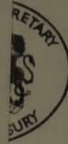


TIAL

Tel: 01-233-



*Handwritten signature*

**with compliments**

Sir Kenneth Couzens KCB  
Second Permanent Secretary  
Overseas Finance

H M TREASURY

cc PS/Chancellor of the Exchequer  
Sir D Wass  
Mr Barratt  
Mr Bridgeman  
Mr Hancock  
Mrs Hedley-Miller  
Mr Middleton  
Mr Gill  
Mrs Lomax  
Mr Riley  
Mr Allan

EUROMARKETS

The Financial Secretary has read your minute of 6 December following up a point which he raised at a meeting with officials on 8 November, relating to the possibility of <sup>our</sup> coming to an agreement with the US that each country would lean on its own banks and their branches and subsidiaries abroad, to prevent evasion of US or UK domestic monetary controls through offshore lending.

The Financial Secretary has noted the points which you record and is grateful to you for having raised the issue with the Bank.

*SAIL*

S A J LOCKE

12 December 1979

CC 14/12<sup>12</sup>



SIR K COUZENS

cc PS/Chancellor of the Exchequer  
Sir D Wass  
Mr Barratt  
Mr Bridgeman  
Mr Hancock  
Mrs Hedley-Miller  
Mr Middleton  
Mr Gill  
Mrs Lomax  
Mr Riley  
Mr Allan

EUROMARKETS

The Financial Secretary has read your minute of 6 December following up a point which he raised at a meeting with officials on 8 November, relating to the possibility of <sup>our</sup> coming to an agreement with the US that each country would lean on its own banks and their branches and subsidiaries abroad, to prevent evasion of US or UK domestic monetary controls through offshore lending.

The Financial Secretary has noted the points which you record and is grateful to you for having raised the issue with the Bank.

SAL

S A J LOCKE

12 December 1979

12.12.79 (u)

see 12/2/79

17.12.79  
M.F. 12.7961  
THE GOVERNORSCopies to: Mr. Fforde  
Mr. McMahon  
Mr. Dow  
The Chief Cashier  
Mr. Walker  
Mr. Goodhart  
Mr. Coleby  
Mr. George  
Mr. QuinnThe Consultative Document on Monetary Control

At JSff's request, I attach drafts of the various elements suggested for the Consultative Document. JSff will be circulating a brief of his own ahead of the first meeting on the subject (scheduled for 4 pm on Thursday, 13th December). *Discussed for CC.*

Attached are:

1. The main paper (a first draft).
2. Annex 1, "The target aggregate". (this draft has been discussed by the Bank working group and redrafted in the light of their comments).
3. Annex 2, "Requirements for reserve assets, special deposits and primary liquidity". (Status as for item 2.)
4. Annex 3, "Monetary base control and prompter official responses to changes in the money stock". (Parts of this, especially section E, are still tentative in view of the intrinsic difficulty of the subject matter and of presenting it in comprehensible form for non-experts.)
5. A small addendum to Annex 3, showing how the weekly £M3 figures have moved in the last year and how a moving average smoothes the short-term fluctuations.

Economic Intelligence Department,  
12th December 1979.

M.D.K.W. Foot (4315)

*Michael Foot*

The Chief Cashier

6  
DRAFT (10.12.79).

CONFIDENTIAL

MONETARY CONTROL

1. This paper first sets out the views of H.M. Treasury and of the Bank of England on the aims - and limitations - of monetary policy and explains the nature of the monetary control they are seeking to achieve. It then describes some of the practical difficulties that have arisen in operating such control and discusses - as a basis for wider consultation - some possible changes in technique designed to improve the effectiveness of monetary control.

THE AIMS OF MONETARY POLICY

2. The official approach to monetary policy rests on the conviction - derived as much from practical observation and experience of economic management as much as from any particular theoretical considerations:

- (i) that control of inflation is a necessary long-run condition for the achievement of the wider goals of economic policy; and
- (ii) that monetary control - which, in an inflationary environment, has to be defined as control over the trend rate of monetary growth since nominal interest rates provide only a highly uncertain guide to monetary conditions - is a necessary, and possibly ultimately a sufficient, long-run condition for the control of inflation.

3. The relationship between monetary conditions and the rate of inflation is complex and far from perfectly understood. In the short run it seems clear that inflation can be aggravated by external factors, such as a rise in world commodity prices, including oil prices, or, internally, by wage increases in excess of the rate of increase in labour productivity, that may have little directly to do with the domestic monetary situation. Even in the longer term, weaknesses on the supply side of the economy, for example structural factors making for slow growth of productivity, can, when set against strong aspirations for higher living standards for the population as a whole, produce a lasting inflationary bias. But while there clearly are other factors of this kind operating, so that monetary developments do not provide a total explanation of inflation, few serious commentators would now question that persistent monetary growth in excess of the productive capacity of the economy will tend to encourage inflation or, conversely, that inflation will tend to moderate over time if the trend rate of monetary growth is held persistently below the rate of growth of nominal national income. This proposition is not easily proved, although statistical relationships of this kind have been identified in many industrial countries, and have remained relatively stable over long periods. Indeed it is true that the high nominal interest rates associated with tight monetary conditions (though less than they immediately appear to the extent that interest charges may be set against a tax liability) themselves directly add to production costs. Nevertheless it is undeniable as a matter of harsh experience that, in persistently tight monetary conditions producers find it more and more difficult to pass on higher costs, and are ultimately forced to contain them in order to survive.

4. It would be foolish to pretend that the use of monetary control to bring down the long-term rate of inflation can be a painless process, or that it will not involve some short-term sacrifice of the ultimate economic policy aims of growth of output and higher living standards. If, within a given restrictive rate of monetary growth, rapid cost inflation continues in the short term - as appears to be the case in the U.K. at present - then the burden of adjustment will

necessarily fall initially on the volume of production - through cut-backs or failures by high cost producers - with damaging consequences for employment and investment. These heavy costs are not under-estimated. But they are seen as the price that has to be paid to bring inflation under control, and to provide the framework of stability that is - as the U.K.'s economic experience throughout the past 20-30 years has shown - a necessary pre-condition (though not on its own a sufficient condition) for a sustainable increase in activity over the longer term. It is a matter of having to take some steps backwards in order to progress.

5. This process of adjustment can be shorter and less painful if the longer term purpose of monetary policy is clearly understood, and if the country as a whole is convinced that it can and will be carried through. Then, expectations about the future rate of inflation would tend to abate, creating a climate in which more of the necessary accommodation to the rate of monetary growth could be achieved through an earlier fall in the inflation rate, e.g. through more moderate wage settlements or through lower nominal interest rates, leaving correspondingly more room for sustained real economic activity. [It is in this context that incomes policy - if in practice it could be devised in a form which did not add to existing structural rigidities while it applied, and did not lead after a period to an outburst of wage settlements aimed at making up lost ground - could in principle be helpful, though practical experience has not been encouraging.]

6. It is in large part with the aim of establishing such confidence that specific quantitative monetary targets have been adopted, and publicly announced, in recent years by many industrial countries, with policy directed to their achievement. Such targets - if they are not obviously unrealistic and carry the conviction that they can reasonably be adhered to - provide an explicit framework within which the likely consequences of economic decisions by employers and employees especially in relation to wage negotiations can be assessed. But it would be misleading if the presentation of monetary

objectives in terms of a specific target indicator (or even of two or three such indicators) were to give the impression that that indicator alone was important or adequately described the total monetary situation or that the authorities can easily and reliably control the development - in the very short run - of any particular monetary indicator chosen as the publicly announced target. Misunderstanding of what is and is not possible in these respects can lead to exaggerated disappointment with the results of monetary control in the short run, which in turn may make public confidence in the longer run more difficult to achieve.

7. In reality the concept of money for the purpose of monetary control is itself elusive. Any attempt at precise definition immediately runs into a host of difficult analytical questions that are explored at some length in the technical annex. There is a whole range of possible statistical measures of money, of liquidity more broadly defined, and of credit expansion, and in the short run at least their rates of growth frequently diverge. To make the thrust of monetary policy clearer to the general public, and to provide a sharper focus on the need for policy action, it is helpful to select a single official target aggregate, and because this aggregate then assumes a special significance this choice is important. (The reasons for choosing £M3 in the U.K. in recent years are explained in the Annex.) But this does not mean that the whole range of other indicators can then be ignored: they all provide additional information on what is happening to monetary conditions in a much broader sense and it is money in this sense that one must suppose has an influence upon inflation and real economic activity. The development of £M3 month by month (or of any but the very broadest aggregates) can be heavily affected by marginal shifts of funds into or out of the particular financial channels measured by the chosen statistical definition with little meaningful effect on underlying monetary conditions or credit flows, and it is important that the significance of such purely statistical changes in the rate of monetary growth is not exaggerated. Short term movements in the £M3 statistic therefore have to be carefully interpreted in the light of all the other available information - and it may, as a result of such assessment be judged necessary on occasion to take policy action to affect monetary conditions even though the £M3 statistic has not moved outside its intended range or, equally, to refrain from such

action if a policy signal from the M3 statistic if other information points overwhelmingly in a different direction. The need to take account of other information, even though monetary objectives are specified in terms of a single target indicator, also explains the authorities' reluctance to employ control techniques that depend essentially for their effect upon just such marginal shifts of funds into or out of the M3 statistic.

8. Finally, it is important to recognise that the authorities' are not able to regulate the pace of monetary growth - no matter what statistical series is chosen to measure that growth - in the very short run i.e. on the basis of a month or two's figures. It is impossible in the first place to forecast month by month movements, even for a short period ahead, in any of the available statistical series, with anything like enough precision, for such forecasts to be a reliable guide to policy; and even if this were possible the effect of possible policy changes - both as regards the timing and the extent of the effect - is too uncertain for such close, short-run, control. The effect of policy measures is not, as is sometimes supposed, automatic or mechanical, it depends very heavily on the impact of the measure on expectations and will therefore vary depending on the surrounding circumstances. Fluctuations in the rate of monetary growth are therefore bound to occur - and in themselves have little significance in relation to the long-term counter-inflationary role of monetary policy. For these reasons the authorities have consistently emphasised that their objective is to control the trend of monetary growth and have set their announced targets for periods of a year at a time. [? Add something on medium term monetary targets - staying with "progressive reduction in the medium term"?].



9. Nevertheless the problem of short run fluctuations cannot be ignored. Even if the official aim of longer-term control is clearly understood, such fluctuations - unless the financial markets are convinced that they are indeed erratic and likely to be self-cancelling - can cause damaging and unnecessary fluctuations in interest and exchange rates, and failure on the part of the authorities to respond to short-term developments may be interpreted by the public generally as a weakening of their commitment to monetary control. This in turn can damage longer term confidence in monetary policy and increase the costs of such policy as described above.

10. The difficulty - for both the authorities and the markets - is to know immediately whether a short-run divergence from the intended rate of monetary growth - taking account of all the available information - is erratic, or purely statistical, or whether it is more fundamental and needs to be corrected. And there are risks on either side. Overhasty reactions, either by financial markets or by the authorities, causes the damage associated with undue volatility; whereas if policy action is too long delayed - or is inadequate - the measures ultimately necessary to regain control are likely to have to be more severe than initially called for. A good part of the current debate about control techniques is concerned with the appropriate response to short-run fluctuations in the rate of monetary growth, and more particularly with whether the authorities should respond quasi-automatically to each and every departure from the intended path, risking unnecessary action, or whether they should - as hitherto - seek to assess the nature of a particular divergence, case by case, risking delay in making a necessary policy response. Although much of the debate appears to revolve around issues which are highly technical, this question - on which differing opinions may in large part reflect differing assessments of the balance between the opposing risks - is perhaps the central issue. It is considered further in paragraphs to .

CONTROL TECHNIQUES

11. Against the above background, the rest of this paper describes the existing techniques of monetary control and some of the difficulties of operating them; and considers possible changes designed to improve the effectiveness of control. But it would be wrong if this were taken to imply that the continuous struggle to maintain counter-inflationary control in recent years was due solely - or even mainly - to deficient techniques. In large part it reflects the difficult climate in which the monetary authorities have had to operate. Inflation and inflationary expectations, often associated with the course of pay settlements, have been high and variable. The Government's borrowing requirement has been large and difficult to contain. Productivity and profitability have been low, with little dynamism in the economy. External disturbances have been frequent. The adverse climate is not, of course, a reason for not seeking to improve control techniques wherever possible. It does however mean that there are limits to what can be realistically expected in terms of the smoothness and painlessness with which monetary objectives can be achieved.

12. In considering the policy instruments available for influencing monetary conditions, in the sense of paragraph 7 above, it is convenient to start from the accounting identity that:

The change in the money stock (£M3)	=	The PSBR less sales of public sector debt - mostly gilt-edged securities - to the non-bank private sector.	+	The increase in bank lending to the private and overseas sectors.	+	The net external inflow or outflow to or from the domestic private sector.
---	---	--	---	--	---	---

These credit counterparts of the growth in money stock provide a helpful framework for discussing the available monetary control techniques and are considered in turn below; but it needs to be emphasised that £M3 is not a comprehensive measure of monetary conditions; and that its credit counterparts are linked together by complex causal inter-relationships - the policy action discussed below in relation to one of the counterparts will typically induce changes - directly or indirectly - in the others as well.

X PSBR and debt sales

13. The difficulty of containing the size of the PSBR has been mentioned above as one of the elements in the adverse monetary climate in recent years. This has imposed directly a heavy burden on control techniques that are perhaps more properly thought of as monetary. It has also left those monetary techniques persistently vulnerable to confidence effects in financial markets which have seriously complicated monetary control whenever the PSBR showed signs of accelerating.

14. The consequent strains have shown up particularly in the gilt-edged market where the bulk of the government's borrowing has had to be financed to limit its monetary consequences. The fact that massive sales of gilt-edged securities outside the banking system have been achieved consistently in the past several years cannot obscure the cost of that achievement. The continuous pressure of official sales has contributed substantially to persistently high nominal medium and long-term interest rates that have effectively excluded private sector borrowers from the capital markets, forcing them back on more liquid forms of financing, especially on bank finance. This too has added to the difficulty of monetary control.

