PRIME MINISTER

MONETARY POLICY

Gordon Pepper has sent a copy of his latest bulletin which was written after discussion with Alan Walters. He has also telephoned me to discuss it. He shares with Alan the view that current monetary conditions are probably not too lax but that the build up of liquidity, as seen in the rapid growth of £M3 and PSL2, is a cause for concern. This build up of liquidity could create problems in two ways. First, those holding liquidity could accelerate their spending which would manifest itself in faster growth of transactions balances, i.e. MO. Secondly, liquidity could, at short notice, be switched abroad putting pressure on the exchange rate as happened earlier this year. In either case the result would be faster inflation. Gordon Pepper's proposed remedy is to move to monetary base control, i.e. quantitative limits on the supply of cash to the banking system. He recognises that this cannot be done overnight. If the banks are not first induced to hold significant reserves at the Bank of England, variations in the cash surplus or deficit of the public sector, which can arise for purely technical reasons, can have a major impact on interest rates. It would be essential to build in some cushion to prevent the system being unstable.

Gordon Pepper added, regretfully, that he did not think adoption of supply side control of money was feasible at present. It would be a mistake to impose on those responsible for carrying it out a system which they did not believe in. He thought the second best was therefore to recognise that monetary targets had lost their effect in influencing expectations and that the Government should steer the economy by reference to money GDP and the exchange rate as is increasingly happening in the United States.

It seems to me that monetary policy has reached a crossroads. The option of setting a target for £M3 and varying interest rates according to whether £M3 is growing above or below

target is no longer credible. The alternatives are:

(i) to return to the true spirit of monetarism by controlling the supply of monetary base; or

(ii) to move away from monetarism towards a less specific anti-inflation policy in which the Government responds not to deviations in monetary growth from the target, or even to whether the exchange rate has moved from a certain parity, but according to a judgement of whether inflation is accelerating or is being brought down fast enough. The Chancellor began to move down this road in the last Budget.

If the Government were to adopt (i), it would again be identifying itself politically with a very specific objective of monetary control. It would be essential to deliver if the Government's credibility were not to be damaged. Above all, the Government would have to accept that determination of interest rates would pass out of its hands.

It can be argued that one of the objectives of the 1981 changes was, indeed, to give market forces the dominant role in setting interest rates. Conditions in the money market have, for technical reasons made this impossible to achieve. But I, for one, am sceptical about how Ministers would in practice have gone in abdicating control over interest rates. There was, however, another objective which was to depoliticise interest rate changes and reduce the "bias for delay". In this respect, the new arrangements have been successful and base rates have moved more frequently and with less drama than was the case with bank rate or MLR. Market forces have provided the camouflage which have enabled Ministers to bring about unpleasant but necessary interest rates changes while laying some of the blame elsewhere.

If one looks at the record of the past four years to detect what have been the factors which have induced changes in interest rates one will not find that variations in the

growth of money or the level of the exchange rate have played a significant part. The only thing which has consistently induced a rise in interest rates has been when the Government's inflationary objectives have been threatened, in particular when the exchange rate has fallen rapidly.

AT

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Sterling M3 responds quite quickly to changes in relative interest rates. M1 used to respond quite quickly to changes in interest rate levels. Mo, in contrast, does not respond quickly to changes in either interest rate levels or interest rate relatives. The Chancellor has, therefore, focused attention on an aggregate which the Bank is unable to control with its current mechanisms.

The greatest cause for concern in the present monetary situation is that the accumulation of liquidity which has been building up over the last few years could start to be spent, thereby generating renewed inflation. A mechanism is therefore required to hinder the amount of liquidity which can be encashed in the aggregate. Instead of being ready at all times and in all circumstances to buy whatever quantity of eligible bills the market wishes to sell, the Bank should decide on the amount it is willing to buy. If the market wants to sell a greater amount, the extra finance should be supplied by the Bank at a penal rate.

History

Monetarists originally argued that the supply of money should be controlled. The UK authorities decided instead to try to control the amount of money by influencing people's demand for it. They planned to do this by altering interest rates which, together with the level of nominal national income, are the main determinants of the demand for money. In other words, the authorities adopted a demand-side approach instead of the supply-side one advocated by most monetarists. Our last Bulletin argued that the current approach has just about reached the end of the road.

The authorities also decided to focus attention on M3 rather than the narrower aggregates M1 and Mo favoured by most North American and Swiss monetarists. They did so for various reasons.

First, M3 suited many in the Bank of England because blame for any excessive monetary growth could be placed on the Treasury for failing to control the PSBR.

Secondly, it suited the Treasury because the associated target for the PSBR strengthened the case of Treasury Ministers when arguing with Ministers in charge of Expenditure Departments for lower public expenditure.

