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CHANCELLOR

FROM : D PERETZ

DATE : 20 JUNE 1985

cc Economic Secretary  
Sir P Middleton  
Sir T Burns  
Mr Cassell  
Mr Lavelle  
Mr Lankester  
Mr Sedgwick  
Mr H Davies

**PAPER ON MONETARY POLICY**

I attach a revised draft paper on monetary policy for the Prime Minister's meeting next week.

2. The structure follows that you outlined at your meeting on 17 June. We have also taken account of points made at the meeting with the Bank yesterday. You will see that the first three paragraphs incorporate a summary and guide to the rest of the paper. The Annexes are bulky, particularly Annex II. But we think it important to deal there with the points that Sir A Walters and others have raised.

3. Sir P Middleton is away today, and Mr Cassell engaged giving evidence to the TCSC. But they have seen an earlier draft, and this version includes their comments, and those of others.

4. The paper will need to go to No. 10 tomorrow, once it has been amended to take in your own comments. I attach a draft private secretary covering letter for the purpose. I understand Mr Turnbull will be arranging to get a copy to Sir Alan Walters in Washington.

5. As we promised at yesterday's meeting, I have also sent copies of this draft to the Bank.

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DRAFT LETTER

From : Mrs Lomax

To : A Turnbull Esq  
10 Downing Street

**MONETARY POLICY**

As you know, it has been decided that the Treasury and Bank will submit separate papers for next Tuesday's discussion. I attach the Treasury paper. The Bank will be letting you have theirs separately.

I am copying this letter and the paper to John Bartlett (Governor of the Bank of England's office). You kindly undertook to arrange for the paper to be sent to Sir Alan Walters over the weekend, and I enclose an extra copy for the purpose.

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MONETARY CONTROLI Introduction and Summary

There has been recent criticism and misunderstanding about the operation of monetary policy, and we are facing difficulties, both in the interpretation of conditions and the methods of control. The current divergence between broad money and other indicators has drawn attention to other longer standing problems about the operation of policy. These relate to the choice of targets and indicators, and, at a more technical level, the techniques of control, particularly the way the Bank operates in the money markets and the process of "overfunding" with the resulting growth of the bill mountain. It is right to take stock.

2. The most immediate question is whether monetary conditions are suitably tight to bring us back to a declining path for inflation. The various indicators do not all point in the same direction. Real short-term interest rates are at a historically high level; the monetary base (M0) is growing at a satisfactory rate, well within its target range; the £ is firm, and has risen against all currencies since earlier in the year. On the other hand bank lending and the wider measures of money and liquidity are growing very fast, with £M3 well above the top of its range. Our assessment (paragraphs 4-12 below) is that the recent rise in inflation reflects conditions that had become too loose last year and the short run impact of the higher interest rates needed to correct them. We believe that current conditions are tight enough to bring inflation back to a downward trend. There may not be much room for interest rate reductions but neither do we see any need for an increase.



3. The rest of the paper deals with longer standing problems, many of which have been reviewed on several occasions in the past. The fundamental issue, which underlies the others, is the choice of monetary targets and indicators.

(i) Interpreting monetary conditions in a sophisticated financial system like ours is not easy. MO has had a steady velocity trend and proved a useful indicator in recent years. The exchange rate has also proved a useful supplementary guide to policy. But £M3 has persistently exceeded its targets and grown faster than money GDP and inflation. Along with other measures of broad liquidity, it has been greatly affected by structural changes - which are certain to continue in future - and a rise in the demand for liquid assets as a form of savings (paragraphs 13-23).

(ii) "Overfunding" has seemed a more reliable way to seek to contain £M3 than raising short term interest rates. The process involves the Government borrowing more than it needs to cover its deficit, with the Bank offsetting the resulting cash shortages by short term lending to the market, mainly in the form of acquisition of commercial bills. But it has led to a £17bn bill mountain. This looks absurd; represents a large structural distortion in financial markets; and complicates official day to day market operations. And £M3 has still exceeded its target range (paragraphs 24-29).

(iii) There is some dispute over the extent to which growth of broad liquidity constitutes an inflationary danger. The danger of a liquidity overhang is that it might be converted into spending power at some future date. Some argue that it is right to try to restrain liquidity growth as an insurance against the risk of not being able to act quickly enough when the time came. But on the other hand, there are indicators - the exchange rate, MO, asset prices - likely to give early warning



of any inflationary pressures from this source, signalling the need for a rise in interest rates to contain them (paragraphs 30-33).

(iv) The arrangements for the Bank's operations in the money markets have turned out to be less flexible than originally envisaged when the present system was set up in 1981, partly because of the growth of the bill mountain. But interest rates whether influenced directly or indirectly are a key mechanism of monetary control. It was mistaken to believe in 1981 - if it was - that rates could be "left to the market". The practical question is whether we have adequate techniques for influencing interest rates, and whether these are sufficiently reliable to react quickly to a sudden move to spend liquid balances and the inflationary threat that would imply. We are satisfied that they are, and that we can and would react quickly in response to adverse movements in the monetary base, the exchange rate and asset prices. (It is not true to suggest the Bank are prepared to supply liquidity to the market without limit) (paragraphs 34-36).

(v) The final section of the paper sets out the main policy options on the central issue: the choice of targets and indicators and the role of £M3 (paragraph 40).



## II What are the short term prospects for inflation?

4. The recent inflation increase - as measured by the RPI - from around 5 per cent to 7 per cent largely reflects two factors, both of which we expect to be temporary.

5. The first is the exchange rate fall in the second half of last year which increased import prices and gave companies the opportunity to widen their profit margins. It also meant higher oil prices expressed in terms of sterling; petrol prices are currently 11 per cent higher than a year ago.

6. The second factor has been the effect on mortgage rates of the higher level of interest rates. The timing and extent of the interest rate increase was associated with the exchange rate weakness but a higher level of interest rates was appropriate for domestic reasons as money demand was rising faster than expected; in particular world trade and exports were stronger than anticipated.

7. Both of these influences on prices should unwind in coming months. The increase in mortgage rates last July will fall out of the year on year comparison in August; and the 2 point rise early this year will disappear next Spring. Even if mortgage rates do not fall from today's levels this would have the effect of reducing inflation by 1½ per cent next summer compared with today's rate.

8. In addition the exchange rate has now recovered last year's fall and import price growth is already moderating. Firms will find it more difficult to raise prices and already oil prices in sterling terms are some 10 per cent lower than in January. If the normal relationship of petrol prices to oil prices holds they could be down by nearly as much by next summer.

9. On the basis of the present level of the exchange rate and world oil prices our present expectation is that inflation



would be below 5 per cent by next summer. This is not contradicted by present information on house price increases. Recently there has been some very modest signs of quickening but average increases are below 10 per cent on a year earlier, and rising at around the same rate as over the last two years. There is nothing to suggest that we face the difficult conditions of the early or late seventies when rapid house price increases anticipated an upturn in the general inflation rate (see Annex III, Chart 2).

### III Are conditions tight enough to keep inflation declining in the longer term?

10. Abstracting from these temporary influences we estimate that the underlying rate of inflation has shown only a small increase in recent months. Unit labour costs in manufacturing industry have been rising by less than 5 per cent a year after making allowance for the effect of the Budget which reduced the average rates of National Insurance Contributions. Although this is faster than competitor countries it does not point to higher inflation arising from labour costs. And the lower inflation rate in the autumn should reduce the pressure for larger wage increases, though the settlement rate in the next pay round could well be a little higher than the 5½-6 per cent of the last year or so.

11. In general terms it can be argued that the underlying inflation rate has been on a plateau of around 5 per cent over the past two years; for part of the time the recorded rate was helped by special factors, particularly the mortgage rate; and for part of the time the recorded rate has been damaged by those same factors. Although the actual inflation rate may fall below 5 per cent in 1986-87 the underlying inflation rate is only likely to decline slowly. Maintaining the monetary policy implied by this year's MTF5 may not leave much room for interest rate reductions but we do not, at present, see any need for a further increase.



12. It is right to be cautious about the speed with which we bring down inflation. A policy stance designed to produce a sharp fall would put pressure on companies and would have adverse effects on output and unemployment. The implication is that we should stick to our strategy and not over-react to the high levels of inflation we are experiencing this summer; levels whose origins lie in monetary conditions that have already been corrected and the influence of the mortgage rate on the RPI.

#### IV Choice of monetary targets and indicators

13. In a sophisticated and fast changing financial system like ours, it is not easy to decide what monetary indicators to look at and how to interpret them. The difficulties are most obvious when, as at present, the different indicators are giving conflicting signals.

14. Taking narrow money first, in principle the obvious indicator to choose would be a measure of cash and balances held for transactions purposes - perhaps the aggregate of notes, coin and current accounts. But the figures here have been greatly distorted in recent years by the growth and heavy marketing by banks of interest bearing sight deposits. This has led to funds previously held at longer term, so as to attract interest, being switched into sight deposits; and it also seems to have resulted in a growth of interest bearing sight deposits at the expense of non-interest bearing sight deposits.

#### Growth of transactions money, 12 months to May 1985 (%)

MO	Non-interest bearing M1	Interest bearing M1	Total M1
5.5	4.1	43.8	15.8



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15. It was this distortion to the current account figures that lead us to choose a narrower measure still, MO (the total of notes, coin and bankers' balances at the Bank of England) as our preferred measure of narrow money. This measure has also been affected by structural and technical change, such as the growing use of credit cards and cash dispensers. But these changes seem to have been taking place at a steady pace, giving a fairly steady velocity trend for MO over a long period which we have been able to take into account in setting targets for it.

16. Despite these features, many still doubt that an aggregate that consists largely of notes and coin can be an adequate indicator of monetary conditions in a sophisticated financial system. It may be that the Treasury and Bank could have done more to explain with more conviction the merits of MO as an indicator: it is certainly clear that without some more concerted effort of that kind the market is unlikely to switch its focus from £M3 to MO.

17. Turning to the wider measures of money, an £M3 overshoot is scarcely a new phenomenon. As the following table shows, £M3 has exceeded its target over most of the period since 1979, only coming within it for the 2 years (1982-84) after a deliberate decision to raise the ranges originally announced for those years. Despite this we have brought inflation down.

£M3 performance against target : % growth at annual rate

	Target range	Outturn	Growth of money GDP (financial years)
Jun 1979 - Oct 1980	7-11	16.2	19.8
Feb 1980 - Apr 1981	7-11	19.4	13.8
Feb 1981 - Apr 1982	6-10	12.8	10.1
Feb 1982 - Apr 1983	→ 8-12	→ 11.2	9.4
Feb 1983 - Apr 1984 ←	→ 7-11	→ 9.8	7.9
Feb 1984 - Apr 1985	6-10	11.9	7.0



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18. The explanation lies in developments over the period that have affected the nature of £M3 and the private sector's demand for liquid assets. Bank deposits have become a more attractive way of holding savings, and this combined with other structural changes has diminished the significance of £M3 and other broader aggregates as monetary indicators. Much of the increase is in institutional funds held on deposit at banks as part of investment portfolios. The result is that the velocity of £M3, which rose sharply between 1974 and 1980, has since 1980 been steadily declining (see Annex III Chart 5).

19. One traditional attraction of the £M3 aggregate is the familiar statistical link with the PSBR. But it is clear that in recent years growth of £M3 has not been caused by excessive growth of the PSBR. Our performance here in relation to other countries has been good (see Annex III table 2).

20. It has been the buoyant demand for private sector credit - leading to a very rapid increase in bank lending - that has been the driving force behind £M3 growth. But like the rise in bank deposits that has financed it, this growth of bank lending does not seem in itself to have added to inflationary pressures. In the last three years bank lending has grown at an average rate of 18 per cent, while money GDP has been growing at around 8 per cent.

