For Governor's Mtg
THURS 13/12
4.00-6.00

12.12.79(ii)

See M' 17.12.79
M' 19.12.79

SECRET

THE GOVERNORS

Copies to: Mr.McMahon
Mr.Dow
The Chief Cashier
Mr.Walker
Mr.Goodhart
Mr.Coleby
Mr.George
Mr.Quinn
Mr.Foot

CONSULTATIVE PAPER ON MONETARY CONTROL

Ahead of your meetings later this week, we are today circulating a virtually complete draft of the main paper and of its three proposed Annexes. Our intention would be to amend these papers after your meetings, so as to be able to send a revised draft to Whitehall before Christmas. It will be for consideration who sends it to whom.

See 12.12.79(i)

The main paper has been drafted by EAJG in the light of much prior discussion in the working group; and it clearly reflects the various strands of thinking which are set out in the Annexes. We have not ourselves had opportunity to discuss EAJG's draft in any detail but are well content to put it forward for consideration. In very broad terms the gist of our present thinking and of its associated questioning, which we are putting forward for consideration at your meetings, is as follows:-

(i) Both the monetary-economic and the monetary-operational grounds for expressing our objective in terms of a target range for a single aggregate, or even for two or more aggregates simultaneously, are weak and getting weaker. Some outside commentators are coming to the same position. Annex I is relentless in this respect. It concludes that we should stay with a published target for £M3, but the absence of firm argument supporting that conclusion is striking. Are we content nonetheless to build on that conclusion? For if we are not, the case for constructing durable arrangements for mechanically automatic official responses to untoward movements in target aggregates becomes difficult if not impossible to deploy.

(ii) Recent experience of corset-induced disintermediation, together with the opening up of the Euro-sterling loophole, reinforce

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other familiar arguments against the use of 'direct' controls on the banking system. We have been unable to find any convincing way round these obstacles and have concluded that the consultative paper cannot offer proposals for improved corsetry.

(iii) We remain firmly of the opinion that official requirements regarding the liquidity of the banking system are better determined and administered by the supervisory side of the Bank rather than by the monetary policy side; and Annex II so argues. We do not think that the consequential abolition of the 12½% reserve asset ratio, and introduction of a primary liquidity norm, would weaken our monetary control. Firstly, Special Deposits would in any case be retained. Secondly, it seems to us that it would be better if pressure on banking liquidity arising in part from the official exercise of monetary control was treated by the banks as a matter for genuine prudential concern rather than an opportunity for make-up day engineering. Is this view acceptable to the Bank?

(iv) After next considering, and rejecting, some varieties of monetary base control or use, we came finally to the possible construction of arrangements whereby the Bank would respond automatically to untoward movements in the target aggregate by altering the price at which we would relieve cash shortages. Our reasoning on this is subject to the vital prior judgment that a central bank cannot sensibly refuse outright to create the cash needed to meet a mandatory requirement. This is a judgment we share with other central banks but which we /probably/ do not yet share with some of the monetary base advocates. Is this judgment acceptable, at least for current working purposes?

(v) Next, and subject to the above prior condition, it is argued that there is no real advantage in linking the proposed automaticity to a moving average of the monetary base (as a proxy for £M3) rather than directly to a moving average of weekly £M3; and a possible modus operandi of this latter 'direct linking' is therefore explained. Nonetheless we would not wish to preclude the development and use of the 'indirect link', or even of 'outright refusal', by appearing to oppose an appropriate reconstruction of the existing monetary base; and we accordingly suggest such reconstruction. This should assist full discussion of the issues in the consultative process. Would this approach to automaticity be acceptable?

(vi) If the approach is acceptable, there remain other prior questions about the merits of automaticity as such. Some of these concern a variety of domestic issues ranging from the technical and statistical to the definitely political. We need to discuss these with you but would suggest that apart from perhaps altering the balance of argument here and there, we would do better at present to deploy these domestic issues for further discussion/consultation rather than come down firmly on one or other side of the fence.

(vii) But there remain the prior issues on the external side, best summarised as 'EMS'; and here we perhaps need to be rather less open-minded, at least in talking to Whitehall. For if we must regard entry into the EMS as a serious contingency over, say, the next two years and if we also keep in mind the underlying weakness of the arguments in favour of continuing to tie ourselves closely to a single monetary aggregate (as opposed to a credit aggregate), any early change to 'automaticity' (let alone to more full-blooded base control) would have to be regarded as very provisional indeed. The EMS issue is of course beyond the working group's terms of reference and we can do no more than raise it with you.

(viii) It will be seen that our tentative proposals enable various changes to occur without, so far as we can presently judge, substantial institutional disturbance. The discount market remains, though probably subject to greater competitive pressures. Arrangements for the short-term finance of HMG need not be altered. The structure of the gilt-edged market, and our technique therein, does not require consequential alteration. But neither do our tentative proposals preclude further change, while one possible obstacle thereto, the reserve asset ratio, disappears. In this very complex and sensitive field, we think that consultation on this 'evolutionary' basis could probably be the best course (subject to resolution of prior issues).

GF.

12th December 1979