest rates was likely to prove temporary. Mr George was sceptical whether the current level of interest rates would produce a deceleration in both M0 and sterling M3 growth; a further rise might be necessary. He would not be convinced that monetary conditions were consistent with falling inflation if the only indicator pointing in that direction was M0. He accepted, however, that high interest rates could have the temporary effect of raising sterling M3 growth; and that financial innovation had complicated the task of interpreting the behaviour of broad money. Sir Alan Walters added that the restructuring of the economy could have inflated broad money by increasing the need for bank intermediation. This had certainly been an important influence in 1980 and 1981 and, in his view, was still significant.

Policy options

15. The Chancellor identified two options to deal with the related problems of sterling M3 and over funding:-

(i) to drop sterling M3 as a target altogether, and aim at a "full fund" of the PSBR (or, more

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precisely, the PSBR less the desired growth in M0);

(ii) to keep sterling M3 as a target, but to raise the range (probably in conjunction with a reduction in the target range for M0).

16. It was also worth looking at changes in money market arrangements that might inhibit the growth of bank lending. Sir Alan Walters suggested that this might be achieved by supplying cash to the banking system at penal rates, at least at the margin. He saw this as a logical step in the direction of monetary base control. This would inevitably mean more volatile base rates, which would be politically sensitive. But less predictability in the terms on which the Bank was prepared to supply cash to the banking system was the only way of influencing behaviour, on both the asset and liability side of the banks' balance sheets. The degree of volatility needed to induce such a change in behaviour was of course inherently unpredictable.

17. It was agreed that further work should be done to develop Sir Alan Walters' ideas about money market operations. Both the Treasury and the Bank would contribute to papers for a further meeting with the Prime Minister. These would be sent to Sir Alan Walters in Washington for his comments.

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RACHEL LOMAX