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PRIME MINISTER

SEMINAR ON MONETARY POLICY

Papers

1. Monetary Policy - Note by the Treasury

2. Monetary Control - The Bank's views.

3. Issuing Long-dated Conventional Gilt Edged - Note by the Bank.

4. Paper by Professor Brian Griffiths

5. Comment by Sir Alan Walters (to come - papers have been sent to him in Washington).

6. Note by the Policy Unit

Issues

It will be helpful to take the discussion in the following sequence:-

- Assessment of Monetary Conditions
- Choice of Target Aggregate
- Overfunding and the Bill Mountain
- Determination of Interest Rates/Money Market Operations
- Long term debt sales.

(i) Assessment of Monetary Conditions

You will probably find yourself closer to the Bank than the Treasury. Treasury argue that current rate of

inflation is result of lax monetary conditions last year for which corrective action has been taken. Interest rates are now higher and exchange rate much stronger. As often in the past £M3 is a poor indicator of monetary conditions. The stance of policy is tight enough if interest rates are held up to resume downward path of inflation to below 5 per cent next year.

The Bank say inflation has bottomed out at 5 per cent, the economy is very strong, unit labour costs are growing at 5-6 per cent and that current monetary conditions if sustained will produce only a modest reduction in inflation, and certainly nothing like 3 per cent by 1988.

It is doubtful if the discussion will produce a meeting of minds, though there is agreement that interest rates have to stay up for some time and exchange rates cannot be allowed to fall significantly.

(ii) Choice of Aggregate

Treasury argue that £M3 is a poor indicator of inflationary conditions. There is no clear trend to velocity; it does not respond predictably to higher interest rates and it can be kept under even moderate control only by overfunding. The target range could be raised or better still it could be dropped as a target. This would allow overfunding to be dispensed with. Treasury accept that either option must be accompanied by greater commitment to MO and high exchange rate. Treasury do not propose any immediate change but recommend the role of £M3 be looked at in the Budget by which time the inflation outlook should be better. It is not clear however how much progress can be made in reining back on funding (see below) without announcing a change in status of £M3.

The Bank think £M3 is an indicator of build up of liquidity and even if monetary conditions now are satisfactory, the potential dangers of rising liquidity cannot be ignored. The effect on expectations of downgrading £M3 would be serious. Bank recommend two courses - higher short term interest rates plus technical solutions to reduce the bill mountain - see below. Alan Walters and Brian Griffiths both favour downgrading £M3 and increasing emphasis on MO.

(iii) Overfunding and the Bill Mountain

Policy here flows directly from choices made under (ii). Bank and Treasury agree that in principle overfunding and the resulting bill mountain need to be tackled but Bank is more ready to contemplate overfunding as a second best for holding down £M3. They also think the problem of arbitrage is exaggerated. The Treasury course allows overfunding to be dispensed with. Retaining a prominent role for £M3 as Bank suggest is likely to require its continued use unless short term rates go significantly higher. The bill mountain can be reduced by the Bank making deposits with the banks or by buying in export credit paper. Both represent correcting an absurdity by adding another layer of distortion.

(iv) Determination of Interest Rates/Money market Operations

Neither Treasury nor Bank believe that problems of monetary control lie in Bank buying bills too freely. They agree that Bank buys enough bills, and no more, to take out the cash shortage each day. (Para 26 of Treasury paper; para 25 of Bank paper). Neither see any merit in the Walters/Griffiths proposal that money market assitance should be at progressively more penal rates. The effect of this would be just the same as raising the general level of interest rates, which can be achieved under the existing methods of money market operation if

But by doing this they tend to increase the shortage because however big it is it will always be met.

the authorities so wish. Neither believe that penalty rates have any independent effect on bank lending because the banks lending rates would simply rise to reflect the higher cost of funds.

No - the banks would lend less and there be less shortly cash.

(v) Long term debt sales (there may not be time to discuss this at this meeting)

The Bank argue, and the Chancellor to a degree goes along with them, that conditions have changed since original decision to stay out of long term market.

(i) long term yields now around 11 per cent compared with over 14 per cent earlier.

(ii) real rate of return as indicated by indexed gilts is 3½ to 4 per cent rather than the 2½ per cent which was expected. (i) and (ii) combined mean that the expected inflation built into long term gilts yield has come down considerably.

(iii) companies have shown no signs of stepping into the post 2000 void.

(iv) there is considerable congestion in the 1990s.

In the light of this the Bank believe long dated stocks are not unreasonably expensive and that to foreswear them entirely would add to the existing hump in yields in the 1990s.

Conclusions

You will need to seek conclusions on the following points:-

(i) will the maintenance for some time of current monetary conditions restore a satisfactory downward trend of inflation?

(ii) should £M3 be downgraded? And if so when should this be made public.

(iii) if £M3 is retained as a target, can a satisfactory rate of growth be achieved by higher short term interest rates or will some measure of overfunding be required?

(iv) Should efforts be made to fund the bill mountain?

(v) can existing methods of money market operation deliver the interest rates the authorities consider appropriate.

My own views are:-

(i) provided the authorities keep interest rates up and resist temptation to lower them if the exchange rate improves inflation can be brought down.

(ii) we must move away from £M3, but only when inflation figures have started to improve and only if combined with increased commitment to MO.

(iii) (ii) will allow overfunding to be dispensed with and will prevent bill mountain increasing. Some funding of the existing stock of bills could take place but it does not need to be eliminated as the permanent shortages which it produces keep the banks coming to the Bank and allow the latter to dictate interest rates.

(iv) If operated robustly, the present system of money market operation will deliver whatever interest rates the authorities want. Penalty rates are a red herring.

AT

Andrew Turnbull

21 June 1985

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Treasury Chambers, Parliament Street, SW1P 3AG
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21 June 1985

Andrew Turnbull Esq
10 Downing Street
London SW1

Dear Andrew

MONETARY POLICY

As you know, the Treasury and the Bank are submitting separate papers for next Tuesday's discussion. I attach the Treasury paper. It deals primarily with current monetary conditions in the framework of policy, and the related problems of sterling M3 and overfunding. The technical issues raised by Sir Alan Walters about money market operations and the workings of the 1981 arrangements are discussed in some detail in the separate paper by the Bank, which you already have.

I am copying this to John Bartlett (Governor of the Bank of England's office). I also enclose an extra copy for Sir Alan Walters.

Yours ever
Rachel

RACHEL LOMAX

MONETARY POLICY

I Summary and Conclusion

Different indicators are once again giving conflicting signals about monetary conditions. The buoyancy of the real economy, the rise in RPI inflation and the rapid growth in bank lending and broad money point to a degree of monetary ease. But the strong exchange rate, high real interest rates, and the modest growth in M0 suggest that monetary conditions are suitably tight.

2. We judge that the rise in inflation is temporary. It reflects the weakness of the exchange rate earlier in the year, and the sharp rise in interest rates needed to correct it. Monetary policy has been tightened substantially this year: short term interest rates are still 3 per cent higher than they were in December and the exchange rate is over 10 per cent higher than it was in January. We expect inflation to fall sharply over the next year - possibly to 4 per cent by next summer. Looking further ahead, the aim of policy should be to keep it on a downward trend. This may leave little room for further falls in interest rates. But, like the Bank, we see no immediate need for them to rise.

Inflation is a lot higher

3. Problems in interpreting the monetary indicators are neither new, nor unique to the UK. We have certainly lived with them since 1980. We, like the US, have a sophisticated financial system which has been subject to significant and, at times, abrupt changes as a result of deregulation and increasing competition. Measures of broad money and liquidity have been particularly affected. Since 1980, the growth

of sterling M3 has persistently exceeded that of money GDP, in sharp contrast to the middle and late 1970s. Narrow measures of money - including M1 - have also been distorted by the development of interest bearing current accounts. M0 - largely notes and coins - has not been immune. But the changes affecting it have occurred at a steadier pace and, in the event, it has proved a useful indicator over a number of years. Given the problems of the monetary aggregates, it is not surprising that the exchange rate has become a useful supplementary guide to policy.

