



1A(a-e) - there
No - we have
is only one way to consider
it - when inflation is
down to below 2%
and has been
held there for
at least
1-2 years
net.
CCB/UP a

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

PRIME MINISTER

AN INDEPENDENT CENTRAL BANK

But we have not
carried it out.

One of the most important achievements of this Government has been to place the defeat of inflation at the very heart of our economic policy. Although we are still only part of the way there, we have unequivocally reversed the rake's progress of the 'seventies and brought about a major cultural change.

It is not
yet there

I have been giving a great deal of thought to how we can best entrench that hard-won change, and make it a permanent feature of UK economic policy, while at the same time assisting us in the completion of our present task. I have reached the view that the best way to do this would be to give statutory independence to the Bank of England, charging it with the statutory duty to preserve the value of the currency, along the lines already in place and of proven effectiveness for the US Federal Reserve, the National Bank of Switzerland, and the Bundesbank. - with the right of the Chancellor on the Bank!

No - it would
be seen as
an abdication
by the
Chancellor
when he is at
his most
vulnerable

Such a move would enhance the market credibility of our anti-inflationary stance, both nationally and internationally. It would make it absolutely clear that the fight against inflation remains our top priority; it would do something to help de-politicise interest rate changes - though that can never be completely achieved; above all there would be the longer term advantage that we would be seen to be locking a permanent anti-inflationary force in to the system, as a counter-weight to the strong inflationary pressures which are always lurking.



It would also, incidentally, make clear that we see a very different role for the Bank of England than absorption into some European central banking federation.

Clearly, since we have no written constitution, it would in theory be open for any future Government to repeal the legislation. But in practice there would be a powerful market sanction against that: the mere announcement of the intention to do so would in itself be so damaging to market confidence that any Government would be extremely reluctant to attempt it. And of course the longer the independent central bank had been in place, the more effective that sanction would be.

I have had some work done on this proposal by a very small, high level group in the Treasury (I have not mentioned any of this to the Bank of England at this stage). It is clear that the move would be perfectly feasible. The heart of the scheme would consist of the following division of responsibilities:

Exchange Rate?

(a) The Bank would assume sole responsibility for the operation of monetary policy, with a statutory duty to protect and maintain the value of the currency. It would thus be responsible for setting short term interest rates and monetary targets.

(b) The Government would remain responsible for determining the exchange rate framework - for example, whether we were part of any international agreement, of whatever kind, formal or informal. The Bank would then be responsible for the conduct of exchange rate policy within that framework.

I have set out in an annex a number of other points which would probably be necessary to define the new arrangement and ensure it worked successfully.



While there was of course a time, in the era of the gold standard, when the Bank of England possessed more independence than it enjoys today, there is no doubt that what I am proposing would constitute a radical change. But I believe it has substantial merit: it would provide a beneficial jolt to inflationary expectations and would help to lock into the body politic of this country a permanent anti-inflationary force. If you are content, the next step would be to bring the Bank of England into this discussion. My plan would be to publish a White Paper on Budget Day, with the necessary legislation introduced in November 1989.

Why? - because it would be an admission of failure of the role of the government?

I should be happy to discuss this when we next meet.

[NL]

25 November 1988



ANNEX

Further characteristics of an independent Bank of England

- (i) The Bank would be obliged, as is the Bundesbank, to conduct monetary policy within the framework of the Government's economic policy as a whole, but only so far as that is consistent with its primary function of safeguarding the currency. There would also, and within this context, be a joint obligation on the Government and the Bank to work closely together in the conduct of economic policy.
- (ii) The Treasury would be responsible for funding the Government's borrowing requirement (or for buying in debt when the Government was in surplus). But it would not be permitted to do this in a way which added to money or liquidity - ie it would have to sell longer term instruments. This is the arrangement followed in Germany.
- (iii) A portion of the reserves would be available to the Bank for use in intervention, but the Government would be able to set limits on total intervention (in either direction) and the Bank would have to obtain the Government's agreements before those limits were exceeded.
- (iv) The Bank would, at least for the time being, retain responsibility for supervising the banking system and the wholesale and gilt-edged markets. It would, of course, continue to discharge traditional central bank functions such as issuing notes and acting as the bankers' bank.



- (v) We should probably to make the Bank of England answerable to Parliament in the sense that the Governor would appear regularly before a suitable Select Committee. But we would want this to be set up in a way which did not subject the Bank to unwarranted Parliamentary pressure.
- (vi) The Court would be made up, as now, of a Governor, Deputy Governor, Executive Directors and non-Executive Directors. They would be appointed by the Government, though there might well be a case for making the appointments of all but the Governor himself subject to the approval of the Select Committee. Members of the Court would be appointed for a long period, to ensure their independence - probably for a term of 8 years. The appointments could be arranged so that one new non-Executive member came up for appointment each year.
- (vii) We should also take the opportunity of a new Bank of England Act to put the Bank's finances on a proper statutory footing.

