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NOTE OF A MEETING HELD IN THE CHANCELLOR OF THE EXCHEQUER'S ROOM, ON TUESDAY, 3 FEBRUARY, 1981 AT 3.00 P.M.

Present:

Chancellor of the Exchequer
Chief Secretary
Financial Secretary
Mr. Burns
Sir Kenneth Couzens
Mr. Ryrie
Mr. Middleton
Mr. Britton
Mr. Monck
Mr. Unwin
Mrs. Lomax
Mr. Turnbull
Mr. Ridley

Mr. Walters - No.10

MONETARY TARGET AND MONETARY CONTROL

Consumer credit control

The Financial Secretary said that although there had been a case for some tightening of consumer credit controls, the time for this was now past. Nor would such controls fit well as part of a new system of monetary control, although the possible need for them at some future date could not be excluded. It was generally agreed that the contingency work already done was satisfactory, and that there was no need for any further work. It was noted that it would be necessary to revise the Bank's "directional guidance" to the banking system, but this was a secondary and minor issue.

Minimum Lending Rate

2. Mr. Ryrie said that he was perhaps more favourably inclined to an early move on MLR than others in the office. It seemed likely that the market had already discounted a 1 per cent fall and that the reception of a change would be favourable. 12 February

was probably the last date on which a change could be made before the Budget. In further discussion it was noted that the most convenient justification for a reduction in MLR would be the slow growth of M1 - but at the same time there would be risks in following this approach before any decisions had been taken about future arrangements for monetary targets and monetary controls. An immediate change in MLR would re-emphasise its character as an administered rate, and would not be consistent with letting the markets have a bigger say in the determination of interest rates. Meanwhile it could well be that expectations of a change in MLR were doing more to secure gilt sales and to edge down the dollar exchange rate than would be achieved by the change itself. It was agreed that the discussion should be resumed later in the week, in the light of further information about the January money figures.

Monetary control

3. Mr. Middleton said that a new question had arisen about future arrangements for monetary control, which ought in principle to be considered before any decisions were taken on future monetary targets. Since 24 November work had been proceeding on the assumption that the system of monetary control would evolve gradually in a ~~matter~~ manner consistent with an eventual move to Monetary Base Control (MBC), but without the authorities being committed to such a movement. The Bank had now produced proposals involving the abolition of the reserve assets ratio (RAR) and of lending through the discount market window. (No progress had yet been made on the suppression of the clearers' cash ratio and the future arrangements for assuring the Bank's income.) The Bank proposed in future to rely on open market operations in commercial bills, and had proposed some underpinning of the Discount Market as a means of ensuring that the functioning of the commercial bill market could be relied on. There was a close relationship between these arrangements and the arrangements for future prudential supervision of the banking system; it was important that supervision should be consistent with the requirements of monetary control. All these developments were consistent with the Chancellor's statement of 24 November and - leaving aside the cash ratio - would not require further consultation

with the banking system. However, Mr. Walters had now suggested instead a direct move to MBC during the course of 1981.

4. Mr. Walters said the Prime Minister had asked him to establish what administrative steps would be required before a quick move to MBC. He thought such a move should be possible within 9 months, given goodwill on all sides (although he expected the Bank vigorously to oppose such a move). In the absence of statistics for M2, he accepted that MBC would have to be on a non-mandatory basis; and he also agreed that a quick move to MBC would mean a different decision on the future of call money with the discount market. He envisaged that the decision to move directly to MBC might be announced in the Budget speech, with a view to completing the arrangements by the end of 1981. He noted that the Treasury were working urgently on a paper which was intended to clarify the necessary steps on the way to an early move to MBC and the difference between such an approach and the approach previously announced by the Chancellor.

5. In further discussion, it was noted that, if the approach recommended by the Bank were to be adopted, the next step would be to widen the band within which interest rates would be left to find their own level. The authorities would then be able to learn something about the banking system's demand for cash in the situation of much greater uncertainty which would thereby be created. If it were decided to shore up the Discount Market to play a key role in the financial markets under such a regime, it would be reasonable to give the resulting arrangements a run of, say, one to two years before taking decisions whether or not to make further moves to MBC; the Bank would probably be content to maintain the "interim" arrangements indefinitely.