4. The build up of liquidity obviously carries a risk. The risk is that some of it will be spent. We have little idea how much will be used in this way or when. Sterling M3 certainly does not provide a good guide. But some still argue that it is necessary to restrain its growth to ensure against the danger that the authorities will not act quickly enough if it is monetised. However, experience suggests that M0, asset prices (especially house prices) and the exchange rate provide the most reliable warning signs. It is only when these signs have been ignored - as in the early 1970s - that we have got into trouble.

5. The rapid growth of bank lending has been the driving force behind the expansion of liquidity in recent years. The attempt to offset this by selling more debt has driven us into over-funding. But over-funding drains cash from the banking system and the process of relieving cash shortages has led the Bank to buy commercial bills on an increasing scale. The bill mountain was thought to be temporary; but it now stands at £17 billion. If it continues to grow at the present rate, it could double over the MTFS period. It opens up opportunities for arbitrage which may compound the problem of bank credit, and it has been a major reason why the 1981 money market arrangements have never operated as intended.

6. Over-funding and the bill mountain are in danger of bringing our system of monetary control into disrepute and with it our monetary policy. As the Bank paper makes clear, the Treasury have discussed this issue with them on many occasions. The Chancellor said in his Mansion House Speech in 1983 that we should not normally sell more debt than was needed to fund the PSBR. We must now take steps to implement this policy and reduce the bill mountain significantly.

7. Specifically we should:

(i) stop over-funding. Sell enough debt to fund the PSBR and stop there. This is normal international practice in countries which pursue sound financial policies, including Germany, the US and Switzerland;

(ii) ask the Bank to examine urgently other methods for reducing the scale of the bill mountain.

8. This may lead to a faster growth in sterling M3, at least for a time. So it will be all the more important to keep other indicators on track: that will mean maintaining high short-term real interest rates and a strong exchange rate. We do not suggest changing the sterling M3 target yet. But, in the light of experience, we shall need to reconsider the role of sterling M3 and the appropriate target range for it (if any), at Budget time, in the context of the MTFS.

I Inflation: Short term prospects

9. 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.

10. 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.

11. 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 has been foreseen.

12. 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 at all from today's levels this would have the effect of reducing inflation by 1½ per cent next summer compared with today's rate.

13. In addition the exchange rate has now recovered last year's fall and import price growth is already moderating. Firms will find it less easy 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.

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

will be around 4 per cent a year from now. This is not contradicted by present information on house price increases. Recently there has been some very modest and patchy signs of quickening but average increases remain below 10 per cent on a year earlier, around the same rate of increase 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 Chart 2).

15. Abstracting from these temporary influences we estimate that the underlying rate of inflation has shown only a small increase in recent months. The underlying inflation rate has been on a plateau of around 5 per cent over the past two years and more; 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 recorded inflation rate is likely to fall sharply over the next year, the underlying inflation rate will probably only decline slowly. Maintaining the monetary policy implied by this year's MTFS may not leave much room for interest rate reductions but we do not, at present, see any need for a further increase. A significantly tighter monetary stance designed to secure a faster fall in inflation would, in the short term, have adverse effects on output and thus employment.

II Choice of monetary targets and indicators

16. 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 lead to funds previously held at longer term being switched into sight deposits; and it also seems to have resulted, not surprisingly, 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

17. It was this distortion to the current account figures that led 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 predictable 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.

18. 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.

19. Turning to the **wider measures of money**, a £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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20. The explanation lies in developments over the period that have affected the nature of £M3 and the private sector's demand for liquid assets. As real short-term interest rates have turned from negative to positive, 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 Chart 5).

21. The driving force behind £M3 growth has been the buoyant demand for private sector credit, leading to a rapid increase in bank lending. 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.

22. The rapid growth of bank lending is not entirely surprising. We have deliberately encouraged the UK banking system to operate on shore - unlike the United States and Germany. Since 1979, we have abolished compulsory cash ratios, exchange controls, and the supplementary special deposit scheme (the corset). These developments have left our banking system remarkably free of artificial constraints - a situation that has strengthened London's position as a major financial centre.

23. Bank lending has been less of a problem in other countries. But they differ from us in putting the main emphasis on narrower measures of money - M0 in Switzerland, M1 in the United States and central bank money in Germany. With less concern about the growth of liquidity, the role of funding is also different in other countries: the normal rule is to sell enough debt to fund the PSBR but no more.

24. 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 and expectations. In practice, we have found the exchange rate a useful supplementary guide to policy: often a more useful guide than £M3.

almost always?
When did we last change interest rates solely on evidence of £M3?

III **Monetary Control: overfunding and short term interest rates**

25. There are essentially two different approaches to controlling £M3. We can either seek to control bank lending directly via short term interest rates, or neutralise the effect on liquidity by over-funding.

26. The effect of over-funding - that is, selling more debt than is needed to finance the PSBR - is to 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 create money market shortages which, if not relieved, would lead to a sharp rise in short term interest rates. Unless such a rise is thought warranted by monetary conditions, the Bank will relieve these shortages by adding to its holding of commercial bills (the bill mountain).

27. Overfunding has a reasonably reliable impact on £M3, at least in the short run. Changing **short term interest rates**, on the other hand, has at best a delayed effect on £M3 and bank lending. Indeed, the short run effect can even be perverse.

28. 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 is also arguable that although there is a short run effect, overfunding does not greatly reduce £M3 in the longer term. That would be the case, for example, if the extra sales of gilts and higher long rates were crowding potential corporate borrowers out of the long term capital market, and forcing them to borrow from the banks instead.

29. With the persistent tendency of £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 as we did in the summer of 1982 and again last year, we have concluded that it was preferable to avoid overfunding; and on each occasion in practice we have subsequently concluded that reliance on short term interest rates alone did not offer a sure enough prospect of reducing £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 commercial paper - in effect short term loans to the banking system. The total has now reached around £17bn, rising from a negligible figure in 1979.

30. The sheer scale of this bill mountain is now creating a range of technical, presentational and other problems. Not only does it look absurd, but 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. 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?

31. We thus come back to the question of whether we should be seeking to restrain the growth of £M3, and if so what rate of growth is appropriate. The more we are concerned about the growth of sterling M3, the more we are likely to have to contemplate further overfunding, and a further rise in the bill mountain, as the only reliable means of controlling it. 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 ways - eg by persisting with a policy of high real short term interest rates and a strong exchange rate - 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.

32. Table 1 and Charts 1 and 2 show the growth of MO, £M3 and some other indicators against the path of inflation since 1970. They show that both £M3 and MO 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.

33. Conditions today, both domestic and international, are totally different. There is certainly no sign of asset prices taking off in the way they did in 1972-74 sometime before inflation took off (see Chart 2). Had we been operating then as we do today, the movement in MO, the exchange rate and asset prices would have led us to take action even without a target for £M3.

HM TREASURY
June 1985

TABLES AND CHARTS

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

Chart 1: Monetary growth and inflation since 1970

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

Chart 3: MO and money GDP since 1965

Chart 4: £M3 and money GDP since 1965

Chart 5: Velocity of £M3

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

	MO*	£M3*	£ EXCHANGE RATE[1]	INFLATION[2]	MONEY GDP	PSBR/GDP RATIO
1969-70	2.9§	1.7+	127.3	5.0	7.4	-1.2
1970-71	13.0	12.6+	127.1	8.5	10.6	1.5
1971-72	[- 1.0**]	16.9+	128.8	8.0	11.5	1.6
1972-73	14.8	26.5	114.6	7.9	13.8	3.6
1973-74	10.8	22.8	107.2	12.7	11.0	5.8
1974-75	15.7	8.1	105.1	20.3	18.7	8.9
1975-76	9.7	7.3	94.0	22.5	24.1	9.2
1976-77	10.6	6.2	80.9	16.5	16.8	6.4
1977-78	13.9	14.6	84.8	9.5	16.4	3.6
1978-79	14.8	11.2	82.4	9.6	14.6	5.4
1979-80	10.0	12.4	93.0	19.1	19.8	4.8
1980-81	6.5	19.1	101.4	12.7	13.8	5.4
1981-82	2.7ø (3.7)	13.6	91.1	11.1	10.1	3.3
1982-83	5.3	9.8	80.6	4.9	9.4	3.1
1983-84	5.7	9.8	81.7	5.1	7.9	3.2
1984-85	5.3	9.3	72.1	5.5	7.0	3.1