R.H. Lawson, G.T. Pepper, The Lord Annaly, J.A. Rickards, L. Gooderham, T. Quinn, M.T. Higgins, D.G. Thomson, H.N. Seely, T.G. Wakeley, J.F.R. Hammond, J. Wigglesworth, E.J. Fenton, A.J. Bonner, N.S. King, G.P.P. Stewart, K.P. Joseph, A.G.P. Davidson, P.D. Jones, R.L. Thomas, K.C. Brown, J.C. Finch, S.J.D. Posford, R.W. Walker, W.E.A. Bain, R.M. Harvey, R.B. Pomphrett, M.R.F. Wonfor, A.L. Bucknall, M.S. Jaskel, P.B. Lilley M.P., A.J.E. O'Sullivan, G.R. Addison, K.M. Feeny, P.H. Beaufrère, K.A.J. Crawford, J.B. Lake, L. Maddy, R.J.M.L. Ottley, S.H. Wamsley, I.S. White, S.L. Greenwell

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Thirdly, it suited many academics, especially those who specialised in computerised models of the economy, because M3 allowed their neo-Keynesian approach to embrace monetarism much more easily than if attention had been focused on the narrow aggregates.

Summarising, the demand-side approach to controlling M3 adopted in the UK was a distinctly neo-Keynesian variant of monetarism.

Sterling M3

The first detailed mistake the authorities made was soon apparent in the early 1970s. They had focused attention on changes in the level of interest rates and had ignored the importance of interest rate relatives. Once they realised their mistake, they were reasonably successful in controlling the money supply because M3 responds quite quickly to changes in the rates of interest on bank deposits relative to those on similar investments. People switch between bank deposits and other investments reasonably freely and the Bank could control sterling M3 by operating on the difference in interest rates.

After a few years, this method of controlling the money supply ran into difficulties for two reasons. First, the Bank's ability to organise its desired interest rate relatives was progressively hindered by the problem of its growing bill mountain (which is itself a by-product of neglect of supply-side control). Secondly, the very high level of real interest rates, which is a consequence of the policy, increased people's demand for bank deposits as an excellent home for genuine savings. The result has been buoyant growth of the broader aggregates.

M1

The authorities then started to pay more attention to M1. Unlike sterling M3, M1 responded quite quickly to a change in interest rate levels. This was, however, when the non-interest bearing component of M1 was substantial. As the level of interest rates rose, people switched out of non-interest bearing deposits into interest bearing ones. M1, accordingly, fell because it contained relatively few interest bearing sight deposits.

More recently, starting in 1982, there has been a big increase in the interest bearing sight deposits which are included in M1. As interest rates rise, people now tend to switch from non-interest bearing deposits into interest bearing sight deposits, which leaves the total of M1 unchanged. Further, if there is an inverted money market yield curve, e.g. if the rate of interest on sight deposits exceeds that on seven day deposits, there will be a tendency for people to leave more money on deposit on an overnight basis. If so, M1 increases. Summarising, the growth of interest bearing sight deposits, and high interest bearing chequing accounts offered by clearing banks, has meant that the Bank can no longer control M1 reasonably quickly by altering the level of interest rates.

Mo

The Treasury has recently switched its focus of attention to Mo. It is widely known that the Bank has tried hard to resist this development. One of the Bank's reasons is, presumably, that Mo is different from M1 and sterling M3 because neither changes in the level of interest rates nor changes in interest rate relatives have a quick effect on it. As stated in our last Bulletin, a recent Treasury paper acknowledged that it takes about a year before the effect materialises, ie interest rates affect the level of activity in the economy as a whole and then the level of retail sales, which then affects the public's demand for notes and coin which currently amount to 90% of Mo. **In short, the Chancellor has focused attention on an aggregate which the Bank is unable to control with its current mechanisms.**

Attempts to control Mo from the demand-side are almost certainly doomed to failure. The Fed tried to do this in November 1979 and the result was a shambles (as reported in Bulletin No.131, April 1982). The lags in the system were such that the Fed persisted for too long with alterations in interest rates. This caused reverse swings to take place in due course. The result was not merely volatility. The system threatened to become unstable and the Fed abandoned its experiment in August 1982.

It will be no surprise if the target for Mo gradually lapses in the same way as those for M1 and sterling M3. It might subsequently be supplemented by a target for M2 but there are apparently technical problems with this series. Further, the credibility of introducing yet another target variable would be low. Overall, the discipline on the government of having published targets for the money supply is likely to progressively disappear, with the policy becoming almost wholly discretionary.