15. An obvious lesson from this experience is that fiscal policy - including control over public expenditure as well as taxation policy - must be compatible with the government's monetary objectives, and given the difficulty of forecasting the PSBR in the past, with a recurrent tendency for the PSBR to exceed its forecast level which has engendered considerable scepticism in financial markets, it would be prudent in this respect to seek to err on the side of caution. For the medium term, this means that the government's commitment to a progressive reduction in the rate of monetary growth must involve severe restraint in relation to the PSBR. This would significantly ease the problems in the gilt-edged market, and taken together these developments would make a major contribution to more effective control over the trend rate of monetary growth. However neither changes in fiscal policy nor debt sales (for reasons that were explained at length in an article on

The Gilt-Edged Market, Bank of England Quarterly Bulletin, June 1979) are capable of sufficient variation in the much shorter term to be of much help in relation to the problems of short-run fluctuations in monetary growth described in paragraphs 9 and 10 above.

X Bank lending

16. Control over short-term interest rates has traditionally been regarded as the primary means of influencing the trend in the growth of bank lending. But the banks have been subject to specific controls, in the forms of a reserve assets ratio effectively variable through the use of Special Deposits, and of direct quantitative restrictions under the Supplementary Special Deposits Scheme (the "corset"). It is convenient to discuss these techniques in reverse order.

Y The Supplementary Special Deposit Scheme

17. The corset control, like the direct control over bank lending to the private sector that preceded it in the 1960's, was originally intended as a short-term measure that would encourage the banks to become more restrictive in their lending policies while higher short-term interest rates worked through to reduce the demand for credit. To this extent it could directly accelerate restoration of monetary control, and at the same time have a helpful impact on financial market confidence. In practice, again like the earlier direct control over bank lending, the operation of the corset has become semi-permanent.

18. As a semi-permanent technique the corset, in common with other direct banking controls, suffers from two major defects. First, it prevents competition within the banking system which will eventually seriously damage the structure of the system and its effectiveness in bringing together borrowers and lenders. But, secondly, and more immediately important in relation to monetary control, its effect for the most part is not to prevent credit flows from taking place, but to force them into less efficient channels outside the scope of the control. While this may result in a slower rate of growth of monetary indicators that measure the liabilities of the controlled banking system and their

credit counterparts, including the target indicator -  $\text{EM3}$ , it may have little real effect on underlying monetary conditions. This can be seen in the most obvious form of "disintermediation" in recent months, the growth in non-bank holdings of short-term bank acceptances - which to the holder are no less liquid than a bank deposit or Certificate of Deposit of comparable term and to the issuer are a close substitute for direct bank credit. The observed effect on  $\text{EM3}$  therefore is essentially optical, and needs to be discounted, as was explained in paragraph 7 above, in assessing what is really happening to monetary conditions in a more meaningful sense.

19. The need for adjustments of this kind would not be especially troublesome if it was in fact possible to measure with any certainty the distorting effects of disintermediation caused by the corset control. But the "bank acceptance leak" is only one of many possible forms of such intermediation: others cannot be measured, and allowance made for them, in the same way. (It is largely because of the danger that credit flows would simply be forced into less visible channels that the authorities have not attempted to tighten the corset by blocking the bank acceptance leak - to the evident puzzlement of a number of commentators.) Such invisible - and unmeasurable - disintermediation is much more worrying: it means that neither the authorities nor outside market analysts are in a position to assess sensibly what is really happening to monetary conditions, and knowledge of this situation would quickly destroy the credibility of monetary control even though the performance of the particular monetary target statistic might itself be improved.

20. The potential scope for disintermediation of this more worrying kind has been greatly increased by the abolition of Exchange Control. In the absence of the assurances sought from banks that they would not seek to avoid the effects of the corset by external transactions through overseas branches or associates, it would have been very easily possible for banks to take sterling deposits and make sterling loans offshore, that are not subject to the control. Indeed it has to be reconisid

that, without Exchange Control, this possibility places a severe constraint on the burdens or restrictions that can be placed on domestic banking (whether through earnings penalties or direct prohibitions, as a result of monetary or prudential controls or general taxation) without driving domestic banking business abroad.

21. In these circumstances direct controls - whether the corset itself or any other form - are not regarded as serving any long-run purpose, and it is intended that the Supplementary Special Deposit Scheme should be allowed to lapse when its present period of operation expires in June 1980. It is perhaps worth noting at this stage that in the following period it must be expected that the monetary statistics - including M3 - will be substantially distorted by reintermediation and so will need particularly careful interpretation.

#### The Reserve Assets Ratio and Special Deposits.

22. The reserve assets ratio had its origins in the banks' traditional practice of liquidity management and was adapted to its present form, and applied uniformly to all list banks, in 1971 essentially in order to more nearly equalise competitive conditions between different parts of the banking system.

23. The role of the reserve assets ratio has been widely misunderstood: it was never intended - as has been often supposed - to serve as the reserve base on which a pyramid of credit could be created by the banks, and the authorities have not sought to restrict the volume of reserve assets in order to bring about a multiple contraction of credit. Instead, in conjunction with Special Deposits, the reserve assets ratio was regarded as an adjunct to short-term interest rate policy by enabling the authorities to tighten bank liquidity so helping to influence the required level of short-term interest rates generally. This more limited purpose did not require the same precision as the use of a reserve asset base via a credit multiplier to limit directly the size of the banks' total balance sheets, and it was therefore sufficient to include within the definition of reserve assets those private and public sector debt instruments that the banks had traditionally regarded as a part of their liquidity.

24. Initially, reserve asset pressure was expected to affect the rates looked for by the banks on their assets i.e. their lending rates and the yield on marketable short-term non-reserve assets which would then become more attractive to non-bank holders. The subsequent rapid development of the inter-bank market, however, has in practice meant that the banks' more normal reaction to reserve asset pressure - except when the corset has also been in effect - has become the bidding in of additional deposits. This tends to make bank deposits relatively attractive compared with public sector short-term liabilities and so to cause the growth of the money stock - on some definitions, including £M3 - to accelerate in the short term.

25. It is also argued that the reserve assets ratio artificially distorts the yield relationship between short-term assets qualifying as reserve assets and others; and that this distortion is a factor inhibiting the development of a broader (non-bank) market in short-term public sector debt which would otherwise be helpful to shorter-run control of some of the monetary indicators, including £M3 but not wider measures of liquidity. In practice, this "distortion" probably largely reflects the inherent quality of the assets in question as liquidity to the banking system and they would continue to have a particular appeal even in the absence of a reserve assets ratio, so that this argument can be exaggerated.

26. This discussion draws attention again to the fact that the reserve assets ratio was introduced as a monetary control, but that the assets which it includes simultaneously represent the banks' first live liquidity for prudential purposes. This has resulted in some confusion - with adherence to the reserve assets ratio having come to be regarded as satisfying prudential liquidity needs. The two requirements for liquidity are conceptually quite distinct, with a minimum ratio in particular less appropriate for prudential purposes since it effectively freezes just those liquid assets that may need to be drawn upon to finance a loss of deposits.

27. Against this background, which is further considered in the Annex, the authorities have reviewed the operation of the reserve assets ratio and have concluded that it might usefully be dispensed with. It is not regarded as essential to the exercise of effective influence over the level of short-term interest rates: on the other hand its operation is frequently misunderstood - which tends to weaken confidence in the operation of monetary control; it can have perverse short-run effects on certain important monetary aggregates; and it may - at the margin - distort the short-term markets. It is proposed that Special Deposits should nevertheless be retained to provide a continuing mechanism for reinforcing control over interest rates by operating directly on the liquidity of the banking system. And separate arrangements will be made for ensuring that adequate prudential standards of liquidity are maintained - the Bank of England are sending a separate consultative paper on prudential liquidity requirements to deposit-taking institutions simultaneously with the publication of this paper.

Y Short-term interest rates

28. The ability to influence short-term interest rates is at the heart of monetary control in general. The mechanism through which such influence is exercised is described in the annex. The range of rates most directly affected runs broadly from overnight to three-month money rates which in turn are the major influence on bank lending rates. Within this range the Bank's influence falls some way short of total control: market expectations, for example, largely determine - for any given level of MLR - the shape of the interest rate more between overnight and three-months' money and beyond; and there is no means of ensuring a systematic relationship between the rates paid on, say, bank deposits compared with short-term public sector liabilities. Nevertheless the existing mechanism does generally provide for an influence over the overall level of short-term rates, which is generally thought to be sufficient to have significant impact on monetary conditions over a reasonable period ahead; and the precision with which the level of interest rates can be influenced is certainly much greater than the precision with which the monetary (still less the real economic) effects of any particular level of rates can be predicted.



29. The routes by which short-term interest rates affect monetary conditions are extremely complicated and their effects are by no means confined to the single credit counterpart - bank lending. The PSBR - directly through debt interest costs but also through a host of indirect effects - will certainly be altered by a change in short-term rates to an extent and over a period that cannot be foreseen with any certainty. Similarly, public sector debt sales may be affected - as for example when a change in MLR, by removing, for the time-being, uncertainties about the future level of short-term interest rates that were impeding investment decisions, is followed by a surge of buying of gilt-edged securities: but again the effect of a change in short-term interest rates of any given size is not precisely predictable partly at least because it depends upon its impact on expectations. Much the same is true of the evident relationship between short-term interest rates and foreign exchange flows.

30. In relation to bank lending itself the size and speed of response to nominal interest rate changes is uncertain and statistical relationships have been difficult to find. This is not particularly surprising on a priori grounds: the effect will presumably be different if the change in interest rates is expected to be short lived than if rates are expected to remain at their new level for a prolonged period; it will certainly be influenced by the relative level of inflation and by expectations about the future course of inflation; and it will be affected by the extent to which interest changes can be set off against tax etc.

31. These uncertainties about the response of monetary conditions to short-term interest rate movements have been emphasised because it is important that the practical difficulties of monetary control through the use of interest rates should be clearly understood. It is not at all the precise science that often appears to be assumed. On the other hand, the uncertainties relate to the size and speed of response: they do not in themselves deny that interest rates can have a powerful effect on monetary conditions in the broad sense of paragraph 7; nor is the direction of the effect in question.

[More to follow]

27. Against this background, which is further considered in the Annex, the authorities have reviewed the operation of the reserve assets ratio and have concluded that it might usefully be dispensed with. It is not regarded as essential to the exercise of effective influence over the level of short-term interest rates: on the other hand its operation is frequently misunderstood - which tends to weaken confidence in the operation of monetary control; it can have perverse short-run effects on certain important monetary aggregates; and it may - at the margin - distort the short-term markets. It is proposed that Special Deposits should nevertheless be retained to provide a continuing mechanism for reinforcing control over interest rates by operating directly on the liquidity of the banking system. And separate arrangements will be made for ensuring that adequate prudential standards of liquidity are maintained - the Bank of England are sending a separate consultative paper on prudential liquidity requirements to deposit-taking institutions simultaneously with the publication of this paper.

#### Short-term interest rates

28. The ability of the authorities to influence short-term interest rates is at the heart of monetary control.

29. The mechanism through which this influence is exercised is described in the Annex. It falls some what short of total control over any particular market rate for any particular term: market expectations, for example, largely determine - for any given level of MLR - the pattern of rates between overnight money and money for longer term; and the authorities have no reliable or systematic means of establishing any particular relationship between the interest rate on, say, bank deposits and that on short-term public sector liabilities. Nevertheless the existing mechanism is normally adequate for the authorities to exercise substantial influence - to within a percentage point or so - over the general level of short-term market rates.

30. It is one thing to be able to influence the general level of interest rates to this extent, but quite another to know, with any precision, what the effect of any particular level of rates is likely to be on the trend rate of monetary growth. This is particularly true of

all but the narrowest (non-interest bearing) monetary indicators, where the relationships are extremely complicated, affecting all the various credit counterparts of more broadly-defined monetary measures, including £M3

31. The PSBR - directly e.g. through debt interest costs, but also through a host of indirect effects - will certainly be altered by a change in short-term interest rates. And public sector debt sales may also be affected, as, for example, when a change in MLR, by removing uncertainties about the future level of short-term interest rates that may have been impeding longer-term investment decisions, is followed by a surge of buying of gilt-edged securities. Similarly foreign exchange flows may be affected. But in none of these areas can the size and speed of the response be confidently predicted, in part because it depends upon the impact of the interest rate change upon expectations, and this is likely to vary with the surrounding circumstances.

32. The same is true of bank lending itself where a statistical relationship with interest rates has been extremely difficult to find. This is not surprising on a priori grounds: the effect may depend upon how long rates are expected to stay at their new level; it will certainly be influenced by the relative level of inflation and by the expected future change in prices; and it may also be affected by the extent to which interest charges can be set off against tax, and so on.

33. These uncertainties about the response of monetary growth to changes in the level of short-term interest rates have been emphasised because it is important for assessing the operation of monetary control that the practical limitations should be clearly understood. There is no serious doubt about the direction of the response, not that it can be powerful, given time and if the change in interest rates is sufficient to have the necessary effect on expectations: but no-one can confidently predict its size or speed. This means that short-term interest rate management - which is central to the frame work of monetary control - cannot in practice produce the precise, mechanical effect on monetary

growth in the shorter term that would, in an ideal sense, be desirable. It is perhaps largely for this reason that a number of commentators have tried to find forms of control that do not depend for their effect on interest rates, but which seek to regulate the money supply directly by controlling the size of the cash base of the banking system. This possibility is examined below, beginning with paragraph .

### External Flows

[Short section to follow - two main points:

- (i) Domestic monetary situation can be affected by external flows even without intervention; but scope for conflict with domestic monetary policy greater if exchange rate objective - inside or outside F.M.S. - being pursued. Problem of inflows leading to tighter domestic policy leading to inflows.
- (ii) Problem of interpreting monetary data in light of external flows - emphasis on D.C.F. e.g. significance of increase in money stock from speculative inflow/significance of monetary developments post-Exchange Control.]

### Monetary Base Control

In a generally unfavourable environment, it has been a continuous struggle over recent years to contain the trend of monetary growth, even over periods as long as six to twelve months, using the techniques discussed so far; and none of those techniques has proved to be sufficient for control to be practicable over much shorter periods, of say, a month or two. This experience has prompted a constant search for new and more effective techniques, and among those suggested are various forms of monetary base control, which are examined in more detail in the Annex.

In oversimplified form, the most appealing and most widely canvassed of these ideas starts from the proposition that if the monetary or reserve base of the banking system were confined to assets that were wholly within the control of the central bank (usually defined to mean cash and balances with the central bank), and if the central bank refused to provide more than that amount of reserve base that was consistent with a credit multiplier) with the target level for monetary growth, then monetary growth would be controlled. Instead of interest rates being used as an uncertain instrument for achieving the required growth of money - as discussed in paragraphs 28-33, the central bank would simply control the size of the monetary base and leave interest rates to find their own level.