* Mid-March to Mid-March

1 Q1 level

2 RPI: Q1 on previous Q1

\+ Q1 on previous Q1

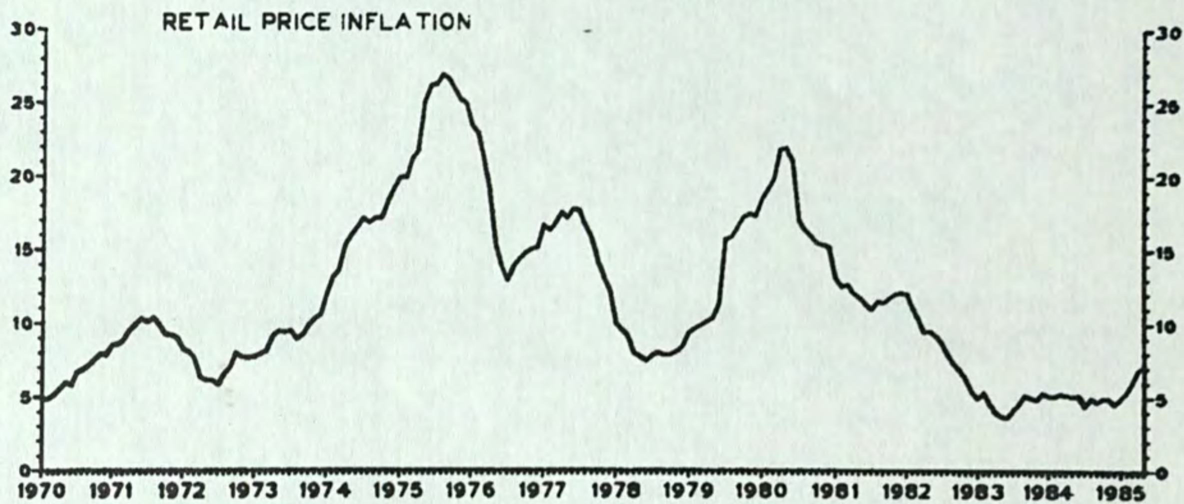
ø This figure is distorted by the change in the definition of MO in September 1981, after which date non-operational balances were excluded from MO. The figure in brackets is the estimated change adjusted for the change in definition.

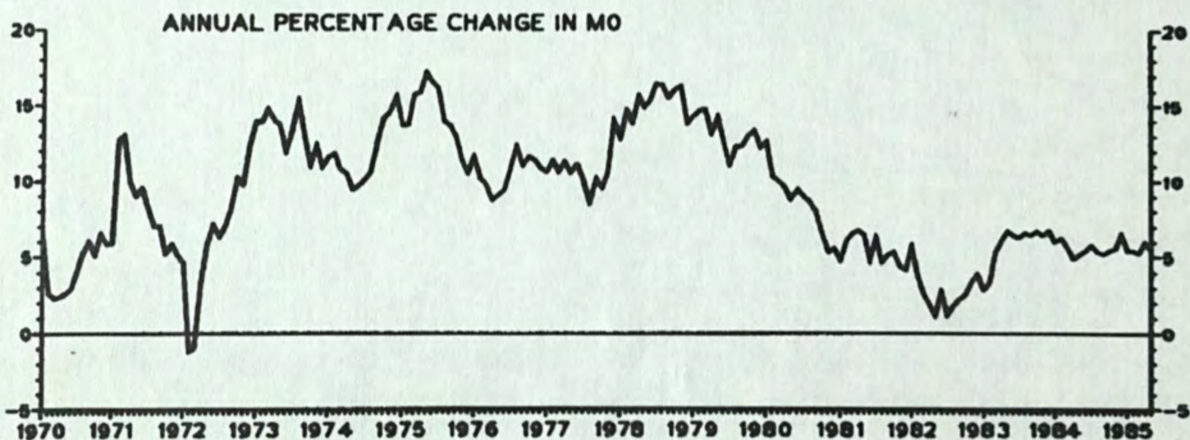
** Prior to September 1971 the clearing banks agreed to hold at least 8% of total assets in the form of till money plus bankers balances. Thereafter under the Competition and Credit Control regime banks held 1½% of their eligible liabilities as non-interest bearing balances at the Bank of England. The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

§ June on previous June.