21. It is important here to recognise both the similarities and differences between monetary control in the UK and in other countries. Annex 1 describes the operation of monetary policy in the US, Germany and Switzerland. In all three countries the authorities place emphasis on the control of a narrow aggregate (in Switzerland, M0; in the US, M1; and in Germany, Central Bank Money - CBM). In the US and Germany there is also a concern with broader aggregates. But in those countries policy operates through a system of mandatory ratios between banks' reserves - that is their cash and deposits at the central bank - and their other liabilities.



On the one hand this gives a more certain relationship between bank reserves/narrow measures of money and broader measures, with which they are also concerned. On the other hand, because the reserve requirements in effect constitute a tax on bank intermediation, the system tends to lead to credit being channelled in other ways than through domestic bank lending. In other words, it causes disintermediation: including disintermediation through the uncontrolled offshore markets.

22. We have deliberately set our face against mandatory reserve requirements for banks in the UK that would drive sterling business offshore. Such disintermediation would, we have argued, distort the money figures to little real purpose. But we should, perhaps, not be surprised if against this background the result of the liberalisation since the abolition of exchange controls and the corset in 1979/80 has been a greater degree of intermediation via banks - and a faster growth of bank lending and a faster growth of the broader aggregates in relation to narrow money and the monetary base - than in countries like the US and Germany.

23. Finally, the exchange rate has come to play a larger part in our assessment of monetary conditions. Although on occasion movements in the exchange rate can reflect events that have little direct relevance to domestic monetary conditions, more normally there is an effect on inflationary pressures. In practice, we have found the exchange rate a useful supplementary guide to policy: often a more useful guide than £M3.

#### V Control of £M3 and bank lending: overfunding v. short term interest rates

24. Annex II contains an account of the techniques we have used to seek to control monetary growth, and some of the operational problems we have had. If we want to rein back £M3 growth, in the short term there is a choice between using funding policy and raising short term interest rates.



25. Using funding, that is selling extra gilts, will in effect raise long term interest rates. Some investors - probably mainly the institutions - will as a result move out of bank deposits and buy gilts instead. But with a given PSBR the effect of this transaction is to contract the monetary base, and it can create money market shortages which, if not relieved, would lead to a sharp rise in short term interest rates as well. Unless such a rise is thought warranted by monetary conditions, the Bank will relieve these shortages by adding <sup>to</sup> its holding of commercial bills (the bill mountain). This combination of "overfunding" and money market assistance does not reduce the total of credit extended: what it does is, in effect, to neutralise some of the impact of the rise in private sector borrowing from the banks by financing part of it with less liquid forms of savings - invested in gilts and recycled via the Bank's purchase of commercial bills. We know from experience that overfunding does have a reasonably reliable and early impact on £M3, at least in the short run.

26. Changing short term interest rates, on the other hand, will have at best a delayed effect on £M3 and bank lending. Despite the political importance of the mortgage rate, we have on occasion - as at present - been through periods of very high short term interest rates. But on each occasion there has been little discernible effect on £M3. There is an impact on non interest-bearing forms of money including M0. But on £M3 the short run effect could, even, be perverse.

27. But if short term interest rates are uncertain and slow acting in their effect on £M3 and bank lending, they can be expected to have a more substantial effect on the real economy - with a rise adding to the financial pressures on large and small companies, both directly and through the exchange rate. Overfunding, on the other hand, probably has much less effect on the real economy - partly because long term interest rates have less effect than short rates. It does, at least in the short term, reduce total liquidity in the economy. But equally it can be argued that the effect on £M3 is mainly cosmetic - like the corset, affecting the



target aggregate, but not inflationary pressures. Another possibility is that, although there is a short run effect, in the longer term overfunding does not even reduce  $\text{£M3}$ . That would be the case, for example, if the extra sales of gilts and higher long rates were crowding potential private sector borrowers out of the long term capital market, and forcing them to borrow from the banks instead.

28. With the persistent tendency of  $\text{£M3}$  to overshoot the targets set for it since 1979, we have regularly been faced with the choice of whether to seek to rein it back by raising short term interest rates, or by overfunding. Each time we have reviewed the choice in abstract, as we did in the summer of 1982 and last year, we have concluded that it was preferable to control  $\text{£M3}$  without overfunding; and on each occasion in practice we have subsequently concluded that reliance on interest rates alone did not offer a sure enough prospect of reducing  $\text{£M3}$  growth, and that gilts sales should therefore be increased. The result has been the steady acquisition by the Bank since 1979 of a massive stock of short term paper - in effect short term loans to the banking system. The total has now reached around £17bn, rising from a negligible figure in 1979.

29. The sheer scale of this bill mountain is now creating a range of technical, presentational and other problems. These are discussed more fully in Annex II, but briefly:-

(i) It looks absurd. This in itself does not help the credibility of policy. The Bank of England's holding of commercial bills is now equivalent to about 15% of  $\text{£M3}$ , and the proportion has been steadily rising by 3-4% a year.

(ii) Because the stock of bills matures and has to be turned over every 4-6 weeks, it creates regular huge daily shortages in the money markets that the Bank has to relieve by purchasing new bills. The Bank is thus



intervening more "regularly and at longer maturities than originally envisaged under the operational arrangements instituted in 1981 giving the authorities a higher profile in the setting of short term market rates. This is not necessarily a drawback. It was a fallacy to envisage, if it was in 1981, that interest rates could in some way "be left to the market". To achieve monetary control the authorities have to be able to act on interest rates. The only question is whether to achieve that influence on rates by following an automatic quantitative rule for dealing in the money market (as with monetary base control), or through a more discretionary policy.

(iii) The scale of daily shortages makes it easier for the authorities to influence rates. But large scale dealing in the bill market can make it hard to avoid opening up opportunities for "round-tripping" arbitrage transactions between bills and bank deposits. Failure here artificially inflates the £M3 numbers and confuses the interpretation of monetary conditions.

#### IV Is the growth of broad liquidity a problem?

30. We thus come back to the question of whether we should be seeking to restrain rapid growth of £M3, and whether growth of £M3 and other measures of broad liquidity should be of concern. If it is, then - as in the past - we are likely to have to contemplate further overfunding, and a further rise in the bill mountain, as the only reliable means of doing so. If we believe the rapid growth of £M3 is of less concern, or that its effects can be offset by tightening monetary conditions in other respects - eg. by raising short term interest rates - then we have the prospect of breaking out of the cycle of ever increasing additions to the bill mountain and beginning to reduce the problems that it has brought in its train.



31. Some argue that a rise in broad liquidity, as measured by £M3, constitutes an actual problem: that it will inevitably lead to faster inflation. Others that it is only a potential problem: a liquidity overhang that could in some circumstances be converted into spending power and hence lead to inflation. Support for both propositions is seen in the history of the early 1970's when, it is argued, it was the growth of £M3 that gave the best warning of coming inflation.

32. Table 1 and Charts 1 and 2 in Annex III show the growth of M0, £M3 and some other indicators against the path of inflation since 1970. They show that both £M3 and M0 gave warning of the inflation of the early 1970s. Conditions in 1972-74 were very different from today's. The exchange rate was weak, fiscal policy was lax, interest rates had for a long time been kept artificially low and an incomes policy was breaking down. Moreover, the international environment was highly inflationary, reflected most dramatically in the oil price rise in late 1973. The conditions today, both domestic and international, are totally different. There is certainly no sign - see Annex III Chart 2 - of asset prices taking off in the way they did in 1972-74 sometime before inflation took off. Had we been operating then as we do today, then the movement in M0, the exchange rate and asset prices would have led us to take action even without a target for £M3.

33. Nevertheless concern on this front - on either thesis - might point to the need to act now to restrain the growth of broad liquidity. On the liquidity overhang theory, this would represent a necessary insurance against not being able to react fast enough if and when the time came. By historical standards the present liquidity overhang is not particularly high. But this is the case for continuing to seek to restrain the growth of £M3, and not changing the target set for it.

34. The alternative approach is to make sure we have adequate defences to ensure that broad liquidity is not converted into spending power. In this respect it is argued that the



way the Bank operates in the money market provides no assurance that liquid balances could not be converted into spending power (in the simplest case, encashed). This derives from the suggestion that the Bank is always prepared to buy any quantity of bills - to lend any amount to the market - at the going interest rate. There is a second, related, proposition that this certainty of always being able to borrow from the Bank may have increased banks' willingness to lend, and so have added to £M3 growth.

35. These suggestions are discussed further in Annex II. The short point is that it is simply not true that the Bank will buy any quantity of bills. They calculate the amount they need to buy each day to take out the expected market shortage, and to prevent an unwarranted contraction in the monetary base or rise in interest rates. If (as on occasion happens) they are offered more bills than required they limit their purchase to the calculated amount.

36. As to an automatic tripwire, this should in practice be provided by a combination of the exchange rate and MO; and as in the 1970s we would also most likely be alerted by a rise in asset prices. The exchange rate would quickly react to any conversion of £M3 balances into spending power. In practice MO did rise before the inflationary surges in the early and late 1970s. Both these movements should be sufficient to bring the necessary rises in interest rates in their train.

## VII Conclusion and Policy Options

37. The key question is thus about our attitude to the growth of broad money and of £M3 in particular. If we were only concerned at the risk that liquidity could be converted into spending power in the future, then we can probably rely on MO and the exchange rate to give us warning signals in time to act to prevent it. If we believe, as we do, that the current rapid growth of £M3 carries little direct threat to future inflation, then we should logically be considering whether to raise or abandon the target for £M3 growth. To



do so would open the way to put an end to overfunding and the various problems associated with the seemingly inexorable rise in the Bank's bill mountain. There is also a subsidiary question about possible changes in the arrangements for the Bank's day to day money market operations.

38. To deal with the latter first, the Bank's operations are both more extensive and less flexible than envisaged in 1981. But it was always mistaken to believe - if it ever was - that short term interest rates could be left to the market. The authorities' influence on them can be discretionary, or work through seeking to change the monetary base: but either way interest rates are a key mechanism of monetary control. Nevertheless, it may be that the official hand on short term rates has become too rigid, and that techniques should be changed so as to permit greater day to day movement in short term rates.

39. On the central question, the future of the £M3 target, whatever our own conclusion there is of course also the market's reaction to consider. A change which undermined the credibility of policy would raise inflationary expectations and interest rates. In this respect the timing of any change would clearly be important: it would be best to wait until inflation was clearly back on a downward path.

40. The main options are:-

(i) No change. Despite our doubts, we could retain the present target for £M3. We could combine this, if desired, with changes in operating procedure of the kind discussed above and in Annex II. It has to be recognised that this would require continued overfunding and a continued rise in the level of the bill mountain. Despite that, no doubt there would be some overshooting of the £M3 target, leading us in turn to continue publicly questioning the significance of £M3 growth if we felt that in practice it was not endangering downward pressure on inflation.



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(ii) Drop the £M3 target. We could combine this explicitly with an end to overfunding. History suggests this is necessary if we are ever to secure a reversal in the growth of the bill mountain. It might be preferable to present this as a suspension of the target, rather than a final break: some of the growth following an end to overfunding might be temporary. Given doubts about the value of £M3 as an indicator, it would arguably be a useful clarification of policy. It would imply greater reliance on M0 and the exchange rate, but we would want to make it clear that even without a target we would continue to take account of changes in the growth of broad money in interpreting monetary conditions, in much the same way as we already take account of movements in the exchange rate. This has many attractions, and in some ways is not as far as it looks from how we already operate policy, with persistent £M3 overshooting. But it would be seen as a major break: £M3 has featured as a target aggregate since 1976. An end to the growth of the bill mountain would settle market doubts that have arisen on that score. But the change could not carry credibility without a concerted campaign by the Treasury and Bank to explain the reasons for it, the merits of M0 as an indicator, and the way that policy would be operated henceforth.

(iii) Raise the £M3 target range. This option is something of a halfway house between (i) and (ii). This might be combined with other changes: for example a widening of the band, or a decision to reset the target more frequently, as recognition of some uncertainty about where it should be. It would be unwise to renounce overfunding altogether. But it might be possible to announce that it would be gradually phased out, with the aim of first slowing and then stopping the growth of the bill mountain. Other countries have at times changed their targets to what were considered more realistic levels, as we did in 1982. As to credibility, there would be a risk of getting the worst of all worlds:



but it might run less risk than option (ii) of being seen as a loosening of policy.