In practice, for reasons set out more fully in the Annex, the control cannot be operated in that way. Banks can only know the amount of base they need to meet their monetary base requirements when they know the size of their total liabilities; and once they know the size of their total liabilities; and once they know the size of their total liabilities the central bank cannot refuse to provide the corresponding base - since otherwise the banks collectively would be unable to meet their monetary base requirement or, if they did, would be forced to default on other liabilities - though it can determine the price at which it will provide the necessary base. Although therefore the hoped-for mechanical or physical control of the monetary base, and hence of the money supply, cannot be achieved in the way that was envisaged,

the divergence between the amount of base demanded by the banks and the amount that the central bank was willing to supply in line with the monetary target could in principle be used to trigger appropriate interest rate changes. But in that case - since it would be known at the same time, or possibly even somewhat earlier - the divergence between the actual growth of the money supply (£M3) and its required trend could equally itself be used, directly as a trigger for interest rate changes in just the same way.

Developed in this way the proposal becomes essentially a mechanism for adjusting the level of short-term interest rates automatically in response to a moving average of (weekly) movements in £M3. As such it raises the issues that were touched upon in paragraph 10 above. There would be a number of difficult technical problems - for example in deriving sufficiently reliable weekly seasonal adjustments for the £M3 series. And the problems associated with uncertainty about the size and speed of the monetary response to a given change in interest rates - discussed in paragraphs 28-33 above - would make the choice of an appropriate scale of interest rate adjustments for different degrees of divergence from the target rate of £M3 growth essentially arbitrary. But the fundamental question is whether such automatic interest rate changes are preferable to the present degree of interest rate discretion.

In favour of more automaticity it can be argued that assessment is biased towards delay. Movements in the money supply are frequently due to causes that are difficult to assess confidently in short order and there is invariably a strong temptation to avoid increases in interest rates that may prove in the event to have been unnecessary because of the unwelcome implications for other areas of policy e.g. industrial investment and confidence, or housing policy. Yet delay, where adjustment is proved necessary, is likely to involve even higher interest rates. On the other hand, as explained earlier, no single monetary indicator can give a total or reliable picture of monetary conditions in the short term, and tying interest rates automatically to movements in £M3 would mean deliberately discarding all other information including that available from other monetary aggregates. It has to be presumed that this would mean on occasions that interest rate changes would occur that could sensibly have been avoided.

Given the latter risks, a minimum position between these extremes could be to provide for the automatic interest-rate adjustment to be overridden in circumstances where the other available data pointed strongly against the interest rate change suggested by the EM3 indicator. Such a decision to override would need to be explained to the financial markets, which might or might not be convinced, and this would ensure that the provision for discretion was not abused.

[Add summary and conclusions - with warning that if the climate remains adverse have to expect continuing bumpy ride: prompter adjustment of rates could help - but not a magic wand.]

Annex 1 The appropriate target aggregate(s)

A. Introduction

1. It was argued in paragraph 3 of the main paper that the reduction and elimination of inflation required a consistently firm monetary policy. To this end, the authorities regard the setting of an appropriate target for some monetary or credit aggregate as essential.
2. Following conventional terminology, it may be helpful for the rest of this paper to distinguish between final objectives (eg. for growth and prices), intermediate targets (set to help towards the achievement of final goals) and operating targets. Monetary targets, as used hitherto in the UK, have been intermediate in nature.
3. Since targets were published in the UK in 1976, the emphasis has been on broader measures of the money stock, first M3<sup>(1)</sup> and then sterling M3<sup>(2)</sup>. However, it has always been recognised that no single aggregate can fully encapsulate the information on monetary conditions that is necessary for appropriate policy formation. Indeed, among the other countries that have set published monetary targets, a wide range of aggregates have been chosen, despite the common policy purpose of wishing to use monetary policy to help counter inflation. Thus, the United States has set targets for both narrow (M1) and broader monetary aggregates; Switzerland and Canada have adopted only narrow - Germany and France only wider - aggregate targets; while Italy has set targets for both the monetary base and "global credit expansion".
4. At an earlier date, in the 1960s, it was quite commonly thought that the choice of one monetary aggregate rather than another as the main target would be of secondary, minor importance, since they would tend to move together<sup>(3)</sup>. That, indeed was broadly the

- 
- (1) M3 comprises notes and coin in circulation with the public, together with all sterling and foreign currency deposits held with UK banks by UK residents in both the private and public sectors.
  - (2) Sterling M3 equals M3 less all deposits held by UK residents in foreign currencies.
  - (3) The aggregates, however, were expected to have differing trend rates of growth since holdings of transactions balances on the one hand and precautionary and savings balances on the other were expected to respond differently to the growth of real incomes and wealth.



experience of the 1960s in the UK; the correlation between the various monetary series, M1, £M3 and M3, during the period 1963-71 was quite high (see Appendix 1). In these circumstances, it seemed, perhaps, of rather less significance which of the aggregates was chosen, and the choice could be the more easily swayed by statistical and technical considerations<sup>(1)</sup>.

5. In the last decade, however, the paths of the various aggregates in the UK have become much more disparate. Indeed, an examination of the series of quarterly percentage changes in the main aggregates since 1971 reveals no significant correlation at all between movements in narrow money, M1, and in the main broad money aggregates, M3 and £M3 (again see Appendix 1). It, therefore, matters much more now than may have appeared at the end of the 1960s which aggregate(s) is chosen as the target - since each can give - and has given - markedly differing signals at times. Moreover, partly as a result of increasing interest in monetary developments, a wider range of monetary series has now been made available, giving a greater choice for the preferred target(s). Thus, besides M1, there is now a series for non-interest bearing (nib) M1; and besides M3 and £M3 in their own right, it would be possible to add to them overseas residents' sterling deposits held with banks in the UK. Further, there are various wider measures of the liquid assets' holdings of the private sector in the UK, known as private sector liquidity (PSL) series 1 and series 2 (PSL1 and PSL2).

#### B. Definitional boundaries

6. Two monetary aggregates have been left out deliberately from the above list. The first is the monetary base (sometimes known as M0) which is generally defined as bankers' balances with the Bank of England or as the balances plus currency (notes and coin) outstanding. As discussed in the main text and in Annex 3, there is a case for

---

(1) Covering matters such as the ease of seasonal adjustment, the extent to which the series depended on somewhat arbitrary calculations (eg. of the split of items in transit), the degree of purely erratic fluctuations in the various series; most of these considerations told in favour of preferring one of the broader aggregates.

aiming to control the base more closely as a means of achieving the desired rate of growth in the preferred monetary target, eg. £M3. There is less reason to select the monetary base as the main intermediate target itself. It consists of two components. The first, currency [which perhaps could be termed 1/2 MO], has in the past quite closely reflected movements in consumers' expenditure. Nevertheless, there can be quite large structural variations in the demand for currency, eg. as payments methods alter, and, with currency freely convertible and available on demand, the authorities have no way of bringing control to bear directly on currency holdings. The second component of the monetary base, bankers' balances, in practice largely reflects what has already happened to the growth of the other monetary aggregates, subject to such variations as may have occurred in excess reserve holdings. This is further discussed in Annex 3.

7. The second omission is an aggregate of the kind known as M2 in the United States, comprising notes and coin, sight deposits and 'retail' time deposits of UK residents. The banks have found it impossible to distinguish clearly between retail and wholesale money; many deposits made through bank branches - which might be thought of as retail money - are, in fact, for large sums and interest is paid at market-related rates. Prior to 1971, while the clearing bank cartel remained, a rough and ready distinction could be drawn between time deposits at the clearers, which could be regarded as essentially retail in type, and time deposits and CDs at non-clearing banks - including subsidiaries of the clearers - which could be viewed as mainly of a wholesale character. That division, on which a definition of M2 was based in the 1960s, was rendered invalid by the changes following from the reform of the system in 1971. Since 1971, the clearing banks have attempted to collect figures on retail-type deposits once a year. The limited research possible with such occasional data does not suggest that such an M2 series has any closer or more stable relationship with general macro-economic developments, such as the course of nominal incomes, than do the more regularly available monetary series.

8. Another gap in the statistics, which may now become of greater significance with the abolition of exchange control, is the inability of the authorities to obtain data, at least with anything like the same speed and probably with significantly diminished accuracy and detail, on sterling deposits (held both by residents and non-residents) and on foreign currency deposits (held by residents) with banks abroad, (ie. in euro-markets). So long as the various controls placed on British banks do not impose a discriminatory burden, for example through the imposition of direct controls (see paras.18-20 of the main paper), on domestic monetary intermediation, it may be expected that the convenience of undertaking domestic banking transactions within the UK will limit the proportionate holdings of euro-sterling deposits by UK residents to small amounts. However, such a priori arguments on grounds of convenience are far less weighty for a non-resident choosing between holding sterling in the UK or in the euro-sterling market, or for a resident choosing whether to hold a foreign currency deposit in the UK or abroad; elasticity of substitution between sites for holding such funds in these cases is probably high<sup>(1)</sup>.

9. There is, in any case, some analytical doubt as to whether it is appropriate to include either non-resident sterling deposits or residents' foreign currency deposits in a definition of 'the' money stock. Variations in the total of non-residents' sterling deposits have often seemed to reflect largely speculative expectations of the short-term future course of the exchange rate, rather than any longer term relationship with the course of macro-economic developments in the UK. It is, of course, true that such deposits provide funds with which the banks can on-lend in the UK, but emphasis on that aspect would suggest a preference for a credit-based, not a monetary,

---

(1) Therefore, while statistics are obtained from UK banks on non-resident sterling deposits and on residents' foreign currency holdings, the data cover only part of the ground and are subject to potentially sizeable variations, reflecting no more than a shift in the domicile of the deposit. Further estimates on total non-resident sterling deposits and total residents' holdings of foreign currency abroad could be obtained, through international co-operation, but only with a long lag and a significant margin of error.

target aggregate (see paragraphs 23-6 below), rather than representing a valid argument for including such overseas deposits in a monetary aggregate.

10. The case by the authorities with respect to the foreign currency deposits of UK residents has been seen as more evenly balanced, with the first target aggregate (M3) including such deposits. Besides the statistical problem, discussed in paragraph 8 above, however, a survey in 1976 of the holders of such foreign currency balances suggested that they were primarily UK firms (notably oil and insurance companies) with continuing business abroad and that the balances held related primarily to the level of such overseas business. It seemed unlikely, therefore, that these foreign currency balances played much, if any, role in the view taken by such companies of their liquidity and financial position in the UK. On such grounds there seemed a strong case for focussing on EM3 rather than on M3. The limitation of foreign currency deposits to those who needed them for immediate business abroad was, however, in large part a consequence of exchange controls. With the abolition of controls, it remains to be seen how far UK residents will seek to diversify their monetary holdings in different denominations. Subject to the statistical problem raised in paragraph 8, the authorities will need to watch developments closely and to be prepared to adjust definitions - and the emphasis placed on them - as and when structural developments make it necessary.

11. This observation reflects the fact that a key attribute of the financial system, and of the banking sector within it, is its capacity to innovate and to bring about significant structural adaptation, even with a short space of time. Sometimes these structural changes are a response to changes in the "rules of the game" laid down by the authorities; sometimes they occur independently, but may in turn have consequences for any system of monitoring and of control that the authorities have set up. Either way, the capacity for structural change requires a flexible response from the authorities.

12. A number of examples may be adduced. Thus, present holdings of interest-bearing sight deposits probably contain a significant element of wholesale funds awaiting the right moment for longer term investment. Such holdings tend to vary extremely erratically from month-to-month, and the movement in nib M1 may give a clearer indication of the trend in transactions balances. Yet there is no legal barrier against the payment of interest on any sight deposit, and, particularly after the end of the SSD scheme, competitive pressures could lead very quickly to such interest payments being more generally made, as already occurs in Italy. If so, the information content of the nib M1 series would immediately become near zero.

13. Then there is the question of what assets, held with what financial institutions, should be included in a monetary or liquidity aggregate. In part, the answer to this will be pragmatic. Thus, with the passage of the Banking Act, the similarities over certain areas of business at least - between banks and LDTs - suggests that any future aggregate should include (at least) both banks and LDTs. This would be a broader coverage than for M3 and sterling M3 at present<sup>(1)</sup>. A more important question is whether building societies should be regarded as part of the 'monetary' system for monitoring and control purposes. In part, again the answer will be pragmatic depending on the extent to which banks and building societies are seen as providing similar financial and monetary-type services both to their depositors and to their borrowers. In part, however, the decision will depend on the more strategic analytical issues of what is seen as the purpose of the monetary targets, and which series can, in principle and in practice, best play this role. This is the subject of the next Section.

### C. The strategic issues

14. Putting on one side the narrower definitional problems considered in Section B, the main choices would seem to rest between a narrow target (say M1) related to transactions balances, a broad

---

(1) Whether these aggregates are measured with respect to banks or to banks plus LDTs, a break in the series seems inevitable, because the present grouping of "statistical banks" will effectively disappear.

monetary target (say  $\text{EM3}$ ) related to (most) deposit holdings in UK banks, a broad liquidity target (say  $\text{PSL2}$ ) related to liquid asset holdings in the UK, all of which are monetary aggregates, or to certain credit aggregates, such as DCE or something broader. The issues of whether to adopt a credit or a monetary target and of whether it would be desirable to have a number of target aggregates are discussed at the end of this Section. First, however, the arguments for preferring one or other of the three main monetary aggregates as the main target are reviewed.

15. The case for having an intermediate monetary target largely depends on the view that the achievement of the target will facilitate - over the appropriate time horizon - the better achievement of the ultimate objectives of policy (such as price stability, full employment and growth). This would seem to require that there be a stable and predictable relationship between movements in the monetary aggregates and in the macro-economic objectives of policy, again within the appropriate time span, and, in particular, a relationship that will persist when the authorities seek to act to influence the intermediate monetary target for the purpose of attaining these ultimate objectives.