Chart 1

MONETARY GROWTH AND INFLATION





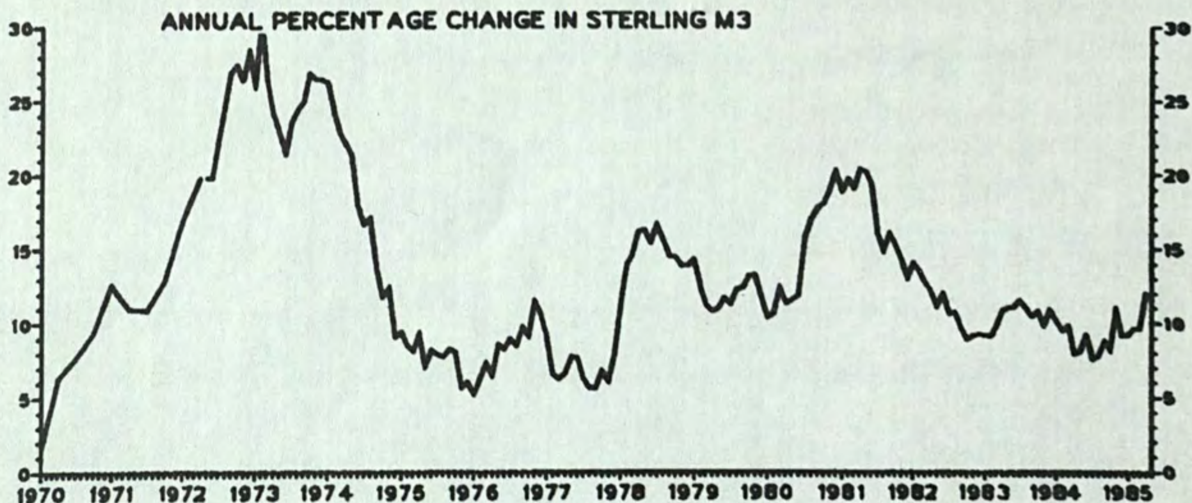


Chart 2

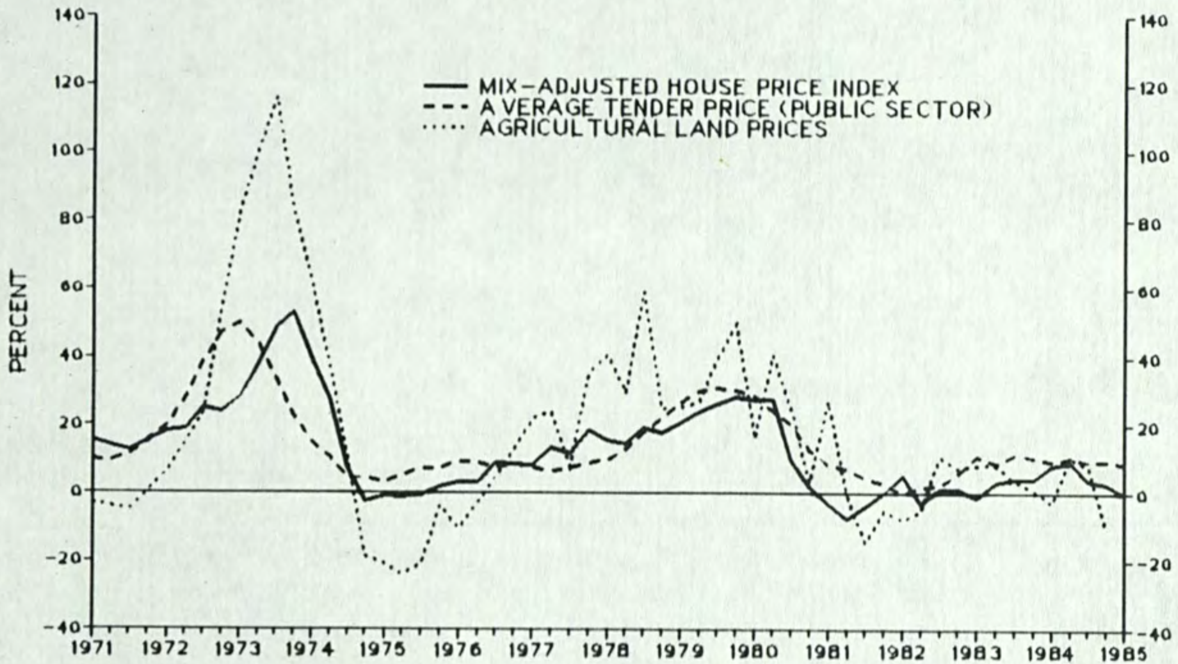


CHART 3

MONETARY GROWTH

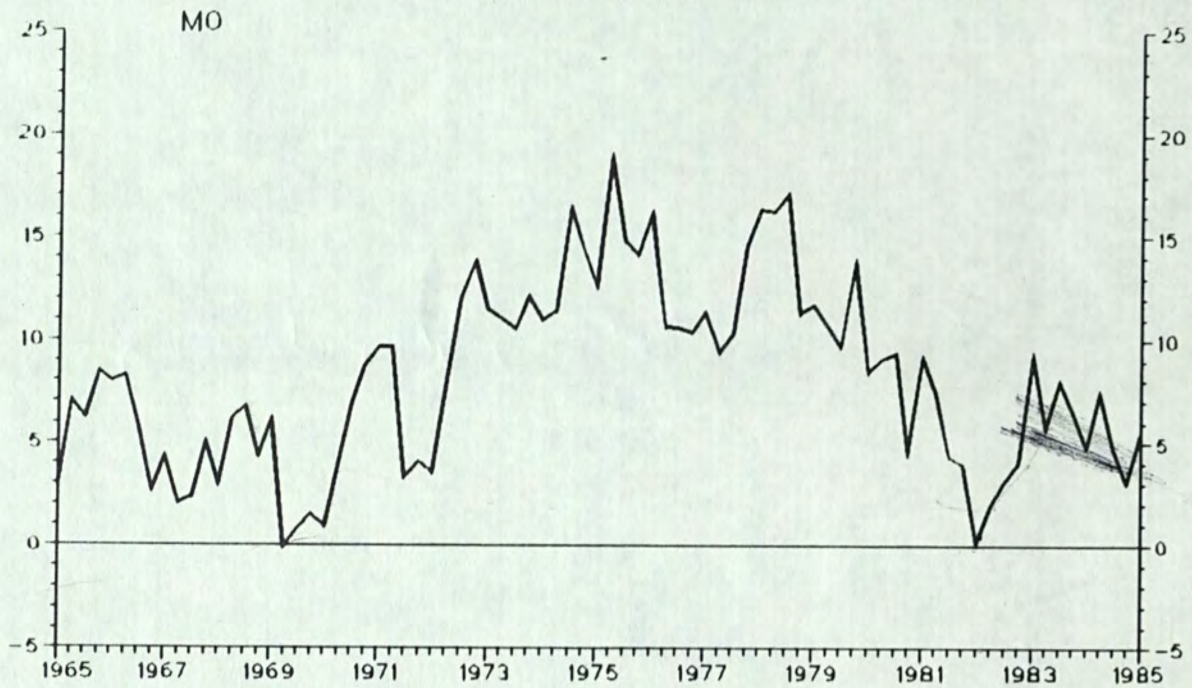
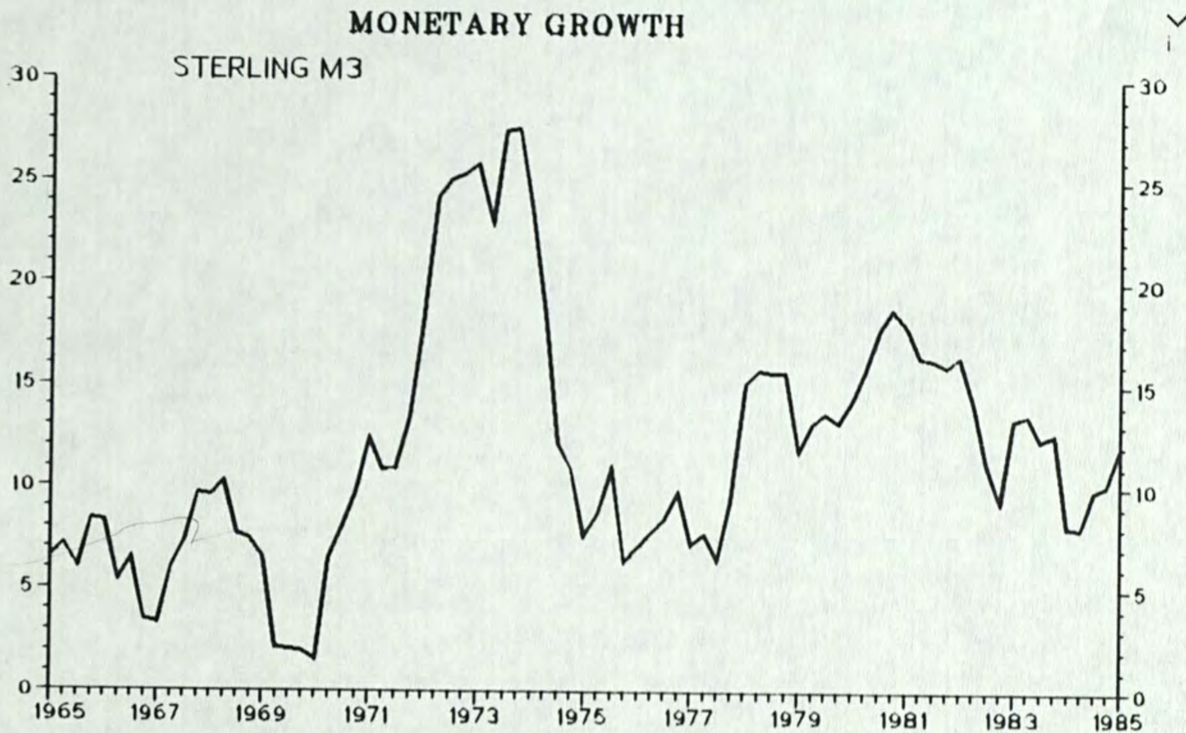