(iv) Switch to an exchange rate regime. If none of these options seemed attractive we could consider again a more complete break with monetary targets. The practical option, which was reviewed in February, is full membership of the EMS. In effect this would be an admission that steering by the domestic indicators had become too difficult, and that we would do better to try to tie policy to that in a low inflation country like Germany. But where exchange rate pressures come from external shocks, like oil price moves or movements in the dollar, it is often preferable to take some of the strain on the exchange rate rather than allowing it all to be transmitted into the conduct of domestic policy. We concluded in February that membership could not in practice be contemplated at a time when pressures on sterling seemed likely, or with the present level of our currency reserves.

H M TREASURY  
JUNE 1985



**ANNEX 1: MONETARY TARGETS AND CONTROL ARRANGEMENTS IN US, GERMANY AND SWITZERLAND****Summary**

1. The United States, Germany and Switzerland have set monetary targets for some years. All three countries place emphasis on narrow measures of money, although the United States also has targets for wider measures and in Germany the Bundesbank monitors M3. The US operates through the level of bank reserves while in Germany the main instruments are short interest rates, repurchase arrangements and alterations to banks minimum reserve requirements. In Switzerland the control problem is exacerbated by the central importance of flows across the exchanges, requiring the authorities to use foreign exchange swaps as well as short term interest rates to control domestic liquidity. Since none of the countries pay all that much attention to broad money they have generally not resorted to overfunding. All three countries have achieved low inflation rates although monetary outturns in Switzerland have often been significantly below target (mainly because of external flows). Excessive interest rate volatility was a problem in the US in the period 1979-81; since then volatility, has been less, in part reflecting changes in control procedures. An examination of the volatility in overnight rates over the last three months suggests that variability (as measured by the standard deviation) in the US, German and Swiss rates is fairly similar, and somewhat below that in the UK (if allowance is made for exceptional movements in the Swiss rate at the end of the month - see para 15).

**United States: (a) Targets**

2. The US targets the growth of M1, M2, M3 and domestic non-financial debt between the fourth quarter of years. M1 is effectively cash plus current accounts at banks and building societies; M2 is M1 plus retail savings accounts; M3 is effectively cash plus all deposits at banks and building societies; and domestic non financial debt is outstanding credit market debt of the government, local authorities and the private non-financial sector. Of these aggregates M1 is available weekly and the rest monthly. M1 is considered to be the most important aggregate as it has the most stable relationship with nominal GDP.



MONETARY TARGETS AND OUTTURNS

Table 1(a): United States: 1979-84

		Target	Outturn*
1979/80	MIA	3½ - 6	5
	MIB	4 - 6½	7.3
1980/81	MIB	3½ - 6	2.3
1981/82	M1	2½ - 5½	8.8
1982/83	M1	4 - 8	10.4
1983/84	M1	4 - 8	5.2

\* % Q4 on Q4

Table 1(b): Germany: 1975-84

	Target for Central Bank Money (CBM)*	CBM growth	Nominal GNP growth
1975	8 <sup>1</sup>	10 <sup>1</sup>	4.4
1976	8 <sup>2</sup>	9 <sup>2</sup>	9.1
1977	8 <sup>2</sup>	9 <sup>2</sup>	6.5
1978	8 <sup>2</sup>	11 <sup>2</sup>	7.8
1979	6-9	6	8.2
1980	5-8	5	6.5
1981	4-7	4	3.9
1982	4-7	6	3.6
1983	4-7	7	4.6
1984	4-6	5	4.6

\* Fourth quarter on fourth quarter

<sup>1</sup> December 1975 on December 1974

<sup>2</sup> Year on year

Source: Deutsche Bundesbank

Table 1(c): Switzerland: 1980-84

		Target	Outturn
1980	Central bank money	4	-7.0
1981	CBM	4	-0.5
1982	CBM	3	2.6
1983	CBM	3	3.6
1984	CBM	3	

% calendar year



(b) Control Procedures

3. The Federal Reserve Board and the Federal Open Market Committee (FOMC) in Washington sets out the short and medium term targets for monetary policy. More-or-less every month the FOMC meets to decide short term policy. The result is a directive to the New York Fed, which is in charge of day to day operations in the money market. Until 1979 the open market desk mainly acted on interest rates to control money supply but since then it has operated on bank reserves in order to achieve monetary targets. The main aggregate M1 is thought to have a reliable relationship with bank reserves and so the New York Fed, adds or drains reserves through repurchase agreements etc to control M1. From 1979 to 1982 the FOMC set a target for non-borrowed reserves but by 1982 it was realised that targetting this alone allowed a 'leakage' through discount window borrowing, which meant that the Feds' control over M1 was not as tight as it might have been. Thus from 1982 the target for non-borrowed reserves has been altered more often to offset changes in discount window borrowing. This means that now total reserves are targetted. Another perceived fault in the 1979-82 procedure was the system of lagged reserved accounting. The latter meant that banks reserve requirements were known before an accounting period began. Therefore the Fed had to supply a certain level of reserves or allow interest rates to be highly volatile as banks scrambled to meet their reserve requirements needs, once again weakening Fed control over M1. In early 1984 a system of contemporaneous reserve accounting was introduced to allow the Fed to control reserve growth and hence M1 more tightly. This system covers a two week period with the banks required reserves at the Fed calculated from the level of the banks current accounts.

(c) Target and Outturns

4. The comparison between targets and outturns for M1 is set out in table 1(a). It can be seen that in 1982 and 1983 the M1 target was overshot, due mainly to the introduction of new interest bearing current accounts. The Fed decided in mid-1982 that for various reasons the targets were too tight and that money could grow above target without harmful consequences on inflation. On the other hand they have overshot their M3 target for each of the last few years by margins ranging from  $\frac{1}{2}\%$  to 3%. In other years the Fed have a reasonable record on M1. Since October 1979 the annual rate of price inflation has fallen from 12 $\frac{1}{4}\%$  to 4%. Meanwhile, the real economy has grown by almost 3% per annum over the period.



5. In the early part of the period interest rates were highly volatile, as was money supply. Indeed prime rates moved from 12.9% in September 1979 to 19.8% in April 1980 then down to 11.1% in August 1980 back to 20.2% in January 1981. The average level of 3 month rates in 1979-81 was almost 8% higher than in 1971-79. Since 1981 and the introduction of a modified form of reserve targetting, volatility has been less pronounced. Although slightly greater than 1971-79 it is nevertheless considerably less than in 1979-81. Indeed since the beginning of 1982 the prime rate has fallen from 17% to 10% at present, with the rate in 1983 and 1984 varying only between 10½ and 13%. Nevertheless nominal rates have remained high. Three month rates even in 1984 were close on 4% higher than in the 1970's despite a 3% lower inflation rate.

6. As the Fed operates on the reserve requirements of the banks and concentrates mainly on a narrow aggregate, it does not use overfunding as an instrument of monetary policy. To ensure that government finance has as little impact as possible on the liquidity of the system the authorities deposit excess income from government operations in accounts at commercial banks, drawing them down only when they are needed.

#### Germany: (a) Targets

7. In August 1973 the Bundesbank changed its policy from influencing bank reserves to controlling the growth of 'central bank money' (CBM) defined as currency plus required minimum reserves on banks domestic liabilities at the reserve ratios prevailing in January 1974. CBM is a weighted average of the assets comprising M3<sup>1</sup> but it has the advantage of being available before data on M1, M2 and M3. Targets for CBM have been set annually since December 1974 on the basis of the growth of potential production plus the rate of "unavoidable" price rises. The hope is that this procedure avoids the need to adjust the targets as a result of transitory effects on prices or output. Since 1978 the Bundesbank have expressed the target in terms of a range for the Q4 on Q4 growth rate. The stated objective is to aim for the lower or upper half of the range depending upon the outturn of other non-monetary indicators during the target period, such as the exchange rate. Although only CBM is targetted the Bundesbank also monitors M3 and presents its counterparts. Indeed there is thought to be a reasonably strong link between CBM and M3 because the former includes reserve requirements based on the latter's deposits.

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(1) CBM comprises all currency in circulation (less banks till money since March 1978) plus 16.6% of residents' sight deposits plus 12.4% of residents' time deposits plus 8.1% of residents' savings deposits held within German banks. These percentages are the required minimum reserves on those deposits as at January 1974.



(b) Control procedures

8. It is useful to distinguish between the methods used for control over the medium term and those used to manage day to day operations. In the former category the main instruments are changes in banks' reserve requirements - which are far more frequent than in the US or the UK - and changes in the amount of, and the rates at which, bills are discounted. The Bundesbank sets rediscount quotas which are varied according to its view of market conditions. The reserve requirements are governed by the Anweisung der Deutschen Bundesbank uber Mindestreserven (AMR). The AMR specifies what reserve ratios are to be applied to the monthly average of reserve liabilities from the 16th of one month to the 15th of the next. For simplicity, the Bundesbank allows banks to calculate their liabilities from those outstanding on the 23rd of the previous month and the 7th and 15th of the current month. (It can order a bank to calculate the full monthly average if it suspects it of "window-dressing" the figures.) This procedure means that by the 15th of the month a bank should know what its reserve requirement is, and can therefore alter its reserves over the rest of the month to satisfy the requirement. Undoubtedly the setting of reserve ratios has encouraged the growth of the offshore EuroDeutschemark market.

9. The Lombard facility is a loan by the Bundesbank secured on eligible collateral granted at the official Lombard rate, which is usually 1% to 1½% above the official discount rate. From February 1981 to May 1982 this system was replaced by the Special Lombard facility which effectively allowed the Bundesbank to decide whether or not to lend and at what rate, thus allowing the authorities to have penal rates for banks short on reserves without raising general interest rates. However, the introduction of the scheme pushed overnight rates up to around 20% to 30%.

10. Day to day control is operated through repurchase agreements, foreign exchange swaps and the Lombard [and Special Lombard] facility. The use of repurchase agreements appears to be on the increase. They are usually for bonds (not bills) for periods of between 25 and 45 days. (The vast bulk of government borrowing is through medium term paper which is not very marketable on a day to day basis as transferability is restricted. Open market operations are therefore carried out using Treasury bills or Treasury discount bonds (ie. zeros) issued by the government to the Bundesbank on request.)



11. Recently the Bundesbank has tried to reduce changes in the politically sensitive Lombard rates and has made increasing use of securities repurchase agreements (repos). To increase the impact of changes in the amount and rates of such agreements, the Bundesbank has gradually increased the size of its holdings of these securities from around DM12bn at the end of 1979 to about DM47bn by the end of 1983. The German 'bill mountain' is therefore mainly a result of a change in the Bundesbank's tactics. Decisions concerning whether or not to roll over the repos are taken in the light of pressure on the DM and the rate of monetary growth. For example, in January and February of this year the Bundesbank kept liquidity tight in the face of pressure on the DM.

12. This combination of altering interest rates and reserve requirements has allowed the Bundesbank to control CBM quite successfully (see Table 1(b)). The overshoot in the period 1975-78 was largely due to exchange market intervention to dampen the appreciation of the DM. The reversal of these exchange rate pressures in the light of the second oil crisis made monetary control easier. This is brought out in table 2 which compares the volatility in interest rates in the period up to 1979Q4, when the German effective rate was generally appreciating, with the period since then when the rate has fallen back a little. During the latter period the Bundesbank has managed to keep monetary growth broadly within the target ranges and interest rate volatility has been reduced. Inflation, which was creeping up to around 8% in Autumn 1973, just prior to the introduction of monetary targets, has been kept firmly under control averaging well under 5% from 1974 to 1985.