16. In some large part, this latter question of the stability of the relationship between the monetary aggregates and the ultimate objectives of policy has been tested econometrically, by examining various statistical functions linking movements in the monetary aggregates with movement in macro-economic variables such as prices, real incomes and interest rates. Earlier, at the end of the 1960s for example, it was thought that a considerable degree of such stability had been found in the UK, with the results little different depending on which monetary series was used. Since then, however, in the more disturbed conditions of the 1970s, the short-term relationship between the monetary aggregates and economic developments has become much more uncertain. There have been some quite sharp, and unpredicted, short-term fluctuations in the velocity of  $\text{EM3}$  and in broader aggregates: indeed, no short-term stable velocity function can, perhaps, be said to exist now for the broader aggregates. While

the equations relating M1 to movements in the macro-economic variables have performed rather better, by some statistical criteria really quite well, the degree of forecast error, and instability, recently in them has made it increasingly difficult to put much faith in econometric equations as a primary guide for policy.

17. The arguments about which intermediate monetary target to choose has moved some way away from a comparison of the statistical details of the respective various econometric equations. The choice of a monetary target is not seen as enabling an 'optimal' number to be picked that can allow the economy to be fine tuned in the short run. Rather, the purpose is to choose an aggregate, the control of which, over the medium-term, can help to assure financial stability. For this latter purpose, it is the strength of the broader, medium-term relationships between the various aggregates and economic developments that is relevant. Seen in this light, the somewhat closer econometric linkage between M1 and nominal income levels has to be weighed against the closer interrelationships between £M3 (or M3) and other major economic developments within the economy. Thus, the growth in £M3 can be analysed in terms of its counterparts, comprising the Public Sector Borrowing Requirement (PSBR), public sector debt sales to non-banks, bank lending to the private sector and external flows. The developments in £M3 reflect in a clear statistical format the influence of the range of policies (notably fiscal policy affecting the size of the PSBR, debt management and the effect of policies on external flows). Analysis in this format may help to allow for a more coherent and balanced mix and structure of policy.

18. The Radcliffe Report advocated that more attention be paid to the structure of liquidity than to the supply of money within the economy, mainly on the grounds that there are so "many highly liquid assets which are close substitutes for money"<sup>(1)</sup> that the velocity of money is likely to be capable of variation up to "any limit"<sup>(2)</sup>. It is certainly questionable whether there is such a high degree of

---

(1) Paragraph 392.

(2) Paragraph 391.

substitution between transactions balances (M1) and other liquid assets held for more precautionary and savings purposes. It does, however, seem much more likely that time deposits, CDs and other similar instruments will be regarded as closely similar assets by their holders whether they are issued by banks, near-banks or by public sector bodies. Equally, borrowing on comparable terms will be regarded in a similar light by the borrower regardless of the exact title of the lending institution. This similarity and ease of substitution, such as it is, not only indicates the danger of direct limitation or penalisation of one channel of finance, leading to a re-routing of financial flows with large apparent effects on the data, but little real effect on the economy, but also provides a case for a wider definition of liquid balances, beyond those issued just by banks, and now also by LDTs. Yet the variety of financial assets is so large and continuous that if the choice was to be made to go beyond the banking system, there appears no clear and logical stopping point or division between liquid and non-liquid assets.

19. The above considerations address the general matter of the relevance of the various monetary series. The second main strategic question concerns the matter of control, the ability of the authorities to control the various aggregates. For it is the case that the choice of target aggregate will largely determine both the instruments and techniques that the authorities may use for monetary control. Thus, for example, with sight deposits - the main component of M1 - forming only a proportion of total deposits, and depositors able to shift funds often quite quickly between one form of deposit and another, it is not possible for the authorities to influence the growth of M1 balances directly through fiscal policy, debt management or external operations, in the same way that such operations would seem to have a direct statistical link with the determination of £M3. (There will, of course, still be indirect effects, for example as fiscal measures influence the level of incomes and thus the demand for transaction balances.) There are both advantages and disadvantages in the distancing of these other policy measures from monetary control that occurs when M1 is the monetary target. The closer involvement - with



sterling or total M3 - of a range of measures involving fiscal, external and debt management policies in monetary control should allow not only for a greater coherence and better balance in policies but also provide a wider menu from which to choose the appropriate response to unforeseen developments. In the short-run, for example, it may be possible to offset unexpected developments in, say, the PSBR, through varying the debt management policy. On the other hand, this very entanglement of other policy measures with the dictates of domestic monetary control (for £M3) can lead to additional and sometimes unwelcome constraints on the authorities' ability to handle such policies in what might otherwise seem a more appropriate fashion, putting undue strain perhaps (to follow the previous example) on the gilt-edged market. Finally, the adoption of M1 rather than £M3 as the main target is likely to lessen the incentive to turn to direct controls, especially on bank lending, as a means of achieving the target aggregate.

20. Indeed, with depositors able to shift between demand and other time deposits at will, the authorities can only aim to influence the level of M1 by affecting the demand for such balances. Their main instrument for doing this - apart from their general ability, such as it may be, to affect the overall level of nominal incomes - is by varying the level of interest rates, thereby influencing the relative cost of holding currency and sight deposits, as compared with higher-yielding deposits. Variations in interest rates represent the key policy instrument that is common both to the control of M1 and of wider aggregates. However, in the case of these wider aggregates, the relationship is more complex. In part, what matters are relative interest rates. If the yield on Local Authority debt rises relative to that on bank CDs, a quite large reduction may be seen in the demand for sterling M3. More meaningful in the context of the economy as a whole is a shift in the relative rates between broad money and long-term government debt. However, the general level of rates may also matter. The private sector's demand for bank credit is probably a function of both the level of bank lending rates and of competing credit rates and the apparently low elasticity of response

of sterling M3 to variations in the general level of interest rates has mainly reflected the interest elasticity of demand for bank borrowing, which, in the short-run at least, is very low.

21. As noted earlier, a number of other countries have adopted M1 targets (USA, Canada), or targets in which differing forms of money balances have differing weights (Germany), or targets which exclude certain longer-term forms of bank liabilities as being 'non-monetary' in form (Netherlands, Germany). In all these cases, an increase in interest rates generally helps to restrict the target aggregate by inducing a shift in balances from more liquid to less liquid forms of bank liability, while the total size of the banks' books may, for a time, remain unchanged. In the UK, on the other hand, a reduction in £M3 can only, in general, occur if the size of the banks' total sterling business is reduced, and this seems to make the task of controlling the target aggregate harder here than elsewhere. From a wider point of view, the implication would seem to be that in the UK a significantly more vigorous and emphatic use of interest rates would be necessary to control £M3 than might be needed to control aggregates chosen by a number of other countries.

22. With even wider aggregates, beyond £M3, the problems of control would probably not improve significantly. Indeed, they could be worse: whereas with sterling M3, as noted above, some apparent measure of control may be achieved if it is possible to engineer a shift in relative short-term interest rates between closely comparable bank and non-bank assets, it would be necessary, with a wider aggregate, eg. PSL2, to induce liquid asset holders to shift generally into longer dated debt to restrict its growth, a shift which can be hard to encourage at times of uncertainty and bad news. Moreover, problems with direct controls would remain. On the other hand, to the extent that certain yields on assets included in PSL2, but not in £M3, have a natural stickiness (notably yields on some forms of national savings and on building society deposits), control via influencing relative interest rates should be facilitated.

23. Because the control of £M3 involves controlling the total size of banks' sterling business in the UK, it approximates in part already to a credit aggregate. That may be regarded as an added advantage. However, to the extent that credit extended by banks in the UK is balanced by external outflows, the size of banks' books remains unchanged<sup>(1)</sup>. Clearly it makes a difference whether a given monetary growth is achieved by a sizeable DCE offset by external outflows, or, per contra, a low DCE matched by external inflows. When the authorities have need to place a greater weight on the achievement of some external objective - as contrasted with domestic developments - then a DCE target comes into greater prominence.

24. Indeed, if the authorities are placing particular priority on the maintenance of some fixed, or pegged, exchange rate, it becomes dubious whether any monetary target is simultaneously sustainable. Thus, an inflow from abroad, tending to raise the monetary aggregates, would, of itself, transmit a signal to the authorities to be more restrictive, thereby exacerbating the inflow, and vice versa. In contrast, a DCE target is consistent with a system of pegged exchange rates. If there are outflows, DCE will tend to rise above target and restrictive action taken by the authorities will serve also to reduce the outflows and vice versa in case of inflows.

25. In the UK, it has been - and will continue to be - the authorities' intention to watch both the liabilities making up a broad money aggregate and the counterparts, of which those summing to domestic credit generally make up by far the largest part. The authorities would not regard as tenable a policy which, for any length of time, kept within a target for the former at a cost of a high DCE and a large unanticipated outflow<sup>(2)</sup>.

---

(1) See, for example, the Bank of England Quarterly Bulletin, December 1978, pp.523-9.

(2) To the extent that the outflow is anticipated, it can be allowed for in setting the monetary target and under certain circumstances - such as with the abolition of Exchange Controls - it would be extreme to seek to ensure the total offset of subsequent outflows in the short-run. The converse is true for factors temporarily adding to the demand for sterling.

26. Indeed, the only occasion the UK authorities were committed to a target for more than one aggregate was during the period 1976-1978 when the authorities had accepted both a target for DCE and an objective for M3. In general, however, the authorities prefer to work to only one target aggregate, despite the fact, illustrated by the arguments in this Annex, that there is additional information to be obtained by analysing developments in a wide range of monetary series. In part, as already noted for example in paragraph 24, the use of several target variables may over-constrain the system, and result in conflicting signals for policy, so that there could often be great difficulty, if it is possible at all, in finding policies capable of achieving the several objectives. Further, as noted in the Governor's Mais Lecture<sup>(1)</sup>, the public impact of the process of setting targets might be reduced in the process. (Interestingly, in the one large economy with multiple targets, the USA, public discussion has tended to focus on one of the three targets generally set.) Consequently, although the shortcomings of any single aggregate are fully recognised, the authorities prefer not to move to multiple targets at this time.

D. Summary and conclusions

27. There is no single monetary or credit aggregate of the many candidates (paragraphs 5-7) which meets all the standards that might be set for an intermediate target aggregate. Nor is it the case that they move in similar fashion (paragraphs 4-5). For some, their analytical relevance is in doubt (eg. paragraphs 8-9). More generally, to date, there has been no clear empirical answer (paragraphs 15-16) to the question "which aggregate will best facilitate the achievement of the ultimate objectives of policy" and what few empirical results there have been, it must always be recognised, are subject to being undermined by changes in the financial system. (The abolition of Exchange Controls is but one possible cause, paragraphs 11-12, of such changes.)

28. A number of countries (paragraph 21) have given perhaps greater weight than have the authorities in the UK to being able to control the target variable. Official and independent studies of the

---

(1) See the Bank of England Quarterly Bulletin, March 1978, pp.31-7.

UK have suggested that M1 is easier to control than the broader aggregates, but the key method of control in both cases is the authorities' ability to affect certain key interest rates (paragraph 20). Direct quantitative controls have no role to play in influencing M1, nor, it is argued elsewhere in this paper, should they have with respect to the broader aggregates.

29. If 'controllability' were the sole criterion, sterling M3 might well not remain the target aggregate. However, the authorities wish to retain it for the present, for the reasons set out in paragraphs 17 and 23-25. It is recognised that movements in aggregates provide information which is useful and which should be taken into account in policy formation. It does not, however, seem appropriate (paragraph 24) to go farther and set multiple targets.

SECRET

Annex 2 Requirements for reserve assets, special deposits and primary liquidity

---

A. Introduction and Summary

1. Since September 1971, all banks and certain finance houses have maintained a minimum ratio of their Eligible Liabilities<sup>(1)</sup> (ELs) in certain specified reserve assets<sup>(2)</sup>. In addition, they have been subject to calls for Special Deposits. This Annex examines the way in which these requirements have operated and concludes that the reserve asset requirement is no longer necessary but that Special Deposits should continue. However, there is a need for those recognised as banks and as Licensed Deposit Takers (LDTs) under the 1979 Banking Act to hold liquid assets, and the proposals set out in the separate Consultative Paper on liquidity are briefly considered in the context of monetary control.

B. The reserve asset ratio and Special Deposit requirements

2. Special Deposits, introduced in 1960, essentially involve those subject to the requirement depositing funds with the Bank of England, on an interest-bearing basis, at some specified percentage of their ELs. While the funds are with the Bank, they are not available to the depositor, and hence an increase in the rate of call for Special Deposits acts to reduce banks' liquidity. Until

---

(1) These comprise, in broad terms, sterling deposit liabilities excluding deposits having an original maturity of over two years, plus any sterling reserves obtained by switching foreign currencies into sterling. Inter-bank transactions and transactions with the discount market (other than reserve assets) and sterling certificates of deposit (both held and issued) are taken into the calculation of individual banks' liabilities on a net basis, irrespective of term. Adjustments are also made in respect of transit items.

- (2) Broadly:
- (a) Balances with the Bank (other than Special and Supplementary Deposits).
  - (b) Money-at-call with listed discount market institutions and brokers.
  - (c) Treasury bills issued by the British and Northern Irish Governments.
  - (d) UK local authority bills eligible for rediscount at the Bank.
  - (e) Commercial bills eligible for rediscount at the Bank (to a maximum of 2% of eligible liabilities).

SECRET

- 2 -

September 1971, only the clearing banks were subject to calls for Special Deposits. But since then, the requirement has applied to all banks.

3. Also since September 1971, all listed banks<sup>(1)</sup> have been requested to hold a minimum of 12 1/2% - on a daily basis - of their ELs in specified reserve assets. Before then, the clearers had maintained voluntary liquidity and cash ratios and the replacement of these by a uniform reserve requirement was seen by the authorities as an integral part of the encouragement of fair competition and of equitable credit control as between banks.

4. The definition of reserve assets adopted in 1971 reflected the Bank's view that no significant change in the structure of the short-term sterling markets or its operations therein was required. As a result of the definition chosen, the authorities recognised that they could not seek to control strictly the supply of reserve assets, for it included claims on the public sector which could be held by non-banks as well as by banks and also certain claims on the private sector.