Chart 4

MONETARY GROWTH



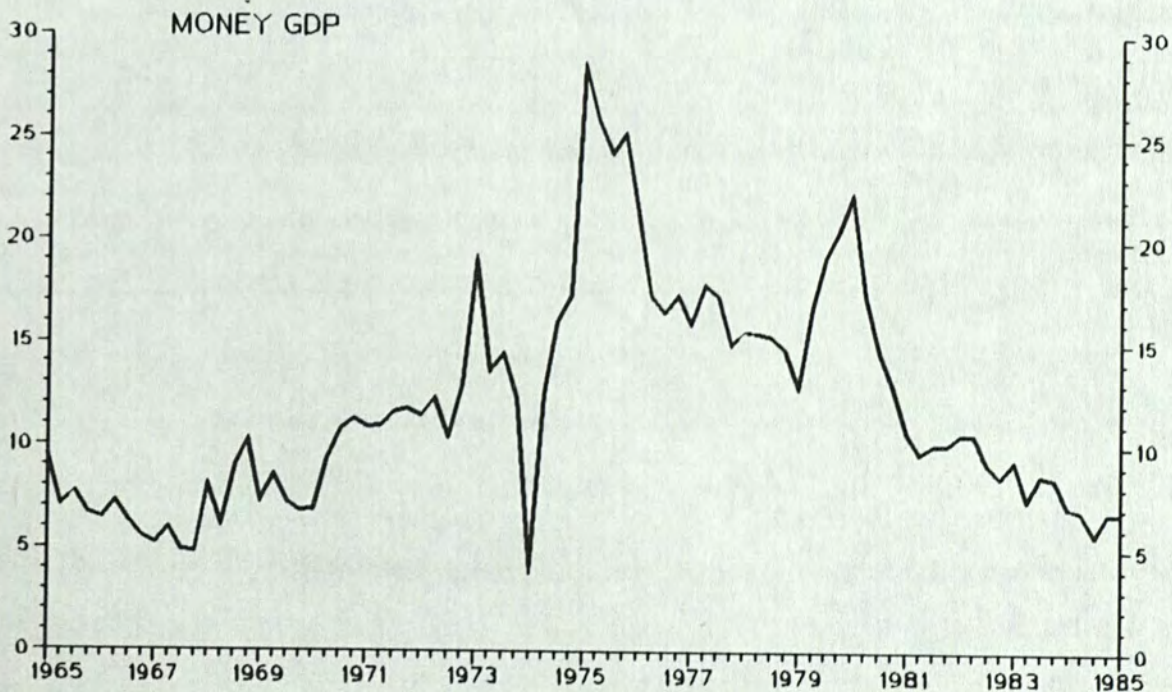
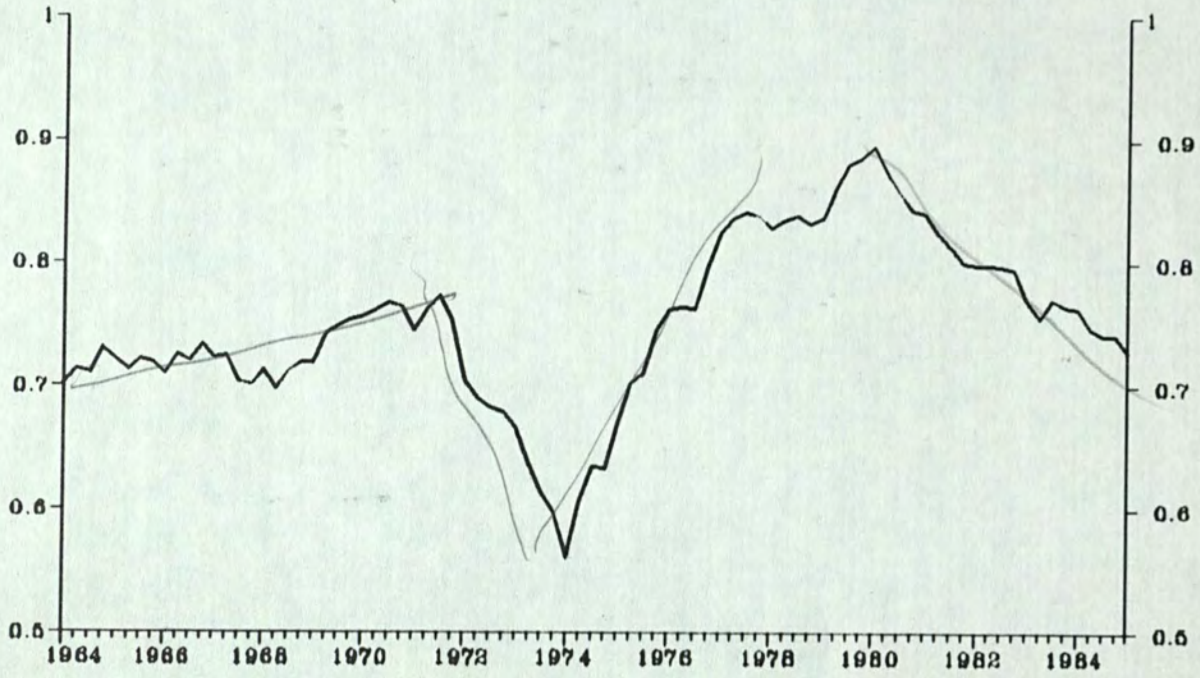


Chart 5



SECRET

Bank of England

London EC2R 8AH

The Governor

21 June 1985

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The Rt Hon Margaret Thatcher MP
Prime Minister
10 Downing Street
London SW1

Dear Prime Minister,

In your Private Secretary's letter of 6 June to Mrs Lomax the Bank was asked to let you know its views on the concerns you have expressed about monetary policy. In response to that request I enclose two notes which have been prepared here, the first commenting on your wider concerns about the present situation and the general framework of policy; and a second note on the more specific question of the sale of long-dated gilts.

You will see that we share some of your concerns about policy. Our fundamental difficulty is over the strength of private sector demand for bank credit. We do not feel we can ignore this without serious risk to the counter-inflationary strategy. But equally it does not readily respond to higher interest rates, so that if we relied upon that means to choke it off, we could risk damage - in the short term at least - to the economy. There are different technical approaches, but this is the heart of our problem which remains essentially unchanged whatever techniques we adopt.

I look forward to discussing the notes with you and the Chancellor on Tuesday.

Yours ever,

Robin

MONETARY CONTROL - THE BANK OF ENGLAND'S VIEWS

MONETARY CONDITIONS

1 The Bank shares the view that the current upturn in inflation, as measured by the RPI is, in part, the consequence of sterling's weakness in the exchange markets around the turn of the year in the context of a very strong dollar, and of the interest rate response to that situation. We expect to see some moderation in the RPI after the summer. But, setting this blip in inflation aside, we are more fundamentally concerned at the underlying upwards pressure on inflation coming from unit labour costs, the rate of growth of which in manufacturing has risen from below 1% in late 1983 to over 5% now, much faster than our major competitors overseas. We fear the persistence of this trend as wage settlements, and earnings, have now begun to edge upwards again while the exceptional gains in productivity of 1983/84 have not been maintained. It seems that the recovery in profitability may have weakened management's position in pay negotiations; and the labour force - which has achieved a persistent increase in real earnings in recent years for those remaining in work - is likely to respond to the upturn in the RPI with higher wage demands.

2 Although we may be helped in the period ahead by weak world commodity prices, the underlying rise in unit labour costs may make it difficult to get back to, and stay on, the recent plateau of around 5% in the underlying rate of inflation. And we are certainly not confident that we are on course for a further gradual decline from that rate in the period up to 1988.

3 It is in this context - and in the context of strong business confidence, which, though it too may weaken later in the year, has shown very little sign of doing so thus far despite the recovery in the exchange rate and persistence of high nominal interest rates - that we seek to assess monetary conditions.

4 Of the monetary indicators, MO has grown steadily over the past year comfortably within its target range. Other narrow measures of

money have been heavily distorted by competitive pressure and innovation within the financial system (particularly by the widespread introduction of interest bearing current accounts) and are, by general consent, telling us very little at present.

5 Broad money, on the other hand, has been growing relatively fast over the past year, including £M3, which was around the top of its target range for most of the last target period, going well above it, to an annualised rate of 12% compared with the 6-10% target range at the very end of the period. In part this was erratic - reflecting inter alia a surge in bank lending to the private sector as investment spending (notably via leasing) was brought forward to take advantage of the higher initial tax allowances available up to the end of the last financial year. But allowing for this the underlying rate of £M3 growth has increased in recent months and is for the time being substantially above the current 5-9% target rate.

6 There are grounds for thinking that this may, in some degree, reflect an upwards shift in the demand for £M3 (rather than the excessive creation of money) which would not have immediate implications for inflation. Broad money too has been affected by financial innovation; and, perhaps more importantly, the persistence of high positive real interest rates on deposits generally has made them relatively more attractive than in the past as a home for genuine long-term savings rather than just a vehicle for transactions balances. If all the other available evidence suggested that monetary policy was visibly tight in relation to the ultimate objective for nominal income and inflation, these factors could provide justification for taking the rapid growth of broad money at less than its face value.

7 But that, in the Bank's view, is not the situation we are presently in. As noted earlier business confidence is exceptionally strong for the time being, and unit labour costs are giving a worrying signal about the future rate of inflation. In this situation therefore the Bank does not consider that the excessive growth of £M3 can be ignored and would be very cautious about any easing of policy until either £M3 growth moderates or the other available evidence points to a slackening of the pace of nominal income growth and underlying inflationary pressures.