Table 2: German inflation, monetary growth, interest rates  
and exchange rates: 1970-85

	Pre-monetary targets 1970Q1-1973Q3	Monetary targets & appreciating DM 1973Q4-1979Q4	Monetary targets & depreciating DM 1980Q1-1985Q2
Inflation	5.4	4.8	4.3
CBM growth	10.4	8.1	5.3
Effective exchange rate at start and end of period	77.7 - 100.2	97.0 - 132.0	131.7 - 121.5
3 month interest rate	8.2	6.0	8.2
Volatility* of interest rates	0.3	0.5	0.3

\* As measured by the coefficient of variation



13. Since less attention is attached to broad monetary growth, there has been no temptation to overfund and debt sales have generally matched government deficits quite closely.

**Switzerland: (a) Targets**

14. From the introduction of targets in 1975 until 1978 the Swiss concentrated on M1, which effectively is cash plus current accounts at banks and post offices. However in view of the instability of the demand for M1 the Swiss switched in 1979 to central bank money, or monetary base, as the target variable. The target for the monetary base is set annually to last a calendar year and relates to the average of the 12-month percentage changes for each month of the year. This is an extremely slow moving indicator and is clearly of little use in guiding day to day or even month to month policies. In the last few years a 3% target has been set, which is thought to be compatible with 2% real growth and 0-1% increase in prices. Besides the monetary base there have been periods particularly in the late 70's and early 1980 when the central bank has found it necessary to intervene in the exchange markets to resist large short term swings in the exchange rate, and hence relegate the monetary target to a secondary role.

**(b) Control Procedures**

15. The primary method of monetary control is through foreign exchange swaps with the most active period being at the end of each month when the banks have to meet the liquidity ratios set by the Central Bank. The need for liquidity, which causes a large jump in overnight rates, is relieved by the central bank through foreign exchange swaps which unwind during the following month. Although foreign exchange swaps are the most important instrument the Swiss also set discount and Lombard rates, and occasionally use bond repurchase agreements. However, except at end month, overnight rates are very stable and the central bank operations are very light.

**(c) Target and Outturns**

16. The comparison of targets and outturns is set out in table 1(c). In 1980 and 1981 there was a large undershoot of the central bank money target

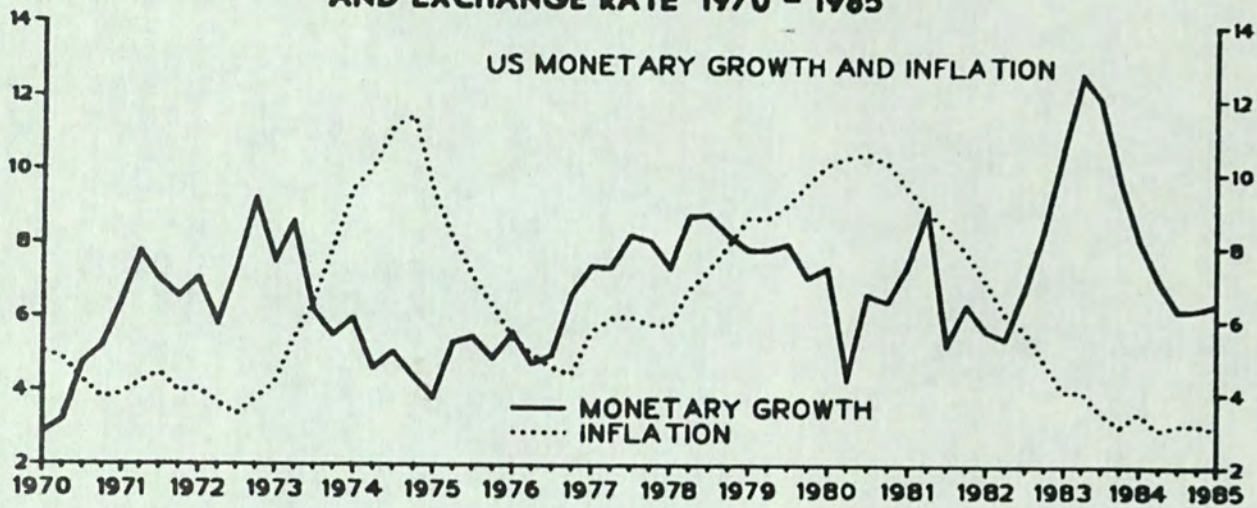


as the authorities absorbed large quantities of liquidity created in 1978-79. Since then the Swiss have been close to their target. Although the growth of the monetary base is stable the growth of the wider aggregates can be volatile, as individuals switch between different types of accounts. The effect of the sharp slowdown in monetary growth in 1980 and 1981 led to a recession in 1982, which co-incident with a peak inflation rate of around 7½%. Since then there has been a slow recovery while inflation moderated to 3% by end 1984. Like most other countries interest rates rose to a peak in 1981 before declining in 1982, since when they have been little changed. Nevertheless three month interest rates in Switzerland only briefly touched double figures in 1981 and soon fell sharply, back to around 3% by end 1982.

17. In Switzerland government finance is not normally a major influence on changes in the liquidity of the banking system.

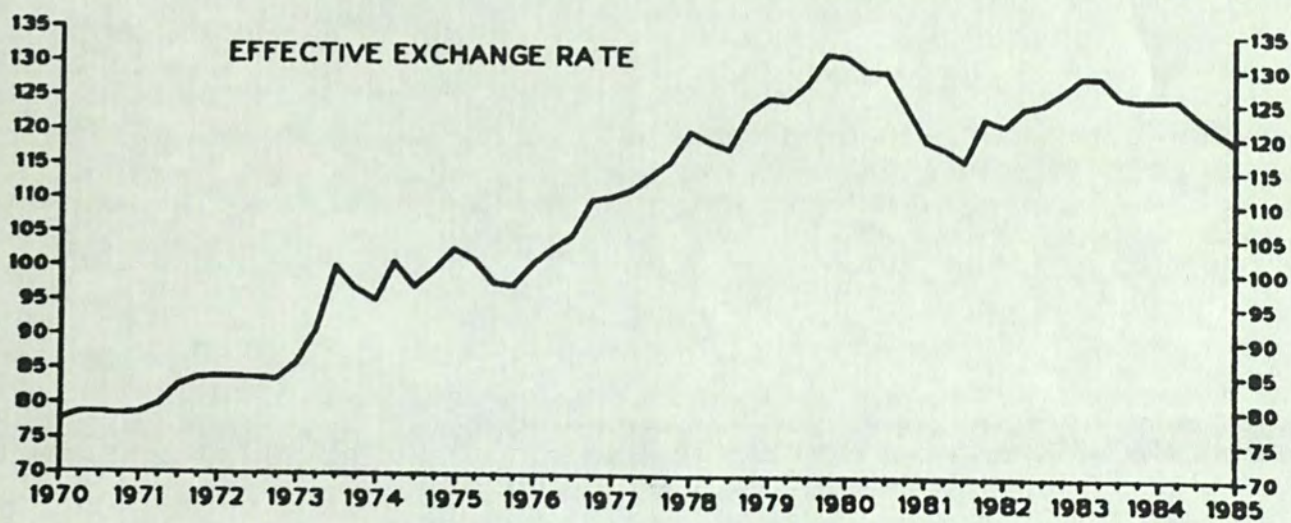
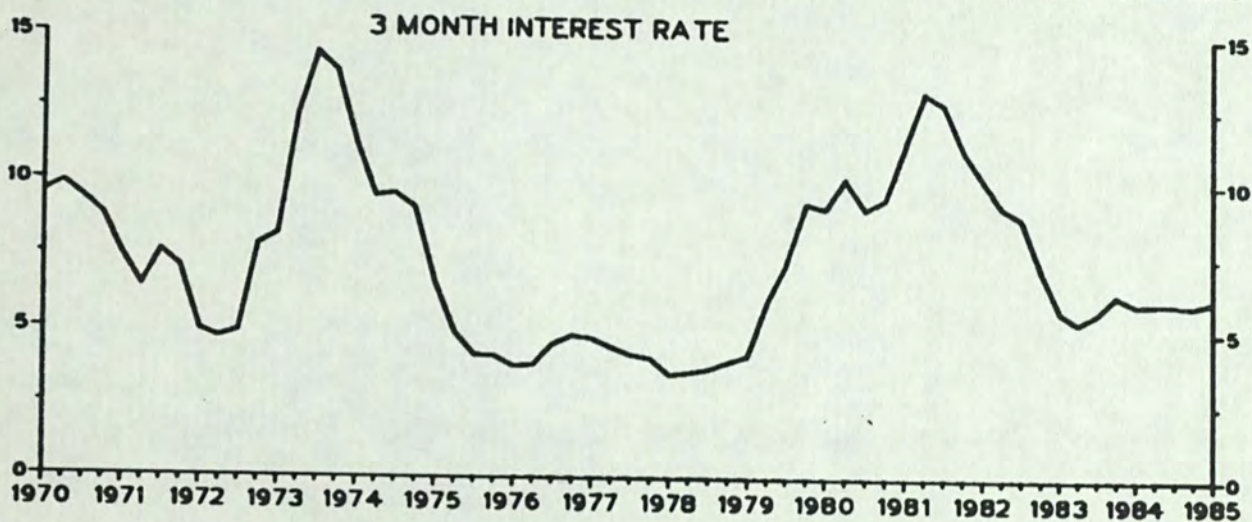
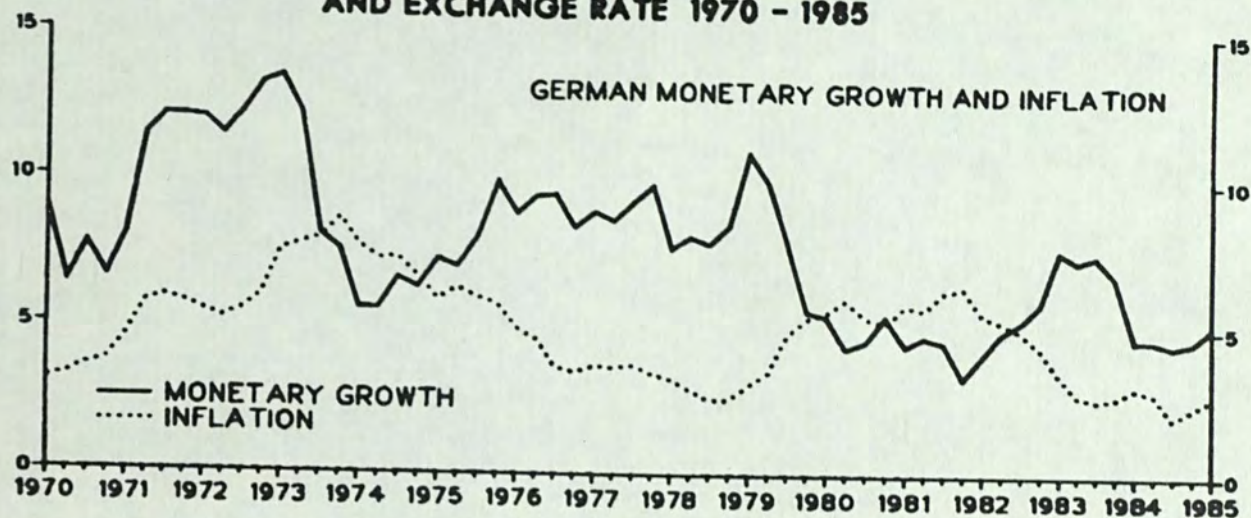