ORIGINAL WITH
DM 1-11-89



1A(a-e) - there
No -
is only one
way to consider
it - must consider
when inflation is
down to below 2%
and has been
held there for
at least
1-2 years
net
CCB/UP a

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

PRIME MINISTER

AN INDEPENDENT CENTRAL BANK

But we have not
carried it out.

One of the most important achievements of this Government has been to place the defeat of inflation at the very heart of our economic policy. Although we are still only part of the way there, we have unequivocally reversed the rake's progress of the 'seventies and brought about a major cultural change.

It is not
yet there

I have been giving a great deal of thought to how we can best entrench that hard-won change, and make it a permanent feature of UK economic policy, while at the same time assisting us in the completion of our present task. I have reached the view that the best way to do this would be to give statutory independence to the Bank of England, charging it with the statutory duty to preserve the value of the currency, along the lines already in place and of proven effectiveness for the US Federal Reserve, the National Bank of Switzerland, and the Bundesbank. - with the eyes of the market on the Bank!

No - it would
be seen as
an abdication
by the
Chancellor
over the
irrevocable
commitment

Such a move would enhance the market credibility of our anti-inflationary stance, both nationally and internationally. It would make it absolutely clear that the fight against inflation remains our top priority; it would do something to help de-politicise interest rate changes - though that can never be completely achieved; above all there would be the longer term advantage that we would be seen to be locking a permanent anti-inflationary force in to the system, as a counter-weight to the strong inflationary pressures which are always lurking.



It would also, incidentally, make clear that we see a very different role for the Bank of England than absorption into some European central banking federation.

Clearly, since we have no written constitution, it would in theory be open for any future Government to repeal the legislation. But in practice there would be a powerful market sanction against that: the mere announcement of the intention to do so would in itself be so damaging to market confidence that any Government would be extremely reluctant to attempt it. And of course the longer the independent central bank had been in place, the more effective that sanction would be.

I have had some work done on this proposal by a very small, high level group in the Treasury (I have not mentioned any of this to the Bank of England at this stage). It is clear that the move would be perfectly feasible. The heart of the scheme would consist of the following division of responsibilities:

Exchange Rate?

(a) The Bank would assume sole responsibility for the operation of monetary policy, with a statutory duty to protect and maintain the value of the currency. It would thus be responsible for setting short term interest rates and monetary targets.

(b) The Government would remain responsible for determining the exchange rate framework - for example, whether we were part of any international agreement, of whatever kind, formal or informal. The Bank would then be responsible for the conduct of exchange rate policy within that framework.

I have set out in an annex a number of other points which would probably be necessary to define the new arrangement and ensure it worked successfully.



While there was of course a time, in the era of the gold standard, when the Bank of England possessed more independence than it enjoys today, there is no doubt that what I am proposing would constitute a radical change. But I believe it has substantial merit: it would provide a beneficial jolt to inflationary expectations and would help to lock into the body politic of this country a permanent anti-inflationary force. If you are content, the next step would be to bring the Bank of England into this discussion. My plan would be to publish a White Paper on Budget Day, with the necessary legislation introduced in November 1989.

Why? - because it would be an admission of failure of resolve on impact?

I should be happy to discuss this when we next meet.

[NL]

25 November 1988

ANNEX

Further characteristics of an independent Bank of England

- (i) The Bank would be obliged, as is the Bundesbank, to conduct monetary policy within the framework of the Government's economic policy as a whole, but only so far as that is consistent with its primary function of safeguarding the currency. There would also, and within this context, be a joint obligation on the Government and the Bank to work closely together in the conduct of economic policy.
- (ii) The Treasury would be responsible for funding the Government's borrowing requirement (or for buying in debt when the Government was in surplus). But it would not be permitted to do this in a way which added to money or liquidity - ie it would have to sell longer term instruments. This is the arrangement followed in Germany.
- (iii) A portion of the reserves would be available to the Bank for use in intervention, but the Government would be able to set limits on total intervention (in either direction) and the Bank would have to obtain the Government's agreements before those limits were exceeded.
- (iv) The Bank would, at least for the time being, retain responsibility for supervising the banking system and the wholesale and gilt-edged markets. It would, of course, continue to discharge traditional central bank functions such as issuing notes and acting as the bankers' bank.



- (v) We should probably make the Bank of England answerable to Parliament in the sense that the Governor would appear regularly before a suitable Select Committee. But we would want this to be set up in a way which did not subject the Bank to unwarranted Parliamentary pressure.

- (vi) The Court would be made up, as now, of a Governor, Deputy Governor, Executive Directors and non-Executive Directors. They would be appointed by the Government, though there might well be a case for making the appointments of all but the Governor himself subject to the approval of the Select Committee. Members of the Court would be appointed for a long period, to ensure their independence - probably for a term of 8 years. The appointments could be arranged so that one new non-Executive member came up for appointment each year.

- (vii) We should also take the opportunity of a new Bank of England Act to put the Bank's finances on a proper statutory footing.