The experiences of the 1960s and early 1970s indicate that it is most unwise to rely on a discretionary policy. The main danger, however, will come from the continued build up of excess liquidity in the economy, which the authorities are currently attempting to contain by operations which result in the Bank's bill mountain.

Excessive liquidity and the bill mountain

When making new loans, banks normally bid for the necessary funds, ie they pay whatever rate of interest is necessary to attract the required amount of deposits. We have already argued that the current rate of interest which banks are offering is so high in real terms that bank deposits are an excellent home for genuine savings. Buoyant growth of bank deposits because of an accumulation of such saving is not an immediate cause for concern. The economy is, nevertheless, becoming considerably more liquid. The cause for concern is that people may at some time in the future decide to spend their liquidity. The mechanism to stop this from happening is currently not in place and the accumulation of liquidity could suddenly become inflationary if something happens to ignite the bonfire.

The authorities have been trying to limit the build up of liquidity. Cutting through the complications, the Bank has, through its purchases of commercial bills, provided no less than £15,000m to banks so that the latter can satisfy the demand for bank loans without having to bid for even more deposits. The incredible fact is that the amount of money which the Bank has needed to borrow for this purpose, by overfunding in the gilt-edged market, is almost twice as much as this year's PSBR. Further, the transactions are causing enormous distortions to markets.

The permanent solution to the problem would be to open up other sources of credit so that the demand for bank loans subsides. The obvious source was the long dated corporate bond market but attempts to revive it have so far had very disappointing results. More recently, attention has switched from long dated to short dated (1-5 year) corporate bonds. Another possibility is to induce banks to parcel up their loans into packages, convert them into negotiable securities and raise the necessary finance by selling the securities rather than by bidding for deposits. The same could apply to building societies with packages of mortgages. The securities could have either a floating or fixed rate of interest.

If recent policy moves are successful, genuine savings will accumulate in securities rather than in bank deposits. The securities will, however, be highly liquid. A very short dated floating rate corporate bond, for example, is quite a close substitute for "primary liquid assets" which the Bank stands ready to purchase. Although reduced in degree, the problem of the excessive build up of liquidity will remain.

Recapitulating on liquidity:-

i) Wholesale deposits are being held in overnight sight deposits rather than in 7 day deposits, and retail deposits are being held in high interest bearing chequing accounts rather than in deposit accounts.
ii) Inspite of this, interest bearing bank deposits for terms longer than overnight are growing.
iii) Building society deposits are also growing.
iv) Substantial holdings of very short dated bonds may well accumulate.

Restricting the encashment of liquidity

There is a strong argument for reinforcing current policy by putting a mechanism in place which would hinder people in aggregate from encashing liquidity. We suggest that the Bank should change its tactics in the bill market in a similar way to the change which occurred in the gilt-edged market in 1971 (explained in "Competition and Credit Control").

In the 1960s the principal aim of debt management was "to maximise investors' desire to hold gilt-edged stock over the long term". The authorities considered that a very important reason why investors were prepared to hold gilt-edged stock was confidence that they could always be sold close to middle market prices. The Bank, accordingly, stood ready to take stock off the gilt-edged jobbers whenever there was substantial selling. When the authorities withdrew this facility in 1971 there were fears that the liquidity of the gilt-edged market would dry up without the support from the Bank. In the event it did not. A very important reason for it not doing so was that the authorities had been interfering so much that they had been inadvertently damaging the market mechanism. Market participants returned to fill the gap left by the authorities. The parallels with the bill market are obvious.

The important strategic change in 1971 was that investors in aggregate could no longer encash gilt-edged stock but, as explained, this did not prevent one investor from being able to sell to another.

Turning to the bill market, under the current procedures the Bank stands willing to buy whatever quantity of eligible bills the market wants to sell. The Bank cannot withdraw to the extent that it did in the gilt-edged market because it needs to buy bills if the Exchequer is in surplus. The Bank could, however, decide on the amount of bills which it will buy rather than leave it to the market. This would prevent holders of bills from encashing them in aggregate.

The change which we are suggesting is more profound than it may seem. To be workable, any amount of cash wanted by the market in addition to that provided by the Bank's bill purchases should continue to be provided by the Bank. But the rate of interest charged by the Bank should carry a penalty (unless there is a genuine need for lending of last resort because a bank is in trouble). One consequence would be that banks would keep much larger balances with the Bank than at present to avoid paying the penal rate. These balances would be included in Mo and, to accomodate the shift in demand, the base of the target for Mo would have to be correspondingly adjusted.

If the changes we are suggesting were to be adopted, the authorities could legitimately be much more sanguine, in circumstances similar to those at present, about the growing liquidity in the economy.

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