**US MONETARY GROWTH, INFLATION, INTEREST RATES  
AND EXCHANGE RATE 1970 - 1985**



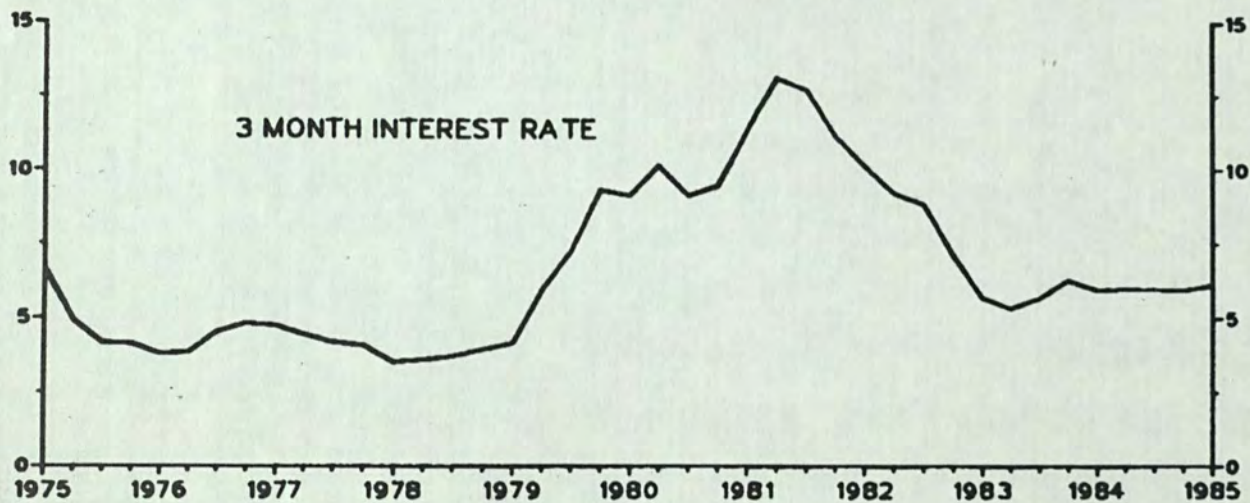
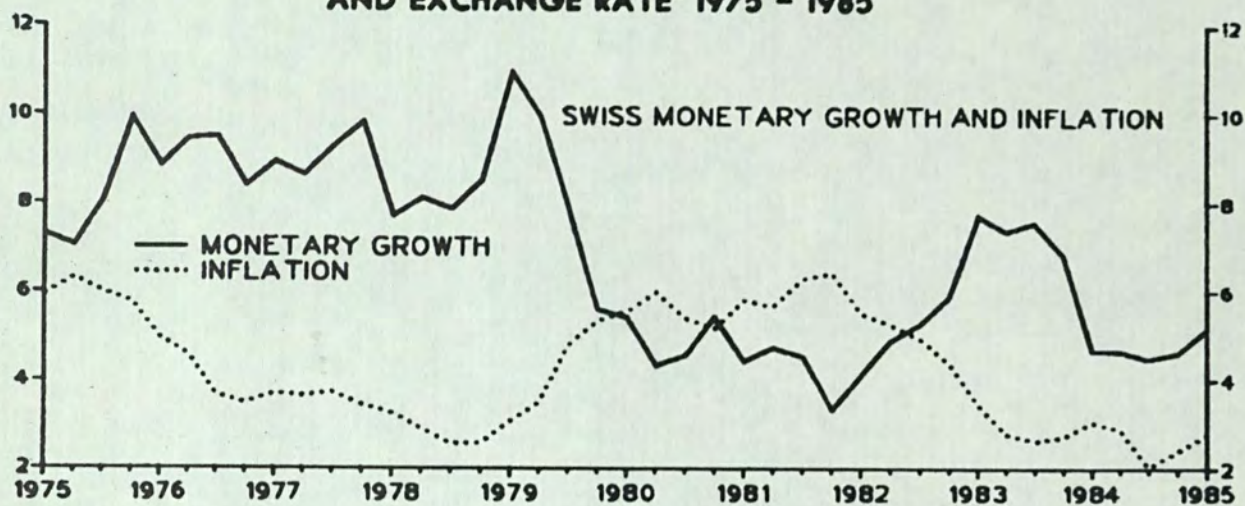


# GERMAN MONETARY GROWTH, INFLATION, INTEREST RATES AND EXCHANGE RATE 1970 - 1985





**SWISS MONETARY GROWTH, INFLATION, INTEREST RATES  
AND EXCHANGE RATE 1975 - 1985**





## ANNEX II - TECHNIQUES OF MONETARY CONTROL

1. We have relied on three main instruments for controlling monetary growth: fiscal policy, funding and short-term interest rates. The first two are particularly relevant for controlling broad money. A tighter fiscal policy (ie lower PSBR) or extra funding will, other things remaining equal, reduce the growth of £M3. Over the medium to long term, higher short term interest rates are also likely to have a contractionary impact through their effect on the demand for credit. But in the short-term their effect is very uncertain: higher short rates may result in an increase in interest-bearing bank deposits and hence lead to an increase in £M3. There is no such ambiguity in regard to narrow money. Thus, higher short rates reduce the demand for MO. While the market has often expected an increase in short rates to counter excessive growth in broad money, we have tended to regard short rates as the more relevant for controlling narrow money.

2. Fiscal policy cannot normally be changed in the short-term, and in any case is beyond the scope of this paper. Suffice it to say that, unless fiscal policy is reasonably tight, too much of the burden for controlling monetary growth has to fall on funding and interest rates. Successive MTFS's have recognised this, though - because of PSBR over-runs - actual experience has not matched up to our intentions.

Funding

3. Over the six years 1979/80-1984/85, the PSBR totalled £61 billion and debt sales to NBPS totalled £65 billion. Because of redemptions and sales to the monetary and external sectors, gross sales of debt were of course very much higher - at £96 billion.

4. In one sense, this has been a major achievement. The Bank have sold large amounts of gilts. Improved selling techniques, notably the use of tranches, and the introduction of IG's (and their derestriction in 1982) have made a major



contribution. National savings, having been allowed to languish in the 1970's, have also played a major role.

5. One question is whether, for a given level of funding, we are minimising our **funding costs**. Clearly, we have to pay whatever the market requires for any particular instrument. On the whole, we are likely to do better if we offer the market a range of instruments. The issue of convertibles, low coupons and IG's have helped in this way, as have the introduction of new National Savings instruments. Further options are kept fairly continuously under review.

6. An important aspect from a cost point of view is the choice of maturities. Over the three years 1979/80 to 1981/82, about one-third of the new conventional high coupon stocks issued were of maturity up to 10 years. In the last 3 years these shares have been reversed, with just under a third of new issues having a maturity greater than 10 years. (This is partly the result of issuing convertible stocks which at prevailing prices are unlikely to be converted into longs.)

7. So we have succeeded, to some extent, our policy of keeping out of the long end of the conventional market. The argument for concentrating on shorts is mainly one of cost. Paying double-digit interest rates into the next century is expensive; for assuming over the medium term interest rates fall, it is cheaper to issue short and medium debt and then refinance it. We have also wanted to leave the long-end of the market to the corporate sector.

8. But these factors have had to be balanced by other considerations:

(i) we face exceptionally heavy redemptions in the late 1980's and 1990's. In theory, the redemption monies can be reinvested in gilts; in practice, they often are not - at least in the short term. It has seemed sensible, therefore, to try to avoid too great a bunching of maturities by stretching out the redemption profile to some extent.



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(ii) at times when the gilts programme has been running into difficulty or when we have wanted a big increase in sales, it has been helpful to issue some longs - though normally this has been as part of a tranchette package.

(iii) partly because of our heavy sales in the shorter maturities, the yield curve has more recently exhibited a pronounced downward slope towards the longer end; consequently, the cost argument is now less compelling.

(iv) it is more effective for the control of £M3 to sell gilts to the non-bank private sector rather than to banks or foreigners, who are more interested in the shorter end.

(v) we have come to doubt whether the corporate sector will ever issue long stock on any significant scale again. It now seems that, if the corporate bond market is to revive, it is more likely to do so in the short and medium maturities.

9. Another important question concerns **overfunding** (which is usually defined as the extent to which debt sales to the non-bank private sector exceed the PSBR). On this definition, in three of the past six years we have underfunded. But taking the 6 years together we have overfunded by £3.6 billion, and in each of the past two years overfunding has amounted to £2.5 billion. There is an alternative definition. That is the extent to which the Government finances the PSBR other than by borrowing from the monetary sector - ie. overseas borrowing is also counted as funding. On this definition overfunding over the last 6 years has totalled almost £1bn and has been around £4bn in each of the last 2 years. The chart attached shows that overfunding also has a much longer history.

10. Overfunding has not been part of the Strategy. On the contrary, the Chancellor said in his 1983 Mansion House speech that over the medium term there should be no systematic tendency to over or underfund. On each occasion when we



have looked at it (as for example we did in some depth in the summer of 1982, and again last summer) we have concluded that it would be preferable to keep £M3 on track by other means; and that ideally, over a period, we should be looking to fully fund the PSBR, and no more. But when faced in practice with the choice between overfunding, putting up short-term interest rates or allowing £M3 to grow even faster, we have often chosen the first. In the past six months, we have veered to a policy of keeping short-term interest rates high, but this has not yet done much to curb bank lending.

11. Since the abolition of the corset in 1980, bank lending has grown very rapidly indeed - roughly twice as fast as our targets for £M3. This expansion shows little sign of abating. It is partly explained by the liberalisation and increased competition which followed the removal of the corset. Despite high real interest rates, borrowers have been happy to take on extra debt.

12. The growth of lending to the corporate sector has been particularly puzzling. The company sector's financial position has greatly improved and there has been a strong revival of equity issues in the past few years (and particularly in the past few months). But neither have prevented a continuing fast rise in bank borrowing. We have taken steps to improve the prospects for corporate bonds - for example, the deep discount tax regime announced in 1984 and the new arrangements to allow shorter maturity bonds announced in this year's budget. But although there have been a few bond issues, this has not yet been on a scale to take the pressure off bank borrowing.

13. We have looked at other ways of restraining bank lending. One option - considered in the run-up to the last two budgets - was a modest consumer credit duty, but it would have been ineffective to bring in such a duty without applying it to mortgages as well. Now that we no longer have exchange controls, the reimposition of something like the corset would simply drive business offshore.



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14. In the absence of other restraints on bank lending, we have felt obliged to overfund. But several criticisms have been voiced against this policy. These include:

(i) Much of the money lent by the banks - eg that to financial institutions - is not going to be spent on goods and services, but held as a financial asset. It makes little difference to the economy whether a pension fund holds an extra bank deposit or buys some more gilts.

(ii) Funding is no answer to excessive growth of bank lending to the private sector, because credit has an independent influence on the economy. Instead, we should constrain credit.

(iii) Aggressive funding is self-defeating. It raises long rates relative to short rates, further crowding private sector borrowers out of the long term capital market and stimulating the growth of bank borrowing - and thus does not reduce  $\text{£M3}$ .

(iv) Overfunding adds to the bill mountain, is costly and complicates monetary management in ways that could inflate  $\text{£M3}$ .

15. There may be some truth in all of these. But as regards (i), some part of any extra funding, particularly if it is provided by the personal sector, is likely to be at the expense of spending; and institutions, instead of holding extra bank deposits rather than gilts, may purchase property or foreign assets - both of which could have adverse inflationary consequences. And as regards (ii), it is hard to argue that reducing private sector liquidity has no effect on spending. Both of these arguments in effect question the relevance of  $\text{£M3}$  as a target aggregate.

16. There is perhaps more force in argument (iii). By tilting the yield curve in favour of short rates, overfunding may have had some effect in adding to bank lending - rather than "sterilising" a given amount of it. But again



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the argument can easily be overstated, and the attraction of overfunding is that, unless this effect were one for one, it will have enabled us to restrain £M3 at lower short term rates than would otherwise have been needed.

17. As regards (iv), it is certainly the case that overfunding has contributed to the need for money market assistance (MMA) and hence to the bill mountain. But it has only been one factor. Thus, between 1979/80 and 1984/85, whereas overfunding totalled £3½ billion, MMA increased by £16 billion. In 1984/85 MMA rose by £6 billion, against overfunding of £2½ billion. Other main factors have been borrowing by the local authorities and nationalised industries from the banks, increases in notes and coins with the public, and debt sales to the banks. All of these drain liquidity from the system, and the resulting shortages have had to be relieved in order to prevent short-term rates from rising to much higher levels. It is sometimes argued that a "neutral" funding policy would in fact be directed at avoiding any increase in MMA. Over recent years this would have involved consistent underfunding.