5. This lack of control over the supply of reserve assets is not of particular concern, because the authorities regard the datum point of control over short-term interest rates as being the 1 1/2% of their ELs kept by the clearing banks since 1971 at the Bank of England on a non-interest-bearing basis. This ratio has not been used as a means of imposing close control of bank deposits; the clearers do not have to meet this requirement on any particular day or over any exactly specified period, and, under present arrangements, the authorities always act to meet a shortage of cash by supplying it at a price indicating their attitudes towards the existing interest rate structure. Instead, the cash base is used as a datum point against which official operations in support of interest rate objectives are effected. For example, if the authorities wish to counteract a downward pressure on interest rates, they can usually create a shortage of cash by adjusting the amount of Treasury bills issued at the tender. This has an effect equivalent to the Bank selling such bills in the open market, because the discount houses are obliged, by

---

(1) Certain of the larger finance houses have maintained a similar 10% ratio and been subject to Special Deposits.

long-standing agreement with the Bank, to cover the tender. The consequent shortage of cash in the system will enable the Bank to force the houses to borrow from the Bank at MLR for seven days, and this in turn will affect the course of short-term rates generally.

6. It was, however, intended that the reserve asset requirement should be used in conjunction with Special Deposits to mop up any abnormal excess liquid assets in the banking system and, on occasion, to go further than this and to require the banking system to seek to dispose of assets not eligible for the reserve asset ratio. It was recognised that this second use might lead to a strong upward influence on, for example, short-term interest rates in the inter-bank market and that, under some circumstances, it would be necessary to accompany a call for Special Deposits with an increase in Bank Rate (Minimum Lending Rate from October 1972) so as to bring about the rise in short-term interest rates and the consequent fall in prices of marketable short-term assets that would be needed to shift debt out of the banking system.

7. In the event, it quickly became apparent that use of joint reserve asset and Special Deposits requirements presented particular short-term difficulties. In the new competitive environment, after September 1971, the inter-bank market became increasingly active, and, when Special Deposits were called late in 1972 and again in July and November 1973, the immediate response of the banking system as a whole was to practise liability management on a much greater scale than had been envisaged in 1971. (In other words, to meet a shortage of reserves engineered by calling Special Deposits, the banks bid for funds in the wholesale money market - increasing their liabilities - with which to obtain more reserve assets, rather than reduce their total assets.) Interest rates in such circumstances tended to shift in an unhelpful fashion, with the Treasury bill rate falling<sup>(1)</sup> (as

---

(1) The introduction of Minimum Lending Rate (MLR) in October 1972 made this a particularly difficult problem. MLR was formally linked to the Treasury bill rate and, although the authorities had the power to override the formula, they were reluctant to exercise this power except when absolutely necessary. Repeatedly during the first half of 1977, however, the formula had to be overridden as the authorities tried to restrain downward pressure on short-term interest rates when a massive volume of funds moved into sterling; while, subsequently, the restoration of short-term interest rates to a level appropriate to domestic monetary policy was achieved through the market related formula only with considerable difficulties. In May 1978, MLR became fully administered.



the banks competed vigorously to buy additional reserve assets) often in absolute, and always in relative, terms compared to the inter-bank rate (pushed up as banks bid for funds). As the inter-bank rate rose relative to other rates, the non-bank private sector was perversely encouraged to switch funds into bank deposits and Certificates of Deposit; £M3 rose as a result, in the short-run at least. The problem was compounded when institutional rigidities in the system or inhibitions felt by the banks (partly, no doubt, the result of uncertainty as to the authorities' attitude to higher interest rates) made the banks unwilling to pass higher rates on immediately to their customers; this led to a slower rise in the rates on banks' lending than borrowing and consequently provided opportunities for "round-tripping"<sup>(1)</sup>. (In the summer of 1973, it is thought that such round-tripping inflated M3 by over 1% in one month.) As a result, it became apparent to the authorities that it was better to put up interest rates directly rather than to use Special Deposits to achieve this effect less directly.

8. When the Supplementary Special Deposit (SSD) scheme was introduced in December 1973 and on the subsequent occasions when it has been in operation, the effect of the reserve asset requirement in combination with the SSD scheme has been to encourage banks to manage their assets rather than their liabilities. This followed from the fact that the SSD scheme put a limit on banks' liability management, by imposing an effective ceiling on the volume of interest-bearing deposits (IBELs) that a bank could take. Thus a bank close to its ceiling and also short of reserve assets tended to find it cheaper to manage its assets (for example, switching from non-reserve to reserve assets) rather than its liabilities (which might incur penalties under the SSD scheme through bidding for funds). The result was still to put upward pressure on at least some interest rates, as banks sought to sell non-reserve assets and thus pushed their prices down. However, the risk of a jump in inter-bank rates, and thus a perverse short-term effect on £M3 was greatly reduced by the operation of the SSD scheme.

---

(1) This term here refers to borrowing from banks to relend at a higher interest rate on the money markets.

9. There were still major limits on what the authorities could achieve, however, not least because of the difficulty of forecasting the likely reserve asset position of the banking system even over short periods of time (which matters, of course, because, under the terms of the scheme, the banks can dispose of any excess reserve assets and reduce their IBELs). Further, asset management has frequently taken the form of disintermediation, notably through the bill-leak, by which bank lending (and thus sterling M3 and IBELs) has been kept below what it otherwise would have been, without any significant impact on activity in the economy<sup>(1)</sup>.

10. The reserve asset ratio has also had the effect of ensuring that banks always hold a significant proportion of their assets in 'near-cash'<sup>(2)</sup>. However, for prudential purposes, it would be much more appropriate to have a control designed specifically to meet prudential needs, and the Bank's proposals for such a control are set out briefly in Section C below. They differ in a number of important respects from the reserve asset requirement. In particular, the latter is set in terms of a daily minimum, whereas a norm - departures from which are appropriate in clearly defined circumstances - is the more appropriate for prudential purposes. Secondly, the present reserve ratio is calculated against a bank's ELs, a total which makes little sense in supervisory terms, notably because - among other offsets and exclusions - a bank can offset its claims on other banks against its total deposit liabilities in calculating ELs. Further, it relates only to sterling business.

11. The conclusion is that the present reserve asset requirement has little to contribute to the present system of monetary control<sup>(3)</sup>. Its limited prudential value will become redundant once the specific prudential proposals, discussed briefly in Section C below, are adopted. It is therefore proposed that the reserve requirement be abolished, with effect from the introduction, scheduled for , of prudential controls on primary liquidity.

---

(1) For a discussion of the role of disintermediation, see paragraph 000 in the main paper.

(2) The reserve ratio was never intended as a prudential control, but, of course, it grew out of the liquidity ratio maintained by the clearers until 1971, which did have prudential origins.

(3) This holds a fortiori with the proposed abolition of the SSD scheme.

12. There will, however, remain a need for Special Deposits. In particular, it would still be appropriate, as now, to call Special Deposits to absorb excessive liquidity in the banking system. Further, Special Deposits would retain their present role in which releases and recalls can help to smooth out conditions in the money markets and in which announcements of such moves can help to show the pattern of official policy towards conditions in these markets. Finally, the release of Special Deposits would be one option open to the authorities if the banks brought their liquidity position under pressure through, for example, official sales of gilt-edged securities and the authorities thought it appropriate to ease that constraint. Such a response would have a particular attraction as an alternative to the Bank of England's buying-in short-term assets in periods, such as have occurred recently, in which the outstanding volume of Treasury bills has fallen to the minimum required for money markets to function properly.

C. Prudential requirements for holdings of primary liquidity.

13. [Simultaneously with this Consultative Document] the Bank of England has published proposed requirements for the holding of primary liquidity by all institutions subject to its supervision under the Banking Act. In the Bank's opinion, these arrangements would be appropriate even if the present reserve asset ratio requirement were retained for banks and extended to LDTs.

14. The critical features of the liquidity proposals, so far as this Document is concerned, are:

- (a) that it is considered essential that the banking system should normally hold a significant amount of primary liquidity<sup>(1)</sup>; and
- (b) that the range of assets which the authorities regard as primary liquidity includes certain claims on the private as well as the public sector.

---

(1) The reasons why the authorities regard this as a necessity are explained on page 000 of the companion document.

15. As the companion document explains, primary liquidity would be provided by those assets that were cash or which the Bank of England would regard as acceptable collateral when making loans as lender of last resort or which represent claims on institutions in the money market having access to lender of last resort facilities. On strictly prudential grounds therefore, under the present arrangements for their open-market operations, the authorities have no hesitation in including call money with the discount houses and eligible commercial bills in their definition of primary liquid assets.<sup>(1)</sup>

16. One question that naturally arises is whether such a definition (which together with the rest of the prudential proposals are not regarded as likely to have any radical effect on the present structure of the money markets) carries implications for subjects covered elsewhere in this Document. This issue is postponed to Annex 3.

17. A second question is whether the prudential proposals, together with the abolition of the reserve asset requirement would have a significant effect on the relative yields of short-term assets. In particular, would there be any noticeable impact on the present tendency of the Treasury bill rate to be well below other short-term interest rates and for it, on occasion to move in a divergent fashion (see para. 6 ) above?

16. It seems likely that the Treasury bill would remain particularly attractive to banks (and LDTs) as a readily available form of primary liquidity although no longer a reserve asset. As a result, the yield differential between Treasury bills and, say, Certificates of Deposit of comparable maturity may decline, but not disappear. Consequently, the banking system would probably remain the predominant holder of Treasury bills. Further, the likelihood of divergent movements between Treasury bill and other short-term interest rates will remain whenever there is significant

---

(1) The proposed list is:

- (i) Cash
- (ii) Balances with the Bank of England (including Special Deposits)
- (iii) Call money with the London discount market
- (iv) UK and Northern Ireland Treasury bills
- (v) Bills eligible for re-discount at the Bank of England
- (vi) British government securities with less than one year to maturity

SECRET

- 8 -

pressure on the banking system's primary liquidity; however, the fact that the new requirements are cast in terms of a norm rather than a minimum might help to mitigate the effect of very short-term pressures on liquidity.

3. Monetary base control and prompter official responses to changes in the money stock

A. Introduction

1. A wide variety of forms of monetary base control are possible, and this review has proceeded by distinguishing three main types and then discussing in more detail what appeared to be the more practicable versions of each. Therefore, after a brief discussion of the role currently played by the existing cash base of the banking system:

- (a) Section C considers forms of control that fall within the general description of 'negotiable entitlements' which banks would be required to hold in proportion to their deposits;
- (b) Section D covers proposals for reconstructing the cash base of the banking system so that movements in the base might be taken as a leading indicator of changes in the money stock and as a guide to appropriate discretionary changes in interest rates;
- (c) Section E discusses the nature and value of methods of operation in which the authorities would aim to control the size of the cash base over some period, as part of a policy of responding faster and with more certainty to undesired movements in the money stock.

2. The approach adopted in this Review takes as its starting point the statement of aims of monetary policy set out in paras.2-10 of the main paper and the proposition (see Annex 1) that primary attention should continue to be given to a broad monetary aggregate such as sterling M3. Further, the attitude adopted towards the role of disintermediation in the achievement of a monetary target follows from that set out in paras.18-20 of the main paper, and is discussed further in Section F of this Annex.

B. The present cash base

3. The fulcrum of control over short-term interest rates has not been, as explained in Annex 1, the reserve asset ratio requirement; rather, it has been instead the 1 1/2% of their eligible liabilities kept by the clearing banks since 1971 at the Bank of England on a non-interest-bearing basis. This ratio has not been used as a means of imposing close control on bank deposits; the clearers do not have to meet this requirement on any particular day or over any exactly specified period, and, under present arrangements, the authorities always act to meet a shortage of cash by supplying it at a price

consistent with the desired interest rate structure. Instead, the cash base is used as a datum point against which official operations in support of interest rate objectives are effected. For example, if the authorities wish to counteract a downward pressure on interest rates, they can usually create a shortage of cash by increasing the amount of Treasury bills issued at the tender or by calling Special Deposits. The former has an effect equivalent to the Bank selling such bills in the open market, because the discount houses are obliged, by long-standing agreement with the Bank, to cover the tenders. Both reduce cash in the system and the consequent shortage will enable the Bank to force the houses to borrow from the Bank at MLR for seven days, and this in turn will affect the course of short-term rates generally.

C. Negotiable entitlements

4. Viewed in its simplest form<sup>(1)</sup>, this approach would involve the creation by the authorities of a supply of negotiable entitlements (NEs) which controlled institutions would be required to buy in proportion to the deposits that they wished to take. The authorities would be the sole source of supply of NEs and they would increase that supply in line with the growth of deposits<sup>(2)</sup> that they thought desirable. The controlled institutions would bid for new entitlements and trade the existing stock. Competition would ensure that, if the flow of deposits into the controlled institutions tended to rise above the level implied by the stock of entitlements, then the market price of NEs would rise. This would effectively raise the marginal cost of additional deposits to the institutions taking them, because they would have to pay the going market rate for deposits and buy the entitlement as well. The controlled institutions would, in turn, raise their lending rates or otherwise restrict their loans; the process would

---

(1) This approach could also be thought of as involving the issue by the authorities of an asset with a maturity value, which carried both a rate of interest and an entitlement to hold deposits. The fundamental points would not, however, be different and the discussion would inevitably be more complex, and so this version is not taken further in this paper.

(2) The exact definition of deposits which might be covered by the scheme, together with a number of other issues which arise in discussion of any form of monetary base control, are considered later in this paper.

continue until the total credit granted had fallen to the point where the total deposits that the public wished to hold with the controlled institutions at the ruling market rates of interest were within the total allowed by the stock of entitlements.

5. The effects of such an approach would be those of a direct control, such as the SSD scheme, but in which the adverse effects of a permanent control on competition and efficiency within the controlled sector were mitigated by making NEs saleable. As with the present SSD scheme, the impact of a tight monetary policy (in which the demand for deposits was rising faster than was compatible with the authorities' target) would effectively be to tax the intermediaries required to hold NEs, obliging them to raise the margin between their lending and deposit rates and/or to pass the business on elsewhere.

6. Even before the abolition of Exchange Controls, experience with the so-called bill-leak<sup>(1)</sup> and with other forms of disintermediation during the operation of the SSD scheme, demonstrated the ease with which direct controls can be avoided. To the extent that such avoidance can be measured, it is still possible for an adequate picture of the stance of monetary policy to be established, but there may even then be significant adverse effects on competition between the controlled and unregulated sectors and, possibly, problems of prudential supervision as well. With the abolition of Exchange Controls, any form of monetary control which did not affect the cost of off-shore as well as on-shore intermediation would generate even more serious problems of disintermediation (and of measurement and supervision) than any direct control used hitherto.

