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22.11.79

MR.FFORDE

Copies to: The Chief Cashier
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Mr.Foot
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A COMMENT ON THE DRAFT OF THE FIRST PART OF THE CONSULTATIVE DOCUMENT

I am going to be absent on the occasion of the first meeting of your standing committee to produce the Consultative Document. Having had a chance to read the draft to be discussed at this meeting, I would like to offer two general points - having had the opportunity also to give detailed drafting comments to MDKWF.

The first very general point came to mind when reading paragraph 15 of the present draft. This paragraph says, correctly, that our applied research has not found any evidence of quick or reliable effects of changes in interest rates on either sterling M3 or the main counterparts thereof. This is the case. Nevertheless, think where the conclusions of the paper are subsequently going to point. For a variety of reasons we are going to accept that sterling M3 will have to remain as the main target variable. Again, for a variety of excellent reasons, which I fully support, we are going to seek to turn away from continued reliance on direct controls. This leaves us with interest rates as our main monetary instrument. All that the adoption of variant (c) would bring about would be a relatively minor technical change in the manner and speed in which interest rate changes would occur. But that brings one back to paragraph 15, which in effect says that such interest rates changes would not represent, under present conditions, an effective lever for controlling sterling M3, at least by itself.

Where does all that get one? Clearly, and naturally, we have to hope that fiscal policy will be such as to allow an easier achievement of monetary targets whatever the system, but we cannot rely on that alone. Whether or not we accept monetary base control of variant (c) type, so long as we abandon (and rightly so) direct controls we have either to accept that interest rate fluctuations will need to be much greater than in the past to achieve the degree of control

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desirable, or that interest rate variations must somehow be made to have a more effective impact on the monetary system.

This leads on to two thoughts. First, the crucial counterpart to monetary growth is bank lending to the private sector, at least in my view, so a major requirement of a system that relied more on such interest rate variation would be measures, if such were possible, to raise the elasticity of response of bank lending to interest rate changes. Even if such changes could be foreshadowed in the Consultative Document, they certainly could not be put into practice in the immediate future. So that, I suppose, turns attention inevitably back on to the system of public sector debt sales. If interest rate variations cannot restrain monetary growth by reducing bank lending, at any rate quickly, they must do so by increasing public sector debt sales. So the fundamental question of this exercise really is not whether monetary base control /variant (c)/ is adopted, or not, but whether one can envisage any way in which the interest rate variations that may be caused quasi-automatically by monetary base control can be associated with more responsive debt sales. Gordon Pepper believes that they will, but we doubt that, as set out in section D of the monetary base control paper already with HMT. If we are right in doubting Pepper's optimistic view, what then is left?

These issues seem to me those to which the conclusions of this paper should at least point. If I may, perhaps, coin a phrase, 'Monetary base control by itself is not enough'.

My second general point is that at present MDKWF's drafting reads to me as too Bank-defensive. My reading of it slightly gives the impression that the Bank is only thinking of changes because outside commentators are pressing for them. Even then, we are only thinking of doing the minimum, or less, necessary to meet criticism, and are doing our best to avoid 'uncharted waters', and are not prepared to think radically. I do not believe that to be true. I believe that many of us in the Bank have been just as unhappy with many, or most, aspects of the present monetary control system as most outsiders, with its present reliance on a leaky direct control and inter-related monetary and market disturbances. I would like to think that we are, and have been prepared, to think of radical changes. My own view is that we have rejected many of the radical changes that would affect the structure of markets, not because they are radical themselves, but because they would not help to solve the basic problem: and the basic problem to my mind is that illustrated by paragraph 15 in the draft, and the discussion of that which I gave above.

CAEG

22nd November 1979.
C.A.E.Goodhart