18. Although overfunding has not been its only cause, the growing bill mountain raises several issues:

(i) since the public sector is lending short and borrowing long, it may turn out to be costly in terms of debt interest.

(ii) the daily shortages in the money markets are now very large simply on account of bills maturing. This has made the Bank a large purchaser of bills almost every day. At times this has tended to put downward pressure on bill rates, opening up opportunities for "round-tripping". Some "round-tripping" has at times almost certainly been a factor in the growth of bank lending;

(iii) the size of the daily shortages, as explained further below, has interfered with the operation of the 1981 arrangements for daily monetary management.



19. Measures being considered for reducing the bill mountain include further encouraging nationalised industries and local authorities to borrow more from central government and less from the banks; and providing part of MMA in other forms, eg through the purchase of export paper from the banks or by making deposits with them. This switch would reduce the quantity of bills held by the Bank and hence also the size of daily shortages.

#### Short-term interest rates

20. The essence of the money market arrangements introduced in 1981 was that market forces should be given greater scope in determining the level and structure of short-term rates. This was to be achieved by the Bank confining their money market operations as far as possible to buying and selling bills of 0-14 day maturity (bands 1 and 2). The Bank would set the rate at this very short end and it would move within an unpublished 2 per cent band; all other rates would be left to find their own level. There was to be a continued but limited role for discount window lending at published penalty rates. The options, which include the temporary reinstatement of MLR and the so-called 2.30 arrangement, were to be used rarely if and when the authorities wanted to have a decisive effect on rates - resisting or encouraging a rate change as the case might be.

21. In practice, the 1981 arrangements have not been fully implemented for two reasons:

(i) technical - Because of the growing bill mountain the Bank have been buyers of bills almost every day and on a big scale. To take out the large shortages, they have not been able to confine their dealing to the shortest bands; and their dealing rates over the whole range up to three months have been clear to all. This has made changes in dealing rates far less frequent than originally envisaged. Any change in rates has come to be seen as



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a signal of a change in the authorities' attitude (and partly for that reason has come to require Ministerial agreement).

(ii) policy - We have been reluctant to accept fully the degree of interest rate flexibility and market influence over base rates which had been envisaged.

22. Nonetheless, the objectives of 1981 have to some extent been achieved.

(i) The official hand in short-term interest rate changes has over the period as a whole been less obvious than it was previously. Market forces have played a bigger role, even though less than envisaged.

(ii) Consequently, interest rate changes have generally had a somewhat lower political profile than previously.

(iii) There has probably been less "bias to delay".

(iv) Interest rates, including base rates, have become more flexible.

23. But even had conditions been as originally envisaged it is doubtful if the arrangements could ever have operated in the way intended. There seems to have been a design fault in the arrangements. As noted earlier, the intention was to confine official operations in the bill market to bands 1 and 2, with these very short term rates acting as a "dragging anchor" on longer term money market rates. But what typically happens when the market is signalling a rise in rates is that the term structure steepens, with longer rates rising, and very short rates (out to 1 month) actually falling. So upward pressure on rates is not always felt at the maturities where the Bank was originally intending to operate. In these circumstances, dealing at unchanged rates would add to, rather than counteract, the upward pressures on longer term rates. So even if we could confine the Bank's dealings to bands 1 and 2, that would probably not be sensible.



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24. Any operations by the Bank in the bill market designed to influence the crucial interbank rate are likely to open up differentials between the bill and interbank rates. Take the case when we are trying to push rates down. As long as the differential is not excessive, this leads to a shift from bank finance to bill finance, which takes the pressure off the interbank rate. But if the differential gets too large, there is an incentive to issue bills and redeposit in the interbank market. It is important to avoid this latter "round-tripping", but it should not be assumed that this is always easy when we are trying to influence rates. Even when we are not positively trying to push rates down, the sheer scale of the Bank's daily bill purchases may open up a sizeable differential. In practice there have been many occasions when we believe such round tripping will have been profitable.

25. It is sometimes argued that, because the structure of its rates changes so infrequently, the Bank inhibits moves in the structure of short term market rates; and that this process can lead to arbitrage transactions that inflate £M3. But it is mistaken to suppose that the Bank can, or does, administer the term structure of short-term market rates. Even within the bill market, where the Bank operates directly and on large scale, the structure of rates can often differ very considerably from the structure of rates at which the Bank is prepared to deal. The same is true of the structure in the more important interbank market. The structure of rates at which the Bank is prepared to deal is changed infrequently, and gets out of line with the market structure, for the reason described at the end of paragraph 21(i): any change, even in the structure of dealing rates, has come to have a high profile and to be taken by a "signal" of the authorities' wishes. This rigidity on occasion limits the Bank's ability to deal in bills of some maturities. But it does not "fix" the structure of market rates.

26. It has been suggested by some that we should get back to the pure intentions of 1981. Certainly, it is desirable



to reduce one of the technical impediments - namely, the size of the bill mountain. But on two grounds at least a return to pure 1981 seems questionable:

(i) Short-term interest rates are commonly stated to be one of our main instruments of policy; yet the extent to which we have the technical means of influencing interest rates is not all that great even now. To return to pure 1981 would reduce our influence on interest rates. Certainly operating at longer maturities has given us a much better handle on the 1-3 month rates that have the largest influence in base rate decisions.

(ii) The 1981 papers assumed that the market was likely to produce interest rates that were consistent with the Government's broader objectives. Without denying that market pressures do have some informational content, there was little justification in logic for this assumption. The market can and does at times produce the "wrong" level of interest rates.

27. Nevertheless, there are arguments for permitting short rates to vary more from day to day, as was the original intention in 1981. Two particular points have been made:-

(a) If there were less certainty about the level of short term rates borrowers might be less attracted by bank borrowing, and more by longer term forms of finance. And banks might be less willing to extend loans if they were less sure of their ability to finance them - or at least to do so at an acceptable cost - by bidding for market funds (or by selling commercial bills to the market and ultimately to the Bank).

(b) An arrangement of this kind would provide reassurance that the authorities would not permit the recent growth of broad money aggregates at some point in the future to be converted into cash and spent.



28. Whether any additional reassurance of the kind suggested under (b) is needed is arguable. We already target MO. It is not true to suggest that the Bank are prepared to supply unlimited liquidity to the market at a fixed price. They limit their daily purchases of commercial bills to the quantity calculated as required to prevent an unwarranted contraction in the monetary base or rise in short term rates. If there were signs of the rise in the wider aggregates being converted into an undue increase in MO - or into other forms of narrow money which we also watch - then we would take offsetting action, allowing interest rates to rise. In any event liquidity can be turned into spending without that necessarily requiring a rise in MO or M1. If the concern were about the apparent lack of an automatic mechanism, then arguably the exchange rate is likely to provide one. For any sudden encashment or spending of £M3 balances would almost certainly be reflected also in sharp movements across the exchanges, and a sharp fall in the £ - which would tend of itself quickly to bring about a rise in short term interest rates.

29. There are certainly some arguments for allowing greater variability in - and thereby injecting greater uncertainty about - short term interest rates. But some of the argument in (a) seems overstated. Since banks lend at variable rates they are (unless the maturities of their assets and liabilities are unmatched) protected against a general rise in market rates. In addition to the points in (a), there is also the argument that more uncertainty and variability in overnight rates could make short term currency speculation a more risky operation, and increase the range of weapons available to the authorities to discourage such speculation. Against that, greater variability in short rates would almost certainly mean more frequent movements in base rates. And we would have to accept less influence over their size and timing.

30. The extreme form of arrangement likely to involve greater interest rate flexibility would be a move to some form of monetary base control (mbc), with the Bank following a wholly quantitative operational rule. We have always seen such a move as likely to give rise to considerable transitional



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problems. Banks would certainly require greater operational cash balances than they do now, so - unless the aim were to tighten policy - the change would require some increase in the monetary base. But there is no way of telling in advance how large that increase would be. Nor is there any reason to think there would be fixed relationship between that base and the broader measures of money. We have seen simple forms of mbc as likely to lead to sharp fluctuations at least in very short (overnight) interest rates, which would bring institutional changes in their train. Although some of these, such as an end to the overdraft system, might be positively welcome, there would be difficult transitional problems, significantly distorting the monetary indicators. We have always seen such transitional difficulties as ruling out a rapid move to mbc.

31. That leaves the question, if it were desired to make a move in that direction, are there any possibilities short of fully fledged mbc? Could the Bank, for example, simply on occasion operate so as to require the market to borrow from it at penal rates? This would involve operating initially during a day so as to relieve less than the predicted money market shortage (under-assisting), thereby forcing up short term rates and forcing the market to borrow from the Bank at the end of the day.

32. It is perhaps important to emphasise that this would not, or should not, involve regularly under-assisting, by only meeting part of the daily shortage and lending some tranche of daily assistance at a penal rate. That would only be appropriate when - perhaps because MO had been growing fast, or sterling had fallen sharply - we felt that short term rates should rise and that market conditions should be tightened. It is indeed possible that on occasions we would want to over-assist, and seek to push rates down or prevent a rise - though our experience is that trying to prevent a strong upward market move in rates by such tactics is likely to be counter-productive.

33. Like a move to fully fledged mbc, but to a lesser degree, we could face transitional problems with such a change of



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tactics. Banks might wish to increase their reserves of cash somewhat, changing the significance of MO. More generally, more frequent base rate moves might be unsettling to industry. But arguably these effects should not be too sharp if we were to make what at first might be only fairly minor changes in the Bank's operating techniques.

34. While it is not difficult to envisage money market operating techniques being changed in this way, it is perhaps harder to see what operating rule the Bank would follow. With a fully fledged mbc system it is simply a question of operating so as to keep the growth of the monetary base on a predetermined track. Even then there is a question - as is clear from the description of other countries' arrangements in Annex I - of how far to operate on a day-to-day basis, or how far (for example like the Swiss) to try to keep the base on track over a longer period, permitting short-term variations. The latter would not necessarily lead to any great increase in short-term fluctuations in interest rates. In Switzerland the normal variability of very short term interest rates appears little different from in the UK. Had we operated such a rule over the last year, in relation to MO, it is indeed not clear that the Bank would or should have operated in any different way than in fact they did: on this criterion the amount of assistance given to the market has proved about right.