7. There is no convincing way out of these problems. Thus, for example, the extent of the discrimination could be limited by allowing controlled institutions to pay only a modest penalty if they held an inadequate volume of entitlements. This would effectively put a ceiling on the market price of entitlements and limit the implicit tax. However, some discrimination would inevitably remain and, of course, the lower the penalty, the less the control that the authorities would have over the total of deposits.

---

(1) The take-up by the non-bank sector of commercial bills guaranteed by banks.



8. More plausibly, it could be argued that the system could be operated not as a control in its own right, but as a rather better indicator than anything available at present of movements in the money stock, with any significant rise in the market price of entitlements indicating the need for the authorities to take some restrictive fiscal or monetary action.

9. This, however, raises two questions:

- (a) Would this scheme in fact provide better or quicker information than present indicators of the monetary position?
- (b) Would a significant rise in the price of entitlements ever actually occur, given the scope for disintermediation to unregulated areas that is available?

10. The first of these questions is best discussed in Section D below, where the general role of the monetary base as an indicator is considered. On the second, the evidence from the periods of the SSD scheme in the UK and from the behaviour of the euro-dollar market over the years<sup>(1)</sup> suggests strongly that the signals of a rising price, on which the approach rests, would be very difficult to observe in practice; only small rises in the price of entitlements would be sufficient to shift business out of the controlled sector, causing the demand for entitlements (and thus their price) to fall back again, giving no adequate indication on which to base discretionary changes.

D. Using the monetary base as a guide to discretionary interest rate adjustments

11. As foreshadowed in paragraph 8 above, it is possible to envisage the base, whether defined in terms of negotiable entitlements or in the more generally used sense of banks' balances at the Bank of England (plus, perhaps, notes and coin in circulation), as being used to monitor developments in a monetary aggregate of interest to the authorities. They would have a view of the desirable growth path of that aggregate and the initial question would be whether movements in the base could - or could be made to - show more reliably than do

---

(1) It is assumed that the growth of the euro-dollar market provides considerable information on the likely development of the euro-sterling market in the absence of Exchange Controls.

present indicators of the monetary position what was happening to the target aggregate. Of consistently greater value would be an indication from movements in the base of some future undesirable movement in the target aggregate.

12. Perhaps the easiest case to consider is monitoring of the kind undertaken by the Swiss central bank (SNB)<sup>(1)</sup>. In Switzerland, the banks voluntarily hold balances at the SNB for prudential purposes (largely because - at least until recently - there has been no adequate alternative source of primary liquidity). The SNB found that the resulting monetary base (defined to include these balances) was a stable and leading indicator of movements in M1 (for which the SNB set targets until the end of 1978). From movements in the base, the SNB could therefore determine whether the growth in M1 was likely to remain on target and, if not, could conduct foreign exchange operations to influence the base. It is important to note that the relationship of the base to M1 did not depend upon Swiss banks observing some required minimum ratio of cash to M1 deposits<sup>(2)</sup>.

13. In the UK, a system along Swiss lines, without regular compulsory cash reserves, would be most unlikely to work - in the sense that movements in the base would indicate anything about the money stock. The banks, in practice for this purpose the clearing banks, would hold some balances at the Bank of England, because they are not allowed overdraft facilities at the Bank and need balances to settle inter-bank transactions at the end of each business day. However, the total of such balances would be most unlikely, of itself, to give any idea about the immediate or future movements in any monetary aggregate in which the authorities were interested.

14. The system could be brought closer to the Swiss case by encouraging the banks to hold prudential as well as operational balances at the Bank, in the hope that these holdings would bear some stable relation to, say, sterling M3. Naturally, it would be several

---

(1) Reference to Schiltknecht.

(2) Swiss banks have to meet cash requirements on only four days each year and the SNB always ensures that adequate cash is readily available on these days.

years before it could be said definitely whether or not such a relationship might emerge but, given the existence of the highly developed short-term money markets in London, the odds against a relationship emerging are high. Unless the authorities were prepared to suppress many of the existing short-term money markets, a bank would have a wide choice of forms of primary liquidity, of which the facility to hold prudential balances at the Bank was only one. Shifts in the attractiveness of various competing assets would almost certainly lead the banks to change their preferred liquid assets portfolio, but in no easily predictable fashion. Under such circumstances, the information content of the figures for banks' balances would approach zero, as the level of prudential balances at the Bank would be a function of probably small shifts in relative (actual or expected) short-term interest rates, rather than being indicative of some current or future change in the money stock.

15. The authorities are not prepared to make banks' balances at the Bank of England the sole primary liquid asset, and so it remains to consider whether the value of the base as an indicator could be established by requiring banks and LDTs to keep minimum ratios of balances at the Bank (or of negotiable entitlements) to deposits.

16. The fundamental issue here is the accounting basis on which the requirement might be imposed. There are three possibilities:

- (i) The deposits held in period  $t$  could require regulated institutions to hold reserves in some subsequent period (this is lagged accounting, the basis of the present system in the United States).
- (ii) The deposits held at  $t$  could require reserves to be held at the same time (current accounting, as with the present reserve asset ratio requirement).
- (iii) The deposits held at  $t$  could require reserves to be held some period previously (lead accounting, a basis recommended by some observers in the United States but never, to our knowledge, used in any major country).

17. If the reserve requirement is set on a lagged accounting basis, the movements in the reserve base indicate more about what has happened to the money stock than about what might happen in the future. Under such a system, the banks would have no incentive to build up excess reserves (the level of which is often taken by the proponents of the base as an indicator suggesting likely future expansion by the banks<sup>(1)</sup>). They would know their reserve requirement exactly and it would be unprofitable to hold an excess because almost invariably reserve assets yield less than other assets available. Further, after roughly a week - ie. possibly before the reserve requirement period was over - the authorities could calculate the money stock figures directly.

18. If reserve requirements were placed on a current accounting basis, figures for the base would be available roughly a week ahead of the weekly money stock data itself, but again there would be nothing particularly indicative about the level of excess reserves in the system. The banks - at least the non-clearers - would know fairly closely what their reserve needs on the day were likely to be and would again have a profit incentive to avoid excess reserves.

19. A worthwhile improvement in information would therefore require lead accounting, because then - provided they faced some penalty for inadequate reserves<sup>(2)</sup> - the controlled institutions would have to forecast movements in their balance sheet over the lead period and a significant rise in the demand for reserves would suggest that the banks expected a similar rise in their deposits.

20. For such a system to work, the first question is whether banks could be expected to make tolerably accurate forecasts of their balance sheet, when much of the volatility and vagary of monitoring growth is in fact caused by fluctuations in the public sector's

---

(1) It can, of course, mean the reverse. During the 1930s, American banks held massive excess reserves, because the demand for loans had collapsed.

(2) If there were no penalties, the banks would have little incentive to make realistic forecasts.

position<sup>(1)</sup>, not only in revenue and expenditure accounts but also arising from a whole range of financial transactions. Moreover, even if it were possible for the banks to predict the public sector's position accurately, the present structure of the system of lending to the private sector would make it difficult, if not impossible, for the clearing banks to forecast their future position vis-a-vis the private sector at all accurately, because they, in effect, provide the residual finance for the banking system by offering overdraft facilities.

21. One natural response to these uncertainties would be for banks, particularly the clearers, to hold reserves above the level that they thought likely to need. There might frequently then be occasions when movements in the overall level of reserves sought indicated a change in the banks' perception of uncertainty of the demand for deposits in the coming period, rather than the expectation of a definite change of trend.

22. Another response would be for institutions subject to the reserve requirements to respond to an under-prediction of the level of their deposits by ensuring that business over and above the level for which they had previously acquired reserves was done through channels which did not require reserves (such as, almost certainly, the euro-markets<sup>(2)</sup> and through the "bill leak"). All the problems associated with such disintermediation would recur.

---

(1) These fluctuations could also affect the base and therefore the banks' ability to obtain reserves. This problem, however, could be overcome; for example the banks could inform the authorities of their intended holding of balances at the Bank of England and the Bank could operate in such a fashion as to offset, after the event, unforeseen swings in the base so that these desired holdings were achieved.

(2) Reserve requirements could be applied by the Bank of England to UK banks operating in this market but not, of course, to foreign banks, who would thereby be given a competitive advantage.

E. Prompter adjustment of interest rates

(i) Introduction

23. Under the present system of monetary control, as explained in para.3 above, the authorities use the existing cash base (the clearing banks' 1½% of eligible liabilities) as a datum point for influencing the level of market interest rates. The authorities normally wish to hold such rates (and MLR) broadly stable, until changing circumstances make them decide to engineer a discretionary change in the level of interest rates. The most important information that will trigger such discretionary changes is new data on the current and prospective trends in monetary growth.

24. At present, the authorities place primary emphasis on the monthly banking make-up figures in evaluating the recent past and they use these figures, together with projections for key variables such as the PSBR, to estimate prospective trends. There are two possible time-lags in such an approach. Firstly, if the figures for a month are thought to have been distorted, it is another month before further figures are available. Secondly, it takes roughly 2½ weeks from the make-up day in any month before aggregate figures of any reliability become available. At roughly the same time the statistics for Eligible Liabilities are published and, from these, the markets obtain a rough idea of the likely outturn for money. Nine days later, the money stock figures themselves are published and it is frequently by then that the authorities decide whether any change in policy is necessary.

25. Over the last couple of years, the information available to the authorities has been supplemented by weekly data from the largest 80 banks and discount houses. These figures have not been published, nor yet made significant use of in policy formation. The raw data are much more prone to error than the monthly figures, partly because of the limited number of banks reporting, but also because the information collected from each bank has, to date, been much less than in the monthly return, giving much less scope for cross-checking and analysis. A further, most important, problem has been the lack of knowledge about the intra-monthly pattern of the raw weekly data and, even after two years, only the most

tentative attempt can be made at seasonal adjustment of the weekly figures<sup>(1)</sup>.

26. Nevertheless, intrinsically, weekly data have the attraction of providing more frequent snapshots of monetary trends and their greater use in policy formation would represent the most promising path towards speeding up the response of interest rates to monetary developments. In particular, if reliable, they would abolish the need for waiting a whole month for further evidence.

27. In principle, although there might be awkward transition problems (especially in view of the increased statistical requirements on banks likely as part of the new prudential controls), it should be possible - using sampling techniques and accepting a greater risk than at present of errors in the data - to obtain weekly money figures one Wednesday relating to the position the previous Wednesday. (The problems involved would need to be discussed with the institutions concerned<sup>(2)</sup>.) As emphasised earlier, there would remain major uncertainties, however, at least in the early years, over the appropriate seasonal adjustment to be applied.

28. This would still compare unfavourably, on the face of it, with the overnight delay which is all that is involved in collecting figures for the monetary base. However, as explained in Section D above, the proposition that the base could provide worthwhile earlier information than at present was examined and found generally unconvincing. Only if it proved impossible to speed up the weekly figures in the fashion described in para.27 (or if the arguments advanced in Section D turned out to be incorrect in practice) would there be any advantage in concentrating on the figures for the base rather than for money.

29. The heart of the matter discussed in this Section, however, relates perhaps not to the speed with which information becomes

---

(1) Some of the problems and evidence of the volatility of the unadjusted data are discussed in Appendix 1.

(2) Not only those sampled might be affected if all banks and LDTs were required to observe a minimum cash ratio to deposits (see para.35 below). [Another major question, for internal debate, would be how far we could dispense with 'supporting' figures - eg. to produce asset counterparts - to help speed up the weekly figures.]

available, but to the speed of policy response by the authorities. The possibility is now explored of using either the weekly money or monetary base figures to ensure a faster response of interest rates, by exchanging some automatic adjustment process for the present discretionary control of MLR.

30. Before doing so, however, it is important to note that any advantages of such a change would have to be offset against at least two distinct possible losses. The first is that, in the process of making discretionary changes, the authorities can explicitly take account of a mass of information (eg. on the future course of the PSBR and of fiscal policy, on exchange market conditions, on funding policy, on the movement of other monetary aggregates and of capital market conditions) in a way that an automatic adjustment process could not. Further, unless a policy of a generally freely-floating exchange rate is pursued, an automatic trigger might exacerbate the authorities' problems; an inflow, taken into the reserves, which led to a rise in sterling M3, would trigger a rise in interest rates which might only encourage further inflows<sup>(1)</sup>.

31. Secondly, it must be recalled that the counterpart of the alleged lack of speed of interest-rate response in the present scheme is that the risk is low of acting when there is no need. Any automatic process, in seeking a faster response than at present, is almost bound to run an increased risk of precipitating action in response to what turns out to be a temporary and self-reversing monetary deviation. Any form of monetary control via interest rates must ensure an acceptable balance of these two risks.

(ii) How a scheme might work

32. The dangers of using weekly figures from a sample and to which a highly uncertain seasonal factor had to be applied could be mitigated by using a moving average of a number of weeks' figures.

---

(1) This is a corollary of the point made in paras.24-5 of Annex 2.



The same would be true of the monetary base. Appendix 1 shows the result of a study of the last 18 months' weekly money data and concludes that a four or five week moving average would adequately smooth the series under normal circumstances<sup>(1)</sup>.

33. Using such an average for weekly sterling M3 rather than for the base for the reasons set out in para.28, the question would then be how to set automatic trigger points so that an undesired movement of sterling M3 automatically set off a change in interest rates<sup>(2)</sup> that would bring sterling M3 back towards the desired growth path.

34. The setting of appropriate triggers could be a very simple or a highly complex process. The authorities would, as now, set a target growth range, with a mid-point of  $x\%$ <sup>(3)</sup> for sterling M3 over the coming year. Movements in the seasonally adjusted moving average of sterling M3 would be compared with the target range and triggers might, at their simplest, be set to affect interest rates when the annual rate of growth of sterling M3 diverged from  $x\%$  by, say, 1%. There might then be a second and third trigger at, say,  $(x \pm 2\%)$  and  $(x \pm 3\%)$ <sup>(4)</sup>. In a statistical sense, this is probably not an optimal response and Appendix 1 explores some more complex reactions.

35. With such a system would go a general cash requirement on banks (and, for the sake of comparability, on LDTs) to provide a datum point for open-market and other official operations in just the same way as the clearers'  $1\frac{1}{2}\%$  of ELs is used now. Indeed, no change to the datum point would be needed, if it were thought equitable for only the clearers to hold balances and if it were thought unnecessary to relate the datum point (the base, narrowly defined) as closely as possible to the target aggregate. However,

---

(1) Appendix 1 is not yet ready, but see Addendum 1.