MONETARY ARRANGEMENTS

8 The Bank agrees that the 1981 monetary arrangements are not working as originally envisaged in a number of respects. We did not contemplate then the degree of overfunding that has been undertaken to keep £M3 within its target range; nor therefore did we foresee the consequent systemic cash shortages within the banking system or the bill mountain that has resulted from relieving those shortages. These questions are discussed further below. It should be noted, however, that, despite these departures from the original intention, the 1981 arrangements have not been unsuccessful hitherto in delivering the Government's objectives for nominal income and inflation.

Overfunding

9 The core of the problem of monetary control for many years has been a persistent tendency for bank lending to the private sector to grow at a faster rate than is consistent with an acceptable rate of broad money growth. It is this excessive growth of bank credit that has driven us into overfunding to contain the effect on £M3; and overfunding in turn has resulted in the bill mountain, which is a symptom of the difficulties of monetary management rather than a cause, though it brings complications of its own.

10 In this situation of excessive bank lending in relation to the £M3 target we have had effectively four - not necessarily mutually exclusive - policy options -

(i) to develop other, non-bank, channels of finance for the private sector;

(ii) to raise short-term interest rates to a point where bank lending to the private sector was reduced;

(iii) to compensate for excessive bank lending to the private sector by overfunding the public sector outside the banking system; or

(iv) to allow faster growth of £M3.

11 We have repeatedly reviewed these options with HMT. As a result a number of actions have been taken under option (i) to encourage more private sector recourse to the capital market - most recently the

introduction of a regime for corporate sector 1-5 year bonds. Further action could be taken in this field, eg a tax on consumer credit and reduction in the tax incentive to borrow on mortgages to dampen what appears to be a structural rise in the personal sector debt ratio; and the introduction of a regime for corporate sector one-name commercial paper on which the Bank will shortly be writing to HMT. But apart from a surge in equity issues in the first half of this year these measures have had limited success and cannot be relied upon to produce any quick or adequate solution.

12 Of the remaining options (iv) - allowing faster growth of £M3 - has, hitherto, been ruled out because it was seen to carry inflationary risks. As explained in the first section in this note the Bank continues to attach importance to containing broad money growth for this reason. So too, despite the recent debate, do the financial markets.

13 As noted in paragraph 6 above, there are grounds on which some relaxation of the £M3 constraint would be justified if we had clearer evidence that policy was tight in relation to its ultimate objectives, notwithstanding relatively rapid growth of £M3. But we need to be cautious about moving in that direction because the build up of liquidity it would represent could equally become a source of inflationary pressure. It would not be enough, in the Bank's view, to rely upon containing that pressure only when evidence of it had emerged. That would carry the danger of acting too little, too late.

14 These risks would be greatly increased if the £M3 constraint were to be abandoned altogether. This would be seen as giving up all attempt to control the monetary consequences of the expansion of bank credit (or, by extension, of the PSBR), which has been at the heart of the problem of monetary control, and would be regarded as a major relaxation of policy. And, although we might undertake to continue to take account of broad money growth, the fact that we did so on a purely discretionary basis would, in the Bank's view, in substance represent a significant weakening of monetary discipline.

15 If, therefore, constraint on broad money growth is to continue to play a role in the monetary policy framework, as the Bank thinks it must, the policy choice of means of influencing it comes down essentially to options (ii) and (iii) above, ie either short-term

interest rates or overfunding (which, with some oversimplification, can be regarded as higher long-term interest rates).

16 Hitherto, at any particular moment, overfunding has seemed more immediate and certain in its effect. Short-term interest rates appear to affect the private sector's demand for bank credit only with a long and uncertain time lag, and they may at the same time increase the demand for broad money. Moreover overfunding has, analytically, seemed justified in that it is the total demand for bank credit from the public and private sectors combined which has monetary effect rather than the demand from these sectors (the boundary between which is in any case somewhat arbitrarily determined) individually. It has the effect, by changing prospective yield relativities, of persuading asset holders to shift from more liquid to less liquid assets so reducing the inflationary risks of the initial creation of credit.

17 This is not to say that overfunding is without its problems. In itself it has now reached the point where it may be damaging confidence in the policy as a whole by being seen as a softer option than more effective containment of bank lending to the private sector, which is the source of the dilemma. Overfunding also has consequences for the money markets leading to the bill mountain. In essence this is a presentational problem - we agree with Sir Alan Walters when he says it looks absurd. And the need constantly to rollover the outstanding market assistance is a technical inconvenience as discussed in the following section. But if we are to avoid overfunding we would have to accept either faster £M3 growth or a general level of short-term interest rates which is systematically higher than would otherwise be necessary, or some combination of the two.

The bill mountain

18 The original intention of the 1981 arrangements was that there should be no systemic cash shortage within the banking system, enabling the Bank to smooth out day-to-day fluctuations in the system's cash requirements by dealing in either direction in short-term bills (normally up to 14-day maturities). This would leave longer-term money market rates free to fluctuate providing a greater degree of market determination of rates, including base rates which were expected to vary more frequently, outside official influence beyond that exerted by the Bank's intervention at the very short end of the market.

19 The cumulative effect of overfunding has had the unavoidable consequence of adding to the bill mountain. (It is not the sole cause of the bill mountain as the parallel paper by HMT explains.) The bill mountain, in turn, has made it impossible for the Bank to confine its operations to the very short end of the market. The daily shortages, resulting from the rolling over of maturing assistance, rapidly became so large that we had to offer to buy bills in all maturities out to three months in order to allow the banking system to meet its liabilities. And the rates at which we deal have, as a consequence of this continuous involvement in all maturity bands to three months, become ossified, normally changing only when there is a change in the general level of short-term rates, including base rates.

20 Despite this unintended development, the arrangements as they operate even now do permit greater market influence over the term structure and general level of short-term interest rates, including base rates, than was previously the case - albeit not to the degree envisaged in 1981. This is because although our bill dealing rates have become effectively frozen from day to day, interbank rates are free to vary around them - and do so quite substantially - and it is interbank rates that largely determine base rates. The stickiness of our dealing rates may serve to reduce the variation of interbank rates; if we moved our longer bill dealing rates more closely in line with interbank rates both would become more volatile. It would even now, without further change in present arrangements, be possible for us to do this, if Ministers were prepared to accept the greater volatility of short-term rates generally, including base rates, that would result.

21 Alternatively we could move back closer to the original 1981 intention by reducing the size of the bill mountain by putting a part of our market assistance on a longer term basis. Two proposals have been put to HMT to achieve this -

(i) the purchase from the banks of their outstanding ECGD-guaranteed export credit paper; or

(ii) the placing of long-term cash deposits with the major banks.

Both proposals, which are still under discussion and which are not without drawbacks, are designed to reduce the continuous rolling-over of market assistance which is a factor in the rigidity of our bill

dealing rates. Here too the purpose would of course be to restore something more like the degree of market determination of interest rates envisaged in the 1981 arrangements.

22 Such steps as those described in the two preceding paragraphs would reduce a technical inconvenience in the way in which we presently operate by reducing the scope for bill arbitrage which arises from the fluctuation of interbank rates around our bill dealing rates. Some market commentators have suggested that this occurs on a massive (and growing) scale and explains much of the recent growth in both bank lending to the private sector and in £M3. In the Bank's view this is wishful thinking. It is certainly true that such opportunities for arbitrage, or round-tripping, open up from time to time. But we have monitored the situation closely day by day and investigated every alleged instance of arbitrage of which we have become aware; we are confident that the scale of such activity is greatly exaggerated and based on, at best, hearsay evidence. But the fact that it can, and does, occur, even if on a relatively small scale, is troublesome, because the stories to which it gives rise also damage confidence in policy as a whole. (It is for this reason, rather than because we believe it to be a real problem, that we have recently made it clear to eligible banks that we do not provide them with eligibility to facilitate purely artifical transactions of this sort.)

23 From this point of view going back to greater market determination of the term structure and general level of interest rates would be helpful. It would, if allowed to operate in this way, also help to reinforce the protection against purely administrative determination of interest rates, with its risks of too little too late, which was an important part of the 1981 objective. At the same time it would leave us more exposed to wrong market signals and perverse movements in interest rates, as in July last year, though these tend, as then, to reverse themselves relatively quickly.

