

THE GOVERNOR PERSONALLY

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Mr Dow )  
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*cc: B. Quinn*

## THE BANK'S POSITION ON MONETARY POLICY

CAEG and JCRD have been suggesting that we should make some form of apologia to the Prime Minister on monetary policy. I was not present, of course, at the two earlier meetings at No.10 but in the light of this morning's meeting perhaps I might give my reaction as to what we should best do.

First, I think we should send a note to the Prime Minister in as clear and simple a form as possible saying why the money supply numbers have gone so wrong. Perhaps this will simply boil down to the PSBR being erratically worse than expected and the external outflows declining as the balance of payments became stronger than expected.

The Treasury will doubtless be putting in something addressed to these questions, but I would see virtue in our putting in our own note.

There is a case for going further than such an account and exculpating ourselves from unfair accusations that have been made. Thus we could refer to our record of scepticism and concern about the effects of the corset; the fact that the rollovers and the so-called "interest rate policy" were a firm Government decision; the difficulties the banks have in reducing rates quickly; the difference between experience here and in the US etc. My feeling in the light of this morning's meeting, however, is that it might be better not to spend time defending ourselves. The danger is that, to hostile or sceptical eyes, such arguments will indeed look defensive. Moreover, since the Prime Minister will now be abroad for a while, a reasoned note will not be able to reach her for another 10 days or more. By this time all the emphasis should be in my view on looking ahead.

Hence the second note I think we should send (or they might be joined in one memorandum - which would perhaps ease the problem of sending a separate note on the past from the Treasury) would be a recommendation for the future.

Here we now have a good starting point in that in response to your explicit question the Prime Minister has told us that she would like to have the exchange rate lower than it is so long as (a) it was consonant with the continuance of the existing monetary policy and (b) it did not involve a plunge. Specifically, she indicated that she felt \$2.20 would be low enough. She did not want this achieved through intervention. I also noted, though it is perhaps not immediately relevant, that she did not join Lawson's strong rebuttal of the idea of joining the EMS. I read her as seeing quite correctly what a real (quite apart from presentational) jam we are all in and very much wanting to be shown a possible way towards the shore. Perhaps we might outline a case somewhat along the following lines. First the short-term forecasts and some simple arithmetic demonstrating the difficulty/impossibility of getting back into the target by next February. Point to the possibility of making some of the overrun a by-gone at the rollover but do not go firm on how much and leave open the possibility that this could be recouped over the next year or so in line with the medium-term financial strategy. This to be done lightly on the basis that detailed submissions and decisions would need to be made in due course. The main lesson to be drawn for present purposes would be the high risk that unacceptably high money numbers would continue together with an unacceptably high exchange rate and an unacceptably severe recession. We should also emphasise, however explosive it may be to do so, that we cannot really promise to control M3 very precisely.

Granted the likely outcomes and the weight given in the Government strategy to the development of M3 some further action would probably need to be taken. One approach would be higher interest rates. The method of achieving these would be irrelevant: administering MLR upwards; going over to a form of monetary base control; or simply not rolling over our support to the banks in full. But any such move would (a) put the exchange rate up even higher at least for a while; (b) cause more distress to companies; (c) could not

be guaranteed quickly to bring M3 down because of the low elasticity of demand of corporate borrowing and the perverse effects on M3 - rolling up of interest and higher PSBR.

If this is accepted, it must be accepted that for the time being, and whatever the pure monetarists may say about our not understanding that we cannot control quantity and price at the same time or that we are operating an interest rate policy, interest rates must not be allowed to rise further and whatever support to the banks is necessary must continue to be provided.

How then might one aim to achieve the objective? One possibility is to move towards direct controls - on either bank lending or inflows or both. I think we should argue fairly robustly against both of these. The similarities to the corset are very obvious and not hard to demonstrate. Controls on bank lending would arouse criticism among monetarist supporters without doing much to allay criticism from those concerned with developments in the real economy etc. [But perhaps we might leave open the possibility of something on lending to persons?] On inflow controls we perhaps need to deal more specifically with the idea the Prime Minister appeared to be interested in this morning: some form of interest equalisation tax. Essentially, the arguments against it are (a) the enormous loopholes; (b) the real danger of a perverse effect because of the implication that high interest rates will remain; and (c) the fact that, contrary to the Prime Minister's present impression, nobody abroad has used such devices except to defend or achieve an explicit exchange rate target and then only as an ancillary to massive intervention.

This leads then to fundamentals. What is really preventing the achievement of the target is the development of the PSBR; and what is really wanted by industry both for its own sake and because of its effect on the exchange rate is lower interest rates. There may not in the end prove to be a need to reduce the PSBR: it may not be much above target and come right down in the last months of the financial year. But no-one can predict this with confidence and the risks are severe. Thus, there is a case for cutting it significantly on its own merits. If a significant cut were made it then might be possible to lower interest rates by enough to make a dint on the exchange rate.

It is a very difficult question whether, if we were to put forward a recommendation like this, we should attempt to go into any detail on the way in which a reduction in the PSBR could be achieved. It would perhaps be incumbent on us to suggest how much we thought should be aimed at.

*Cwm*

18 September 1980