(2) In practice, the authorities would favour retaining a measure of discretion in the system (see para.000 of the main paper) but analytically it is easier here to assume full automaticity.

(3) In the current target of 7-11% pa,  $x$  would, of course, be 9%.

(4) Thus, given the current target, short-term interest rates would be pushed up when the moving average of the weekly figures showed growth of over 10% and then again-if the annual rate rose to 11% and to 12%.

it seems wrong to preclude the possibility of the base providing some useful information, even if - as argued earlier - it is unlikely, and hence a requirement on all banks and LDTs appears preferable. Finally, it would also seem appropriate to think in terms of a lagged requirement - such that the deposits of one Wednesday gave rise to a reserve requirement for the week beginning eight days later<sup>(1)</sup>. This would tie in with the information lag described in para.27 above.

36. As explained earlier, the result of either current or lagged accounting is that the reserves required by any institution are effectively fixed on the requirement day and, therefore, the Bank of England has to provide the necessary reserves (at a price of its own choosing) if the requirements are to be met.

37. Of course, if the controlled institutions foresee a reserve shortage, they can individually try to make good the shortage by bidding for funds (and thus increasing their balances at the Bank) or by selling assets (so reducing their reserve needs). However, for the system as a whole, this has no effect on the supply of base, since, for example, the reserves gained by a bank selling an asset are matched by losses of reserves in the bank of the purchaser of the asset. With lagged accounting, that is the end of the story, unless the Bank of England provides additional reserves. With current accounting, the system can also adjust to a shortage through a reduction in the size of total liabilities (and thus in the required level of reserves) but even for a modest shortage of reserves, the total reduction necessary in the banks' aggregate assets will be large. The attempt to achieve such a reduction within a very short time could cause major disturbances in financial markets and to interest rates; and this, together with the fact that current accounting gives only a week's faster response than the lagged system described above (at the price of less certain information too), has

---

(1) Thus, for a make-up day on Wednesday, 10th October, the reserve requirement would begin on Thursday, 18th October, and run to Wednesday, 24th October. The requirement could apply on a daily basis or, as in the United States, permit averaging over the week.

led the authorities to favour a lagged accounting approach. The inevitable consequence would be a system which was automatic in the response of interest rates to monetary developments but in which the size of the response would have been pre-set by the authorities.

38. In determining the size of response, the authorities would need to bear in mind a number of points. Most importantly, perhaps, as with present discretionary interest rate changes in response to undesired movements in money, the authorities would not know that a particular excess (of base or of money) of  $x\%$  could be eliminated over some desired time period by a rise in rates of  $y\%$ . All they could know is that, by forcing the discount market to borrow persistently at rates higher than those ruling in the market when penalties were triggered, the financial system was being given a push back towards the desired level. They would also know that the steeper the graduation of penalties, the faster would be the adjustment within the system.

39. The case for limits of any kind, of course, is that markets cannot cope with total uncertainty and, in practice, the authorities consider that, at most, a 3% band around MLR could sensibly be the greatest range imposed on the system<sup>(1)</sup>. Such a penalty margin would provide a generally significant and rapid impetus for money to return to the desired path. Within this overall limit, there could, as pointed out earlier, be a number of triggers; 3 of 1% each might be a reasonable starting point. Deviations so large as to leave the system persistently operating towards one end of the range of official rates would suggest a need for MLR itself to be changed.

40. Beyond this, the Bank have considered a number of ways in which the authorities might operate. What follows is a description of the most promising approach, which is also illustrative of the main issues involved.

---

(1) This view could be revised as a consequence of actual experimentation.

41. Every Thursday, the Bank of England would announce the money figures for the Wednesday eight days earlier and/or the moving average (of four or five weeks) being used. They would then announce MLR<sup>(1)</sup>, as at present, together with any change triggered by the money figures. MLR plus or minus this change would be the "operative rate" for lending to the discount market in the week beginning the following Monday. The authorities would also announce the size of the Treasury bill tender for the following day (the Friday)<sup>(2)</sup>. It seems likely that tenders would have to be larger on average than at present, to help ensure adequate control over the size of the cash base. The authorities would wish the present arrangement, whereby the discount market undertake to "cover the tender", to be maintained.

42. When the money markets were short of cash, there would be no changes to the Bank's existing practices, except that any lending to the discount market would be at the operative rate rather than at MLR. If a desired shortage did not materialise (because, for example, Government expenditure was unexpectedly buoyant), open market operations would be needed to reduce the cash base and thus to bring pressure on controlled institutions' cash balances. The aim would be to force them to withdraw call money from the discount market to meet their requirements and thus to force the market to borrow from the Bank; in this way, the operative rate would come to influence market rates.

43. To ensure adequate flexibility for the authorities, it might be necessary for the Bank to undertake transactions in Treasury bills at more volatile rates of interest than at present. In particular, it might be necessary to sell Treasury bills of very short (one or two days') maturity at rates reflecting the current operative rate. Such a procedure would encourage the development of a market in such bills and generally the rate on these bills would

---

(1) MLR would need to be changed, as noted in para.40, whenever either the upward or downward triggers had been in operation for sometime without pulling back the growth of money to the desired level.

(2) Currently the size of the tender is announced a week in advance.

be close to overnight interest rates. Alternatively, experience might suggest that it was necessary for the Bank to take deposits at the short-end of the inter-bank market, to mop up cash in the system, with the object of maintaining short-term interest rates reasonably close to the operative rate. Calls for Special Deposits could be made to mop up persistent cash surpluses.

44. The discount houses' portfolios are largely financed out of overnight money, in circumstances of neutral expectations. The operative rate for the following week is, therefore, likely to affect the houses' bids each Friday at the Treasury bill tender. However, the effect of, say, a rise in the operative rate on three month rates will be muted if there is a general expectation that the money figures will shortly return to the desired path and then that the operative rate will tend to fall back towards MLR in the ensuing weeks. In other words, as at present, market sentiment will largely determine the term structure of short-term interest rates. Banks' base rates might, therefore, be expected to vary less closely with the operative rate than they do at present with MLR.

45. [The effect of the above on the gilt-edged market: to be drafted.]

It becomes a more attractive outlet for short-term investable funds than a time deposit or CD; and, in the context of direct controls, the effect on money is often, and correctly, described as 'cosmetic'. Nevertheless, there have been suggestions that interest-rate relativities could be altered, and disintermediation/reintermediation made to occur, without the need for corset-type controls. If such a means could be found, then it might be possible to arrange that deviations of monetary growth from target showed up initially as 'natural' variations in the volume of short-term securities held by the public, rather than as variations in M3; and this might (but might not) help to avoid the development of exaggerated market expectations of a change in interest rates, and the difficulties arising therefrom.

46. For this to happen under the approaches described in Sections 3 and 4 above, the reasoning might run as follows:

F. Effect on short-term debt markets

(i) The issue in question

46. Sections D and E of this paper have examined the feasibility of restructuring the cash base of the banking system so as to provide the authorities, whether acting discretionarily or 'automatically', with a means of adjusting short-term interest rates more promptly. This is indeed the main purpose of this type of 'base control', as seen by its advocates. But it is not the only purpose; and this section considers a second one which is often argued: namely, the creation and use of wider markets in short-term debt instruments of the public and private sectors, to the end of better short-term control, through disintermediation when official policy tightens, of the recorded sterling M3 or M3 figures.

47. Section C of this paper and paras.17-20 of the main paper have examined the processes of 'disintermediation' under direct quantitative controls. In simple terms, these encourage a movement of short-term paper into non-bank hands in substitution for bank deposits. This occurs through an alteration in relative interest rates, provoked by the controls whereby, for instance, a prime commercial bill becomes a more attractive outlet for short-term investable funds than a time deposit or CD; and, in the context of direct controls, the effect on money is often, and correctly, described as 'cosmetic'. Nevertheless, there have been suggestions that interest-rate relativities could be altered, and disintermediation/reintermediation made to occur, without the need for corset-type controls. If such a means could be found, then it might be possible to arrange that deviations of monetary growth from target showed up initially as 'natural' variations in the volume of short-term securities held by the public, rather than as variations in EM3; and this might (but might not) help to avoid the development of exaggerated market expectations of a change in interest rates, and the difficulties arising therefrom.

48. For this to happen under the approaches described in Sections D and E above, the reasoning might run as follows:

- (1) The discount market, together with other parts of the banking system that customarily hold large portfolios of marketable short-term securities, will know that the authorities will respond in a certain way if the money stock (monetary base) deviates in a defined manner from a known desired path. Such deviations would be observable and, accordingly, official behaviour in the money market will be predictable in respect of interest rate alterations.
- (2) The discount market (and banks) will, in effect, respond to knowledge that money (the base) is growing too fast by selling short-term securities. The yield on such securities will then rise a little, relative to that on bank deposits and CDs, and disintermediation will occur; or vice versa if the base has been observed to grow too slowly. The general level of interest rates will have changed little while the deviation to sterling M3 will have been corrected, albeit in a cosmetic fashion.

49. What actually happened could be very different:

- (1) The discount houses (and banks) will observe the monetary base rising too fast and will know that this heralds an increase in short-term interest rates. They will also know that the increase might well be quite sizeable, because the official purpose is the control of the underlying growth of £M3, which everybody knows is not to be achieved merely by small changes in rates.
- (2) It will also be the case that the expectation of higher rates cannot be confined to discount houses and banks. It will instead be shared among virtually all operators and investors in the money markets. At that point, all investors will wish to sell short-term securities, including negotiable CDs, and get into overnight money until the expected rise in rates has occurred. Simultaneously, banks will try to borrow longer and attempt to issue more CDs before rates rise. This collective behaviour will itself bring about the expected rise in rates and ordinary dealings will recommence

at the new level. Nothing discernible will have happened in this process to alter relative interest rates between, for example, negotiable CDs and Treasury bills of comparable maturity and no 'disintermediation' will have occurred.

(ii) An example under the present system

50. On Thursday, 24th November 1977, MLR was raised to 7% from 5%. This followed a period in which domestic rates had been driven down by external inflows and the money supply had begun to rise too rapidly in relation to the published target. It also followed a period of some two years during which non-bank holdings of Treasury Bills had become significant. Over the ensuing few days, the rise in MLR to 7% was thought by some operators in the money market to be inadequate to achieve the required correction in monetary growth; and, because of the readiness with which the Rate had been raised in the first place, this, in turn, aroused an expectation that it would soon be raised once more. In a matter almost of minutes, on the following Wednesday morning, this expectation took such hold that Treasury Bills, commercial bills, CDs and other short-term securities were aggressively offered for sale by banks and non-banks alike. The discount houses, as an important element in the secondary market in such paper, retreated straightaway, with the result that an altogether higher level of rates (consistent with an 8% MLR) was at once quoted by them. A subsequent statement by the Bank, reiterating the adequacy of a 7% MLR, then caused rates to fall back to where they had started.

51. The above episode sheds some light on what can happen in the money market when an expectation gains ground that is itself founded upon a very firm prediction of official behaviour (even though erroneous in that particular case). Much more familiar is the more gradual process whereby an expectation slowly gains ground in more 'two-way' conditions. Some of the discount houses may then, if rising rates are thought likely, endeavour to shorten their books. This may take the form of outright sales of assets, notably short-dated gilt-edged. It will also show itself as a reluctance to take up fresh short-term paper in replacement of maturing Treasury bills, local authority bills, commercial bills, CDs and local



SECRET

- 20 -

authority bonds. At the same time, some of the banks will allow their holdings of such paper to run off and will endeavour to employ the proceeds at call, while also endeavouring to raise more 3-month money in substitution for shorter deposits. In addition, some non-bank investors will look for higher yields on newly acquired liquid assets. In response to all these pressures, the whole level of rates will move up in an orderly manner in two-way markets, provided that the balance of expectations points in that direction. In the process, and depending haphazardly on the distribution of expectations within and outside the banking system, short-term securities may move either into or out of that system, but without the pattern of relative rates altering in any particular way.

52. In the absence of direct controls, the pattern of relative rates under the present system mainly reflects differences of liquidity and credit risk between short-term securities of similar term. But it can occasionally reflect also a condition of relative plenty or scarcity. For example, if a growing money supply is associated with large governmental borrowing and a depressed state of private sector loan demand, the banking system will tend to become very liquid. Banks will then not wish to acquire additional Treasury bills if their counterpart has to be additional 3-month wholesale money, for the latter normally costs more than can be earned on a Treasury bill. They may instead buy higher-yielding gilt-edged which, if supplied by the authorities, will eliminate the unwanted supply of Treasury bills. But if, because of adverse expectations, intermediation into gilts is not attractive, the banks will simply reduce their wholesale money rates somewhat and cease intermediation at the margin. The unwanted supply of Treasury bills will then flow into non-bank hands. This has happened on various occasions over the past decade, helped by the marketing skills of the discount houses. But it bears little resemblance to the processes required for short-run control of sterling M3. For this can hardly be expected to be achieved by, for example, deliberately rendering the

banking system over-liquid when sterling M3 is rising too fast<sup>(1)</sup>.

53. It has to be concluded that the evidence in favour of the hypothesis that base control of the type discussed in D and E above would produce favourable dis/reintermediation, except occasionally and by chance, is weak. To succeed in this, the control would need to create an expectation that a small but significant change in interest rate relativities was going to occur, and nothing much else. But control of the money supply, except in a very transitory sense, in fact requires periodic substantial alteration in the level of interest rates. The markets know this, and their expectations are formed accordingly; the processes whereby such expectations become translated into a change in the level of rates are likely to be neutral in their effect on relativities.

---

(1) In this general context, it is sometimes suggested that a wider market in Treasury bills would grow up if their special attractiveness to the banks were reduced through abolition of the reserve asset ratio. This is discussed in Annex 2, para.16 Even if, nonetheless, a wider market for bills did grow up, there is little evidence, on the examples cited, to suppose that interest rates relativities could then be purposively changed in the right way and at the right time.

Annex 3: Addendum

In paragraph 32 of Section E of Annex 3 it is stated that work presented in Appendix 1 to that Annex would show that "a four or five-week moving average would adequately smooth the weekly monetary series under normal circumstances". The technical work which will be used as the basis of Appendix 1 has been done, but it has not yet been written up in a draft form suitable for the Consultative Document. In the meantime, in order to provide an indication of how this moving average series behaves, a chart showing the path of a five-week moving average from the end of 1978 through 1979 to date is appended (Charts 1a &

As the text states, in paragraphs 33 and 34, the fluctuations in this moving average series might trigger off automatic changes in interest rates. One such automatic trigger could be the movement of the series above or below the desired target in the rate of growth by a given percentage. Such a set of triggers is indicated on the chart by a series of parallel lines, one and two per cent above and below the target rate of growth.