24 Freer market determination of interest rates could be a means of ensuring a more "automatic" rise in rates in response to an excessive build up of broad money. But it would not, in and of itself, resolve the question of whether, or how far, we should continue to overfund as an alternative to higher short-term interest rates as the

means of constraining the growth in broad money. That is a distinct, and prior, question. If it were decided, for any given £M3 target, to do more or less overfunding, our need to provide money market assistance would be correspondingly altered, but the more important effect would be on the level of short-term interest rates that would need to be produced, by one means or another, to produce an appropriate rate of growth of bank lending to the private sector.

25 It is sometimes suggested that we should approach the problem from the other end, ie that we should begin by declining to provide all the money market assistance which the banks require to square their books, or do so only at progressively rising interest rates. In principle one could do this to achieve the same ultimate effect as in paragraph 24 above. The general level of interest rates would rise, ultimately reducing the growth of bank lending, which for any given £M3 target, would then reduce the need for overfunding, and, in consequence, the need for money market assistance. This approach would be a form of monetary base control. If one could assume that there was a reasonably stable relationship between the quantity of base money which we supplied and either broad money as the intermediate objective or nominal income as the ultimate objective and that this could be identified and relied upon to continue, the approach would have the attraction of allowing the process of short-term interest rate formation to be more automatic, reducing the need for the exercise of official discretion. Even at the conceptual level there is considerable doubt whether such a relationship could be identified. At the practical level there is the problem that we would have no idea, possibly for some years, about the starting point: the change in our operating procedures, and associated interest rate volatility, would cause the demand for bankers' operational balances with ourselves, and so the necessary stock of base money, to increase, but we would have no means of telling whether it was this factor or an underlying expansion of bank lending that was creating the need for money market assistance, nor therefore of deciding upon the amount of assistance we could appropriately provide.

26 It has been argued that controlling the "supply" of our money market assistance would exert an additional discipline on the lending decisions of banks - independently of the effect of the rise in the general level of interest rates it would produce - by exposing them to

potential losses. This argument would appear to depend upon a view that it would be possible to inflict penal interest rates for our money market assistance upon those individual banks which were expanding their lending most rapidly. Because banks can borrow from each other in the interbank market, however, and will do so until interbank borrowing becomes as expensive as borrowing from ourselves, this is not the case. Equally, since all banks are now in the position where their assets are overwhelmingly interest rate variable, they are protected from serious loss as a result of an increase in the general level of interest rates. We conclude, therefore, that rationing the supply of our money market assistance has its effect by raising the general level of interest rates and so affecting the demand for bank credit in just the same way as an interest rate rise brought about by other means. The problem of bank lending from which we started cannot therefore be made to disappear by a change in our operating techniques, it simply surfaces in a different form; and, unless its monetary effects are neutralised by overfunding, it can only be resolved by higher interest rates which can be brought about in more direct ways - with a greater or lesser element of market determination - if that is what Ministers are prepared to see.

THE POLICY OPTIONS

27 It is possible that bank lending to the private sector will moderate over the course of the year particularly if the present level of interest rates is sustained. In that case the present policy dilemma would become somewhat easier with the need to choose between overfunding, higher short-term interest rates or relaxing the £M3 constraint reduced. If that does not happen, the Bank would be cautious about easing the £M3 constraint, and would strongly advise against removing it altogether. This would be interpreted as meaning that we were paying less attention to the monetary consequences of the excessive growth of bank credit to the private sector and might be seen as the prelude to relaxation of the PSBR target too. It would, in the Bank's view, carry substantial risks for the underlying rate of inflation. Some tolerance of £M3 growing above the top of its present range may be justifiable - to take account of the apparent upwards shift in demand for £M3; but this would only be the case if there were clear evidence - which might include slower growth of MO or a strengthening of the exchange rate - of inflationary pressure diminishing into the next wage round.

28 Even with some relaxation of the £M3 constraint we are likely to continue to face the difficult choice between overfunding or a higher general level than otherwise of short-term interest rates. In that case it would seem unwise to exclude the possibility of overfunding altogether. But we would be content to seek generally to fund less heavily provided that the corollary were accepted of short-term interest rates being held higher than otherwise.

29 In any event the Bank would wish to continue exploring ways of reducing the private sector's demand for bank credit, including the possibility of a commercial paper market mentioned in paragraph 11.

30 And the Bank would wish to take action on the lines of paragraph 21 to reduce the size of the bill mountain and the associated need constantly to roll over its maturing money market assistance. This in turn could serve to increase the present degree of market determination of interest rates to something closer to what was envisaged in the 1981 arrangements.

ISSUING LONG-DATED CONVENTIONAL GILT-EDGED

1 In 1980 and 1981 we began a policy of reducing the dependence of the funding programme on sales of long-dated conventional gilt-edged. There were two main reasons for this.

2 First, it was expected that long-term gilt yields, which averaged 14 3/4% (for 20-year stocks) during 1981, would fall as the rate of inflation fell, so that the Government would be able to fund itself more cheaply either by issuing shorter-term debt and refinancing when that matured, or by issuing index-linked debt. In the event, long-term gilt yields fell sharply during 1982, and got down to just about 10% in the autumn of that year. Since then, however, they have remained in the range 10 - 11 3/4%, as chart 1 shows.

3 Second, it was hoped that if the Government kept out of the long-term debt market, companies would thereby be induced to issue their own long-term debt, so that their demand for credit from the banks would be reduced. Although there was a spate of corporate issues of fixed-interest debt in autumn 1982 when gilt yields came down to 10%, and there has been a number of further issues since then, the flow of such issues has been by no means sufficient to have a perceptible effect on corporate demand for bank loans.

4 It was, of course, recognised that this policy would lead to a bunching of gilt-edged maturities in the second half of the 1980s. This has now become a major concern. On the most optimistic assumption about outstanding short-convertible stocks being converted by the holders into long-dated stocks, we face maturities over the four financial years 1986/87 - 1989/90 averaging £8.2 billion a year or £680 million a month. The concern is that those funds could turn into money: if gross sales fall short of £680 million a month, there will be net redemptions of gilts, adding to rather than subtracting from monetary growth.[1]

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(1) On the least optimistic, but by no means unrealistic, assumption that none of the outstanding short-convertible stocks are converted, maturities over the next four financial years would average £8.8 billion a year (£730 million a month).

Although the funds will naturally accrue to holders of gilts there can be no guarantee that they will in fact be reinvested in gilts. This short-term maturity schedule is about twice as heavy as it was in 1981 (see chart 2); in addition a substantial burden of maturities in the second half of the 1990s has already built up.

5 Partly for these reasons, we have recently been anxious to reduce our dependence on short-dated stocks. In addition we have been influenced by the fact that the building societies' demand for short-dated stocks has lessened. This reflects not only the slackening in their inflows of funds but also the fact that they have deliberately aimed for lower liquid asset ratios, partly because the change in their tax treatment in February last year has made gilts less attractive to them. The main other sources of demand for short-dated and, increasingly, for medium-dated, stock are in the monetary and overseas sectors, but sales to those sectors are not as helpful to broad money control as sales to the non-bank private sector, adding to the bill mountain without directly reducing £M3.