35. The conclusion is that we could, if we wished, bring about more variation in short-term interest rates than hitherto. It would be possible for the Bank to over or under assist the market day by day and lend at penal rates, on occasion, at the end of the day. Before introducing such a change in the Bank's operations it would be desirable to reduce the size of the daily market shortages by measures of the kind described in paragraph 19. There could be some benefits, but against those we might have to accept greater variability in base rates, and less control over their extent and timing than we have exercised recently. No doubt an operational rule for deciding when to under (and when to over) assist could be devised. But



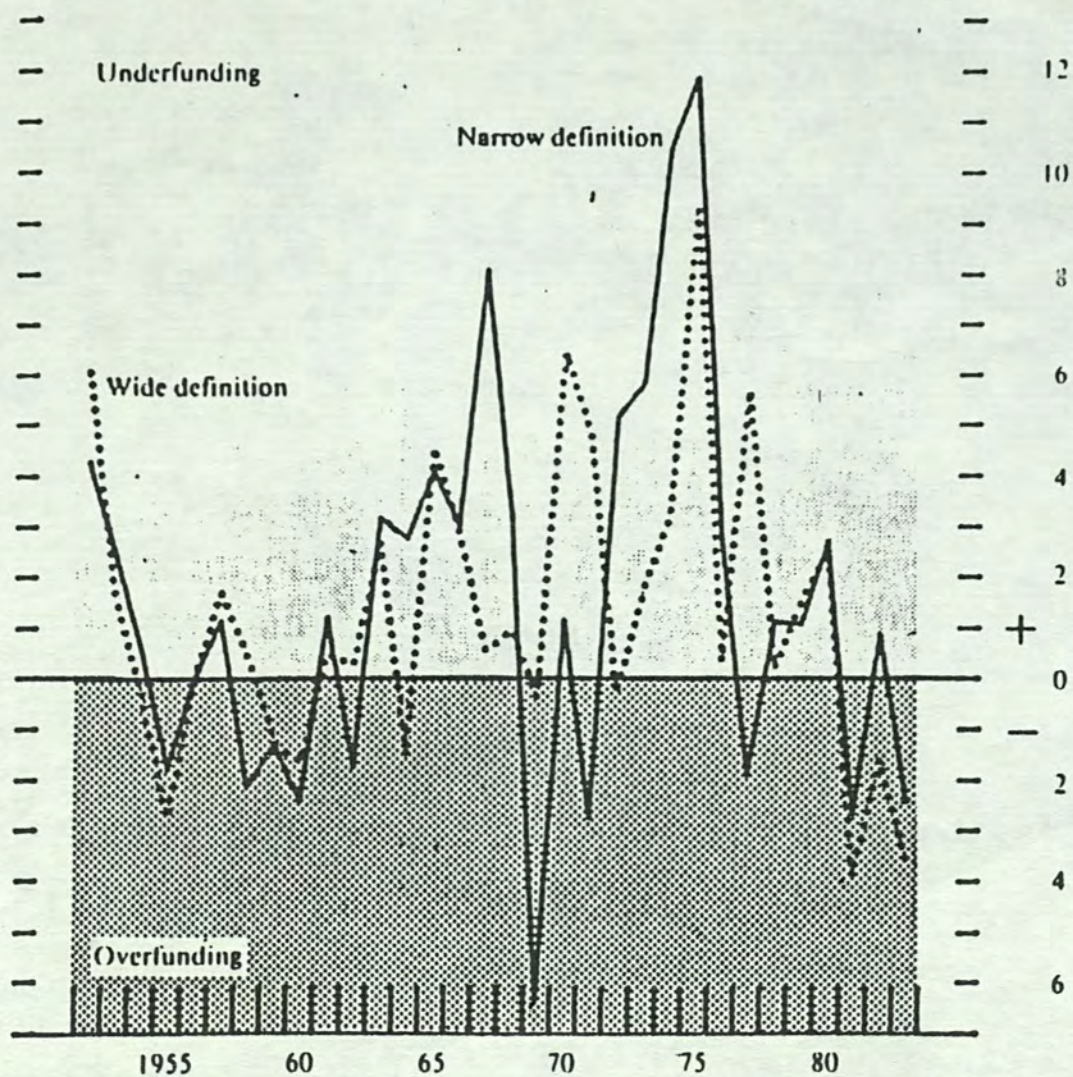
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if the focus were on the trend growth of M0 it is not clear that an operational rule related to that would in fact have caused any greater movement in short-term rates than we have actually seen over the last year or so.



# Chart Funding of the PSBR

£ billions, 1982 prices





## TABLES AND CHARTS

Table 1: Monetary aggregates, exchange rate inflation, money GDP and PSBR/GDP ratio, since 1969-70

Table 2: Fiscal deficits in 7 major countries, 1979-1985

Chart 1: Monetary growth and inflation since 1970

Chart 2: Assets prices (house and land prices) since 1970

Chart 3: M0 and money GDP since 1965

Chart 4: £M3 and money GDP since 1965

Chart 5: Velocity of £M3



Table 1

MONETARY TARGET AGGREGATES, EXCHANGE RATE, INFLATION AND PSBR/GDP RATIO : 1969-70 to 1984-85

	MO*	EM3*	£ EXCHANGE RATE <sup>1</sup>	INFLATION <sup>2</sup>	MONEY GDP	PSBR/GDP RATIO
1969-70	2.9 <sup>§</sup>	1.7 <sup>+</sup>	127.3	5.0	7.4	-1.2
1970-71	13.0	12.6 <sup>+</sup>	127.3	8.5	10.6	1.5
1971-72	[- 1.0**]	16.9 <sup>+</sup>	127.1	8.0	11.5	1.6
1972-73	14.8	26.5	128.8	7.9	13.8	3.6
1973-74	10.8	22.8	114.6	12.7	11.0	5.8
1974-75	15.7	8.1	107.2	20.3	18.7	8.9
1975-76	9.7	7.3	105.1	22.5	24.1	9.2
1976-77	10.6	6.2	94.0	16.5	16.8	6.4
1977-78	13.9	14.6	80.9	9.5	16.4	3.6
1978-79	14.8	11.2	84.8	9.6	14.6	5.4
1979-80	10.0	12.4	82.4	19.1	19.8	4.8
1980-81	6.5	19.1	93.0	12.7	13.8	5.4
1981-82	2.7 <sup>∅</sup> (3.7)	13.6	101.4	11.1	10.1	3.3
1982-83	5.3	9.8	91.1	4.9	9.4	3.1
1983-84	5.7	9.8	80.6	5.1	7.9	3.2
1984-85	5.3	9.3	81.7	5.5	7.0	3.1

\* Mid-March to Mid-March

<sup>1</sup> Q1 level<sup>2</sup> RPI: Q1 on previous Q1<sup>+</sup> Q1 on previous Q1

<sup>∅</sup> This figure is distorted by the change in the definition of MO in September 1981, after which date non-operational balances were excluded from MO. The figure in brackets is the estimated change adjusted for the change in definition.

\*\* Prior to September 1971 the clearing banks agreed to hold at least 8% of total assets in the form of till money plus bankers balances. Thereafter under the Competition and Credit Control regime banks held 1½% of their eligible liabilities as non-interest bearing balances at the Bank of England. The net result was a large reduction in till money plus bankers' balances and hence in MO.

§ June on previous June.



TABLE 2

CENTRAL GOVERNMENT  
FISCAL DEFICIT AS PERCENT OF GDP

	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
Canada	1.8	2.7	1.6	5.0	6.2	5.8	5.0
US	(0.6)	1.2	0.9	3.8	4.1	3.4	4.4
<u>Japan</u>	4.8	4.2	3.6	3.4	3.3	2.4	<u>1.7</u>
France	0.7	(0.3)	1.8	2.6	3.3	3.3	<u>3.3</u>
Germany	2.8	3.1	3.9	3.4	2.7	2.3	<u>1.7</u>
Italy	9.5	8.0	11.9	12.7	11.8	13.5	12.2
UK	3.3	3.7	3.1	2.4	3.5	3.4	<u>2.8</u>