6. It was noted that the issue of a possible quick move to MBC would have to be resolved without delay. The alternative approach foreshadowed in the Chancellor's 24 November statement would lead to changes which would desirable in their own right, whether or not there were an eventual move to MBC; an immediate move to MBC

would be a "leap in the dark". If, nonetheless, it were decided to follow this course, it was important that markets should be given sufficient time to adapt to the new situation this would create - in particular, people would have to come to terms with the disappearance of the overdraft system. The Chancellor asked that a Treasury paper on the steps required for a quick move to MBC should be circulated without delay, so as to make possible resumption of the discussion on 5 February in advance of his meeting with the Governor on 6 February.

Monetary targets

7. Mr. Ryrie suggested that there were two main questions to be considered:-

(i) should M1 be established as a supplementary or as an alternative target to £M3?

(ii) Should next year's monetary target(s) be in some way conditional on moves in the exchange rate?

The Chancellor questioned the Bank's view that the appreciation in the exchange rate had contributed to the monetary over-run; how was this consistent with the general approach which sought to minimise intervention in the foreign exchange markets because official purchases of foreign current tended to put upward pressure on the monetary aggregates? Mr. Britton said there were differences of emphasis between the analytical approaches followed by the Treasury and Bank; the Bank looked mainly at financial flows, and expected 1981 to show a pattern similar to 1980. Thus they feared a continuing monetary over-run, associated with continuing upward pressure on the exchange rate which would still further damage the trading sector of the economy. The Treasury, by contrast saw financial flows as generated by stock adjustments, although there was bound to be a substantial margin of uncertainty about measures of the stock of money in relation to GDP.

8. The Chancellor questioned how a monetary target conditional on the exchange rate would work in practice; if the exchange rate strayed outside the acceptable band, presumably it would be necessary both to adjust interest rates and to intervene in the foreign exchange markets to bring the exchange rate back within the band - but, once there, the monetary target would reassert itself, thus leading to increases in interest rates which would once again push the exchange rate outside the band. It was generally agreed that the concept of conditionality did not really enable a satisfactory reconcilation to be made between monetary targets and exchange rate objectives; when it came to the point, a monetary target conditional on the exchange rate was very little different ~~difficult~~ from an exchange rate target. An exchange rate target could be presented as an expression of the Government's commitment to an inflation objective, so short-circuiting the possible need for a monetary target as a key element in the Government's counter-inflation policy; but the Bank's approach in practice emphasised an output rather than an inflation objective.

9. In further discussion of the merits of different monetary aggregates, the following points were made:-

(i) although M1 only responded to changes in interest rates with a lag, the reponse was much quicker than that of £M3, and M1 could much more easily be hit within any given year, provided the authorities were not too worried about the mortgage rate. Mr. Walters was inclined to accept that M1 was after all more important than sterling M3, despite the experience of the early 1970s after Competition and Credit Control, which seemed to have suggested the opposite conclusion.

(ii) The Financial Secretary, however, feared that M1 had been discredited by past misuse; he was inclined to prefer M_0 - although others saw serious disadvantages with this alternative.

(iii) The Treasury were preparing a note on the possibility of a weighted average monetary measure on the lines of the German "central bank money"; it was noted, however, that the weights were inevitably arbitary, and that such a measure might be thought to be a "fiddle".

(iv) The authorities should not be too pessimistic about the possibility of controlling £M3; attention had hitherto been focused on short-term interest rates and the PSBR as the only available instruments, whereas there was now a prospect of achieving adjustments in long-term interest rates which would be a substantial help. Mr. Walters thought the Government had been too much preoccupied with movements of £M3 on a month to month basis - there was no point in trying to hit a monthly £M3 target.

(v) In view of the theoretical advantages which M2 appeared to have, it would be undesirable to change the target variable now, since it would then become much more difficult to make a further change when M2 statistics became available.

(vi) The role of the monetary target in the determination of interest rates had to be determined; some assessment would be needed of the operation of monetary base control in relation to the narrow aggregates.

10. The Chancellor, concluding the discussion, said he thought £M3 would have to remain the principle target and that it should not be subordinated in any way to the exchange rate. However, it would be reasonable to give further consideration to the arguments which could be offered against seeking to claw back the monetary over-run; the most promising seemed to be the structural shift in the demand for money, a large part of which could be

attributed to the financial imbalances within the economy (which the exchange rate appreciation had further intensified).

JW

(A.J. WIGGINS)
4 February 1981

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