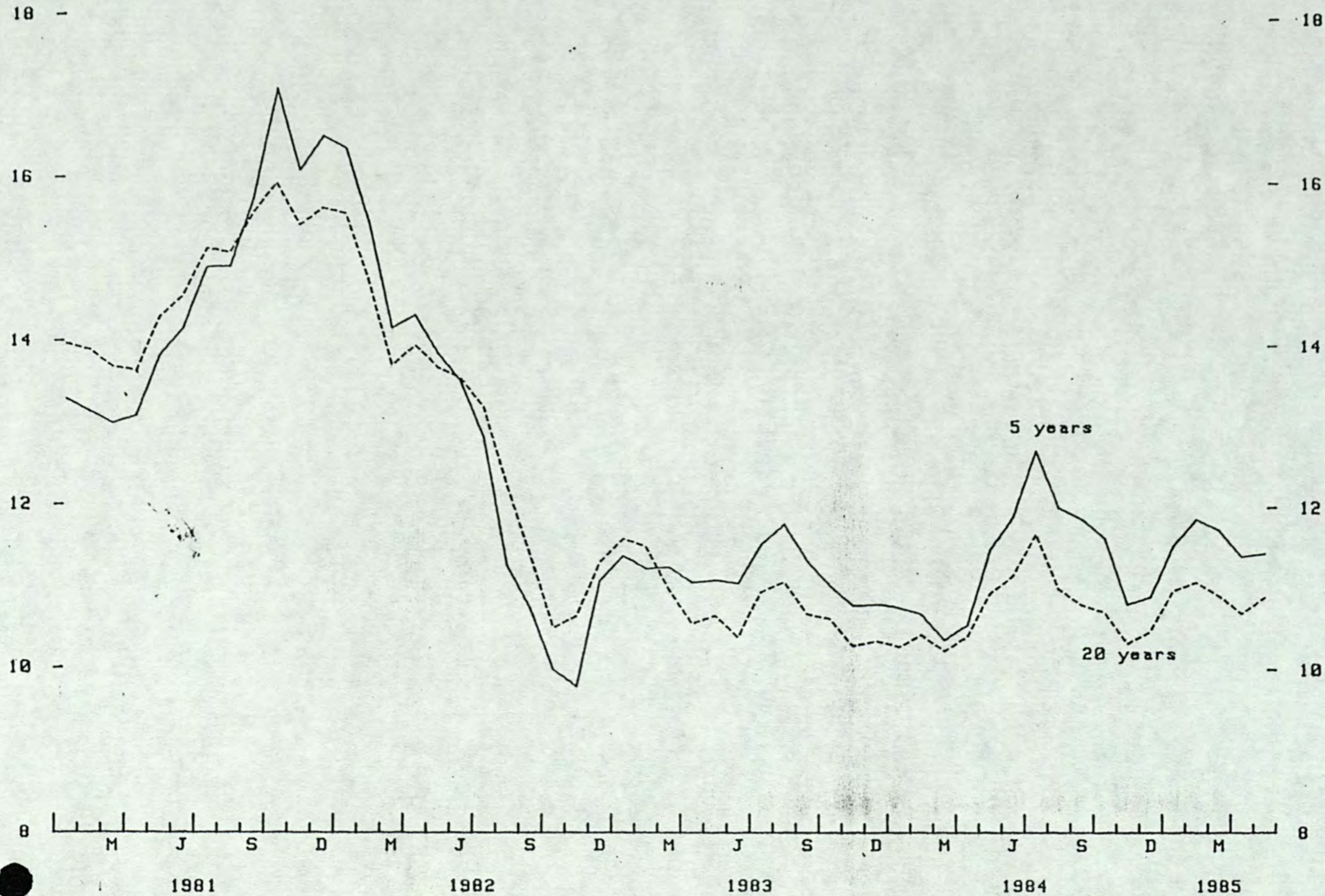
6 Ever since 1981 we have been aiming to maximise our sales of indexed gilts (IGs), particularly at longer maturities. IGs in total have accounted for about one quarter of our net gilt sales since the beginning of 1981, so that 8% of outstanding gilts are now in indexed form. But our keenness to sell IGs has inevitably been obvious to investors, who have realised that as soon as IG prices begin to rise we are likely to issue further stock, thereby pushing prices down again. Partly for this reason the real yield on the 1996 IG has risen from just over 2% at the time it was issued in 1981 to just over 4% now, despite the ending of the restriction on ownership of the stock.

7 Given the build up of maturities (and the fact that companies now tell us that they would be more interested in capital market borrowing in the short-medium area), given the change since 1980/81 in the yield pattern, given the continuing need to fund very heavily outside the banking and overseas sectors, and given the limited market appetite for IGs, we have been obliged - particularly at times when the momentum of the funding programme has threatened to slow - to offer stock with longer maturity. We limit the amounts of longer maturities which we

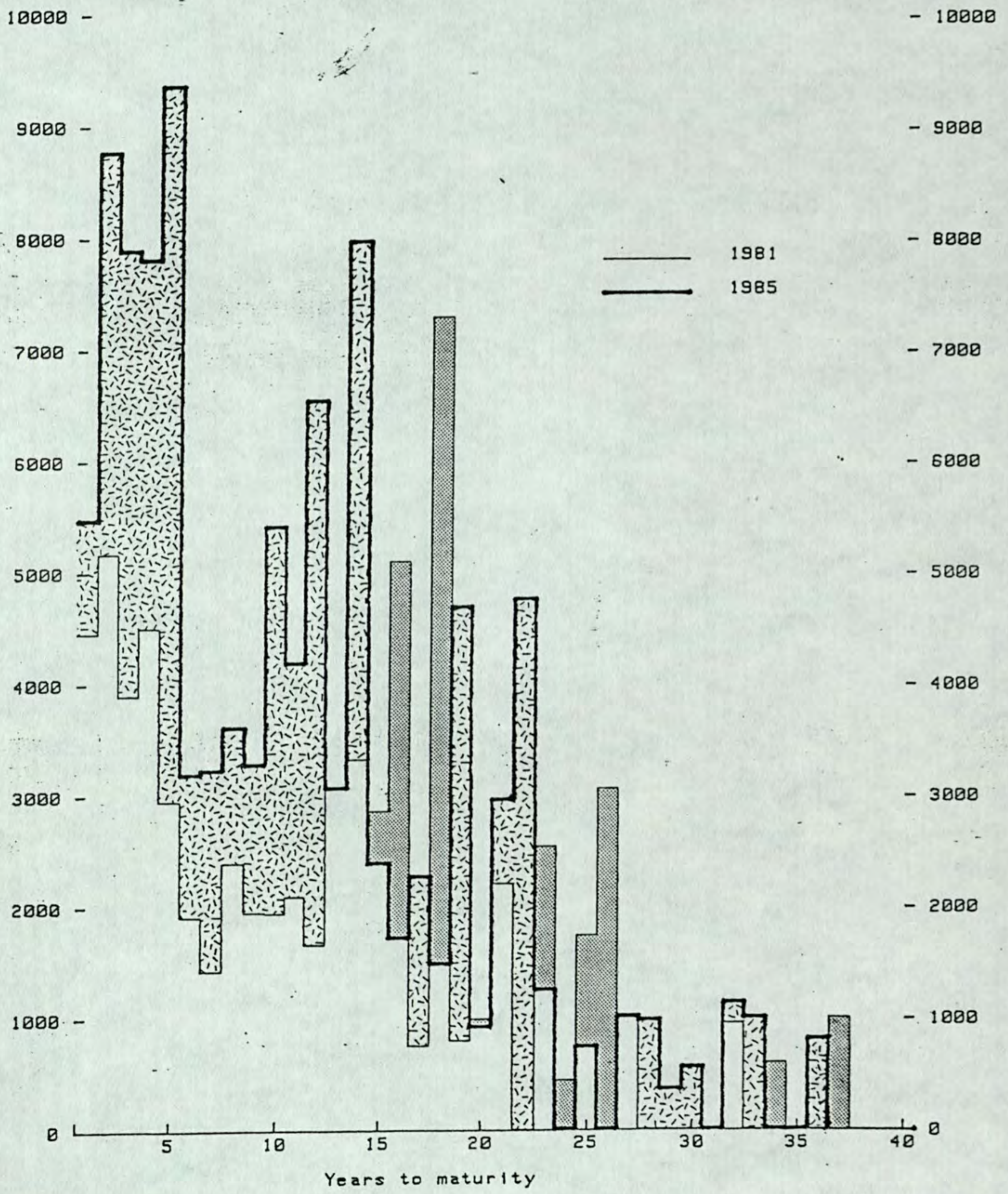
issue as far as we reasonably can, particularly at times of market weakness and higher yields. But, if we are to achieve the funding volumes which Ministers have recently required, we will need to be able to continue to issue next century stocks fairly regularly, occasionally going beyond 20 years.

Gilt-Edged Yields [1]

CHART 1



(1) Monthly averages of gross redemption yields on 5-year and 20-year British Government Securities


Maturities of dated stocks
outstanding at 31 March 1981 & 1985
£millions
10000
9000
8000
7000
6000
5000
4000
3000
2000
1000
0
1981
1985
5
10
15
20
25
30
35
40
Years to maturity