IMF figures ( ) = Surplus



Chart 1

### MONETARY GROWTH AND INFLATION

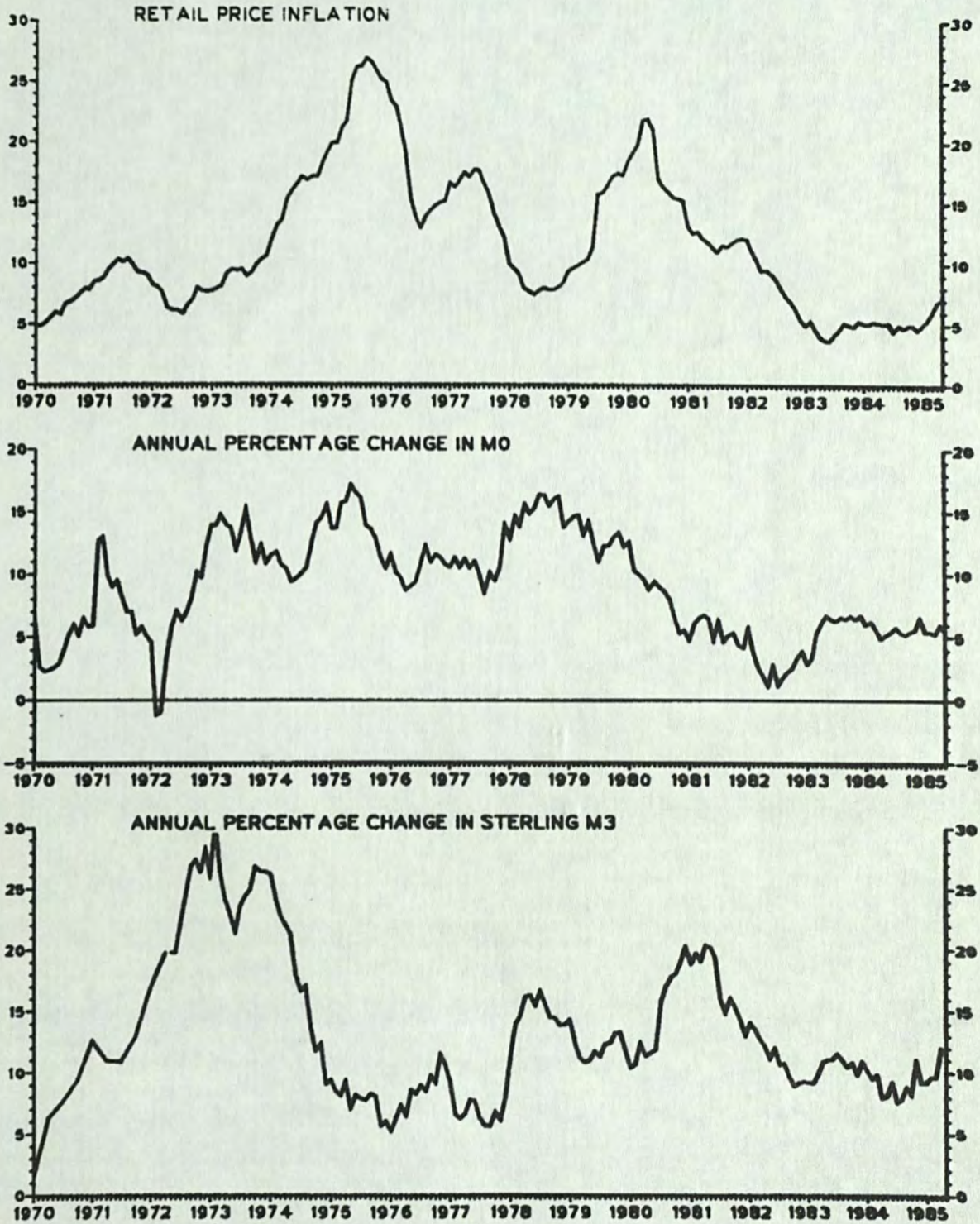




Chart 2

### ASSET PRICES

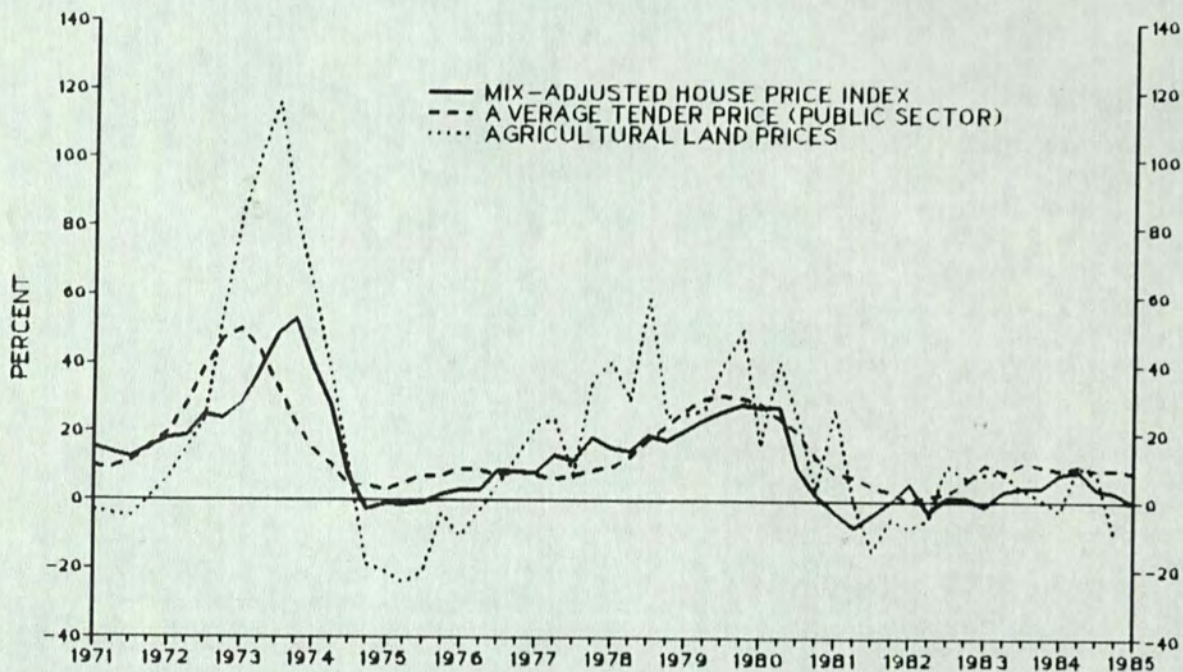




Chart 3

MONETARY GROWTH

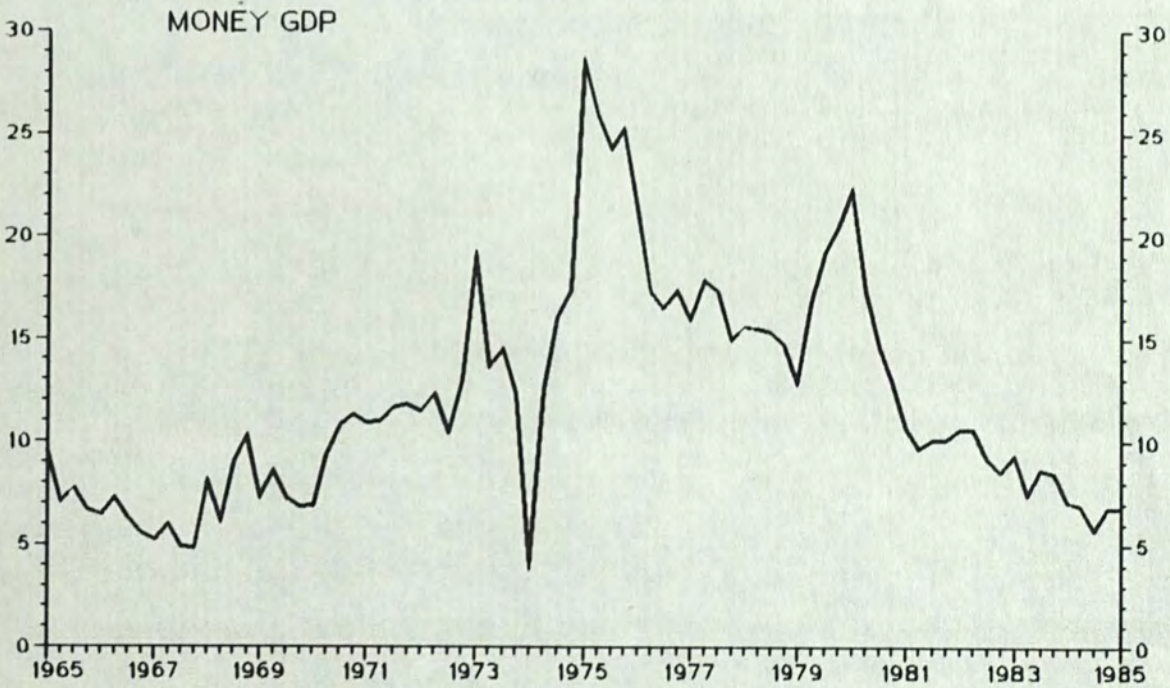
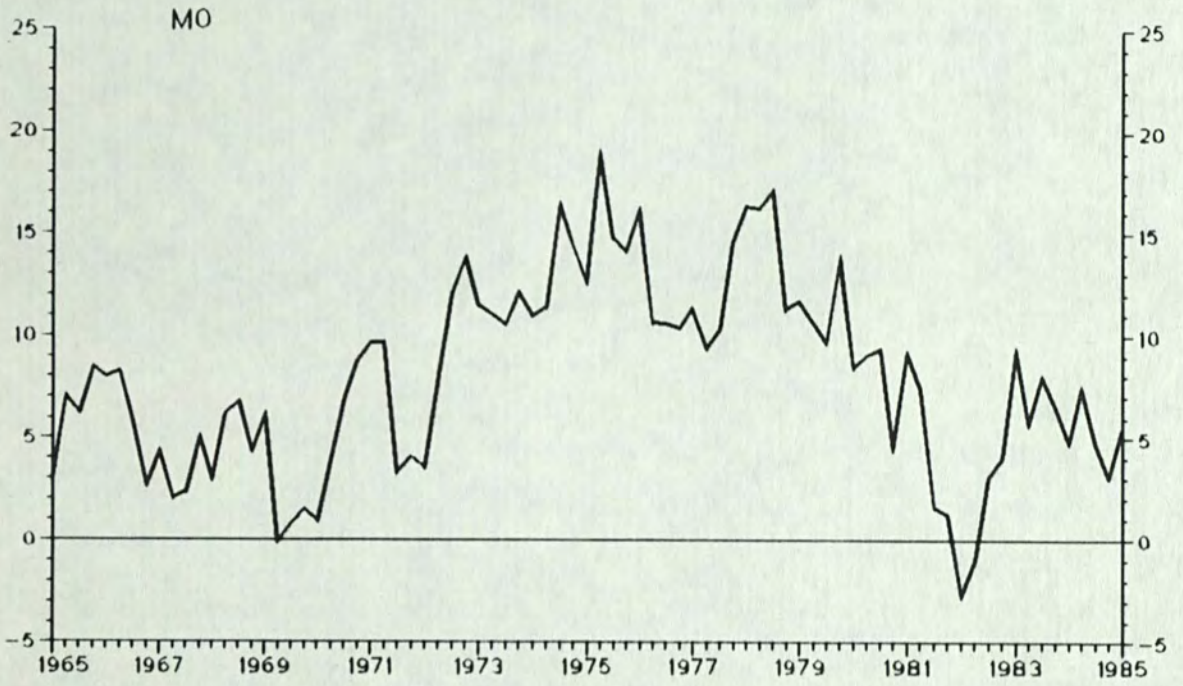




Chart 4

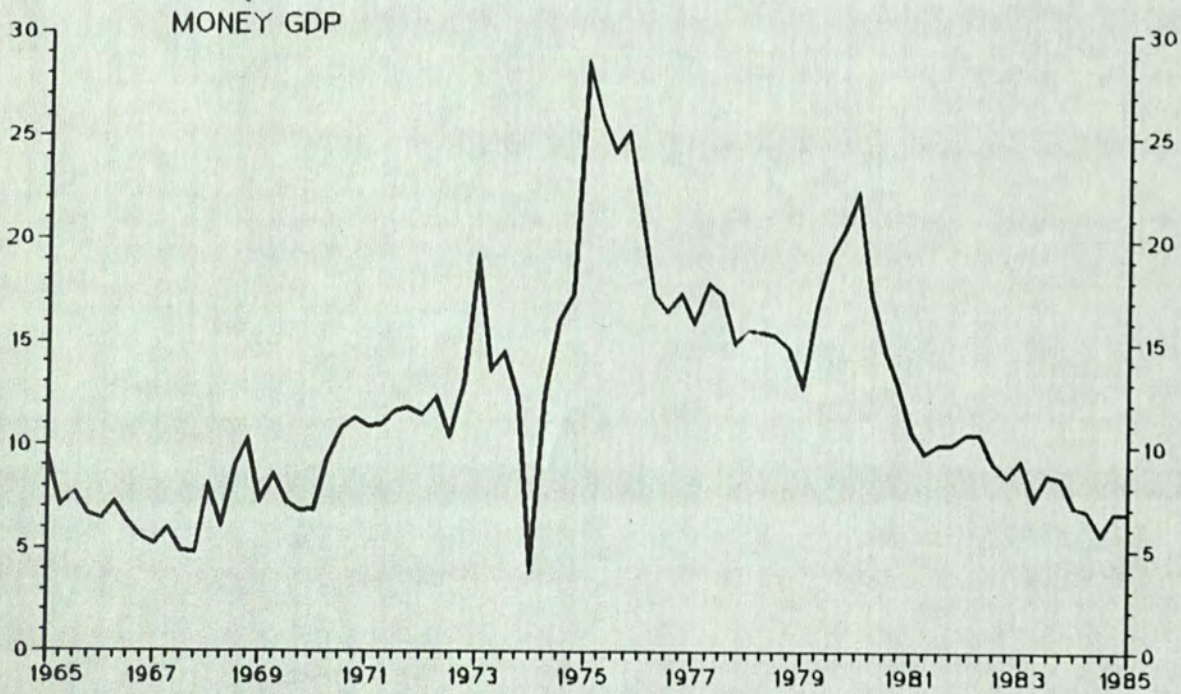
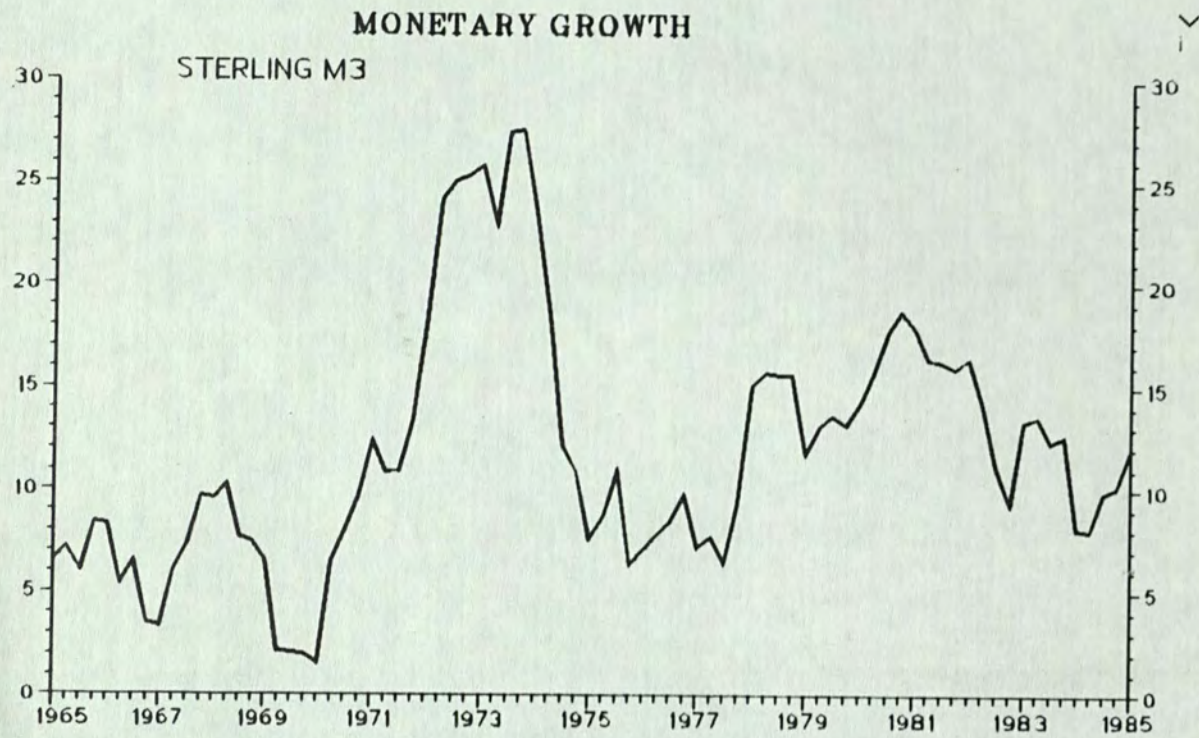




Chart 5

VELOCITY OF £M3