Examination of the chart, therefore, indicates when the authorities might have varied interest rates, on this automatic fashion during the course of the last year and a half.

To show how the application of a moving average has smoothed the data, the individual seasonally adjusted figures are shown on Charts 2a & b.

Chart 1(a)

Seasonally adjusted level of weekly sterling M<sub>3</sub>

Centred five-week moving average filter.

£ billion

52 —

50 —

48 —

46 —

44 —

+2%  
+1%  
-1%  
-2%

MLR (Per cent) — 15

— 10  
— 5

Week	42	46	50	3	8	12	16	20	25
	18	15	13	17	21	21	18	16	20
	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May	Jun.
	1978					1979			

Chart 1(b)

Seasonally adjusted level of weekly sterling M<sub>3</sub>

Centred five-week moving average filter.

£ billion

58 —

56 —

54 —

52 —

50 —

48 —

—

—

+2%

+1%

—

-1%

-2%

—

—

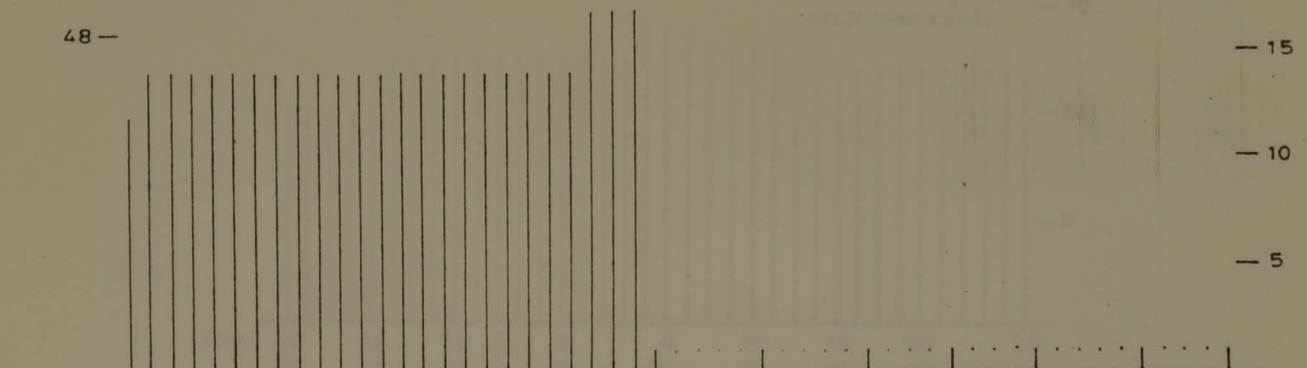
20

15

10

5

MLR (Per cent)



Week	25	29	33	38	42	47	50	3	8	12	16	21	25
	20	18	15	19	17	21	12	16	20	19	16	21	18
	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May	Jun.
	1979							1980					

Chart 2(a)

Seasonally adjusted level of weekly sterling M<sub>3</sub>.

No moving average filter applied.

£ billion

52—

50—

48—

46—

44—

—

+2%

+1%

-1%

-2%

—

MLR (Per cent)

— 15

— 10

— 5

Week 42	46	50	3	8	12	16	20	25
18	15	13	17	21	21	18	16	20
Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May.	Jun.
1978						1979		

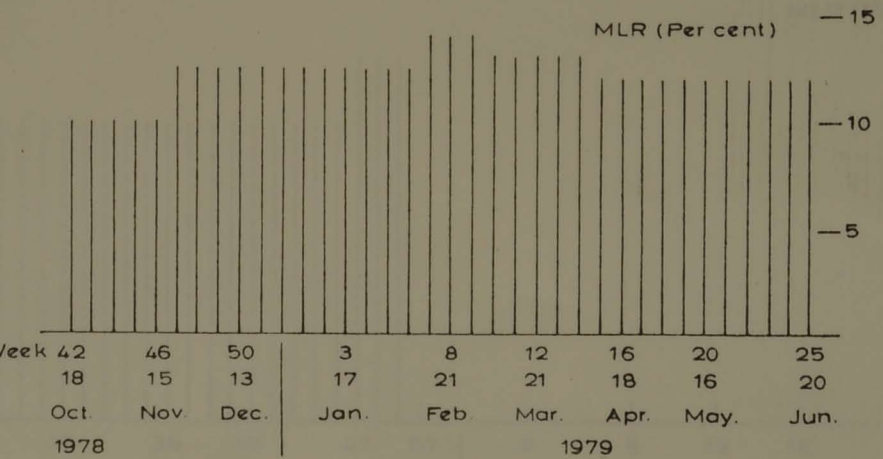
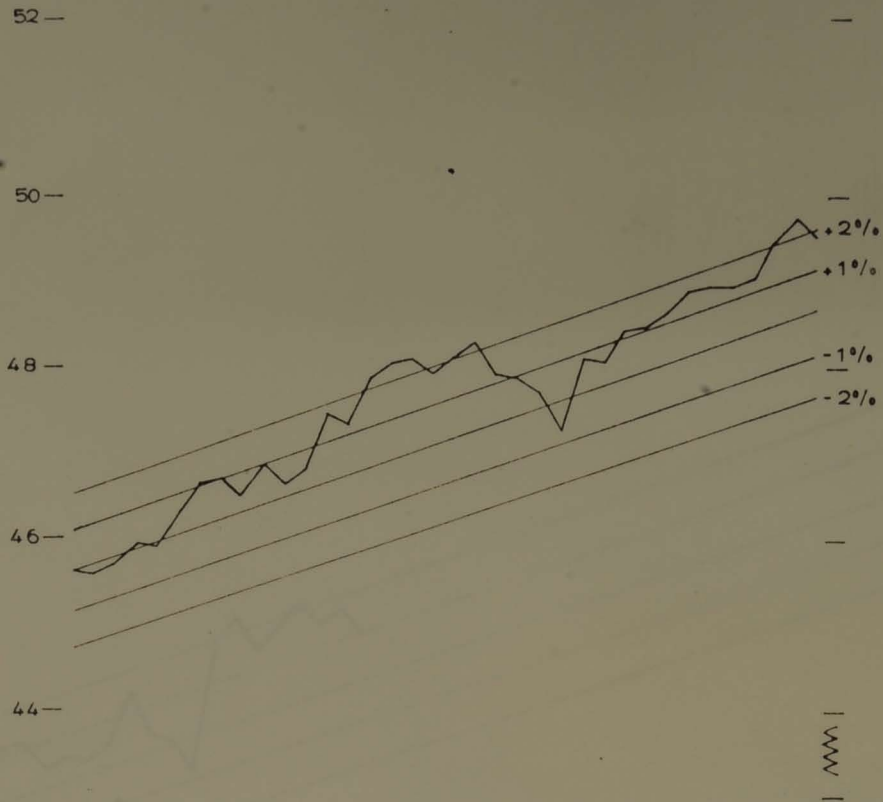


Chart 2(b)

Seasonally adjusted level of weekly sterling M<sub>3</sub>

No moving average filter applied

£ billion

60 —

58 —

56 —

54 —

52 —

50 —

48 —

—

—

—

—

—

—

— 15

— 10

— 5



MLR (Per cent)

— 15

— 10

— 5

— 25

— 18

— 18

— 18

— 18

— 18

— 18

— 18

— 18

Week	25	29	33	38	42	47	50	3	8	12	16	21	25
	20	18	15	19	17	21	12	16	20	19	16	21	18
	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May.	Jun.
	1979										1980		



For Governor's Mtg  
THURS 13/12 12.12.79(U)  
4.00-6.00

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.

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



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).

*S.F.*

12th December 1979

14.12.79

Extract from Deputy Governor's note for record  
on "The Governor's conversation with Sir Douglas  
Wass.

6. Monetary control

The Governor said that he had started discussions here on an early draft of the proposed consultation paper. This raised many difficult problems, not least in that it led into so many related questions - e.g., EMS. He thought that a programme for our discussions would be helpful and Wass welcomed this. It was agreed that JSFf and Littler might work out such a timetable which should provide for talks at the Governor/Wass level before Ministers were brought in. The next step would, in Wass' view, be to take the matter with the Financial Secretary and the Chancellor together. It was noted that the papers were a long way from being in a form suitable for the Prime Minister. Wass noted that the Prime Minister and the Chancellor were continually pressing for progress and made it clear, in answer to a question, that it was the Bank that was seen to be responsible for the absence of faster progress, this being our particular area of responsibility. Wass also said that he had a feeling that we had not yet found the right solution in this area. He was not all that keen on a monetary base control feeling that it would raise as many problems as it solved; for instance it might create institutional problems and would not avoid the facing of problems in the interest rate and fiscal areas. The Governor mentioned the EMS on which Wass said that the Prime Minister had recently seemed to be moving against this. One of his own worries was about the possibility, if any method of rationing credit other than by price was adopted, that we should drive a substantial volume of business offshore. He remained not at all sure that the monetary base was the line to pursue. The Governor said we hoped to get a draft consultative paper to the Treasury before Christmas and would look for talks at the Wass level early in January.

7. Iran

There was a brief mention of the problems here with Wass commenting that the Prime Minister's sympathy had been much eroded by the New York District Court action. The Governor voiced a warning that if anything happened in this context to disrupt severely we should have a major crisis on our hands.

14th December 1979.

*Wass*

# Singer & Friedlander

Feb. 1980 interview.

Not much to add to  
Comments given in November  
interview.

Sterling margins still poor,  
in order of  $3/4\%$ . For the  
medium-term risk there is a  
continuing erosion although for  
the prime rates a bottom limit  
seems to have been reached.

NOTE OF INTERVIEW

J. Henry Schroder Wagg & Co. Ltd.

Solandt and Morris called on 12 December to see WPC for a prudential interview. JBCA and CBV sat in.

We looked initially at their deposit base and the recent growth in bank deposits. Solandt explained that this trend did not reflect any particular thrust by the bank but was a result of their foreign exchange jobbing activities between large banks which had been built up by their chief dealer. The bulk of the deposits were offered funds with SW entering the market as bidders only when they saw interest arbitrage situations. Having said that, however, Solandt realises that SW need to improve their non-bank base and to this end they have established a corporate desk. The desk will actively seek commercial deposits and also corporate foreign exchange business.

On the lending side Solandt confirmed that they had had some success in increasing their sterling lending - part was protective borrowing prior to the rise in MLR, and part was for working capital purposes. There was in general no unwillingness to borrow even at current rates.

Solandt gave the following details of their margins on sterling LIBOR related loans to prime borrowers:-

3 months bills	1/2%
3 months cash	no business except in bridging circumstances when 1/2% would be made
6 months bills	1/2% for really prime borrowers otherwise 3/4%
6 months cash	3/4%
12 month facility	5/8% very exceptionally otherwise 3/4%
5-7 years	5/8-3/4% although they might structure a 7 year loan in two parts i.e. first four years at 5/8% and thereafter at 3/4%

Seven year business does not hold any attractions for them and they only contemplate it from time-to-time in order to maintain a good customer relationship.

We looked at their contingent liabilities taking first their guarantees. Solandt said that the total of £15.5 mn. included a rag bag of items with no single large component. Some of the guarantees related to performance bonds but SW do not undertake much of this business and then only when ECGD, or really good names are involved. We then discussed the size of their acceptance business which WPC commented was still within the range we liked in relation to shareholders' funds. Solandt asked whether there was any justification for having a separate measure of acceptances to shareholders' funds which currently limited acceptance business within a 4:1 ceiling. He felt that if we had conceded in the risk assets ratio, through a 5% coefficient, that acceptances were not particularly high risk, there was no reason why a bank should not increase this business within the confines of maintaining an acceptable risk assets ratio. WPC said that we needed to be

MR. GEORGE

Copy to: Mr. Latter

6.1 (see 21.12.79)

Limited Recourse Certificates of Deposit

Please refer to ALC's note and the proposals for this new instrument by Warburgs and Marshalls.

A number of ideas of this family have been voiced in recent months - most of them, it is fair to say, nothing like so specific nor so worked out in detail. They all owe their origin to the increasing use LAs are making of syndicated floating-rate medium-term loans from banks, in order to lengthen the majority of their borrowing in line with the Voluntary Code without having to turn to stock and bond issues, which, for various reasons, (e.g. the fact that they are registered, and their cost) they find less attractive. The aim of all the suggestions is in some way to establish a secondary market for syndicated bank loans taken by LAs, or for the (unquoted) bonds which LAs issue to banks as security for such loans, thereby reducing the cost of the loans.

I am sympathetic, in principle, to these ideas, but nervous about giving them the green light without knowing very much more about the syndicated lending that underlies them and about the potential ramifications of wider marketability. When the idea of wider marketability was pressed by the LA representatives at the LABC last month, I suggested that a working group should look at the whole question, and this has been agreed. The questions that I think this group will need to address, besides basic fact-finding on the extent of LA syndicated borrowing, are:


- (i) the need for such unquoted bond issues to be brought within COBO for timing purposes (arguably their impact on capital markets is substantively the same as that of quoted bonds, which fall under COBO);
- (ii) the danger of a dual market developing in quoted and unquoted bonds, which the present arrangements for negotiable bonds were specifically designed to avoid;

- (iii) the monetary implications of increasing the attraction to LAs of bank borrowing; and
- (iv) the extent to which there is in fact the potential for a genuine market in unquoted bonds (and how far this would be in practice confined to the banks).

LRCs seem to me a member of this family of ideas and thus raise much the same sorts of questions\* (plus the concern ALC raises at the use of the name "CD"). I would, therefore, be reluctant to see Warburgs proceed until the LABC has sorted out its ideas on the subject over the next few months. This is one reason for asking them to hold off temporarily. Another is the implications you indicate their idea has for the integrity of the corset at a time when we are not allowing banks themselves to issue floating-rate medium-term notes. On both these scores I think we have to ask Warburgs to put the idea on ice for the time being.

We can perhaps best do this by talking to them. They asked for a meeting and I would be happy to see them, if that would be helpful.

It would be helpful also to have any comments ARL may have on the proposed treatment of LRCs under the corset and in relation to reserve ratios (page 3 of the paper).

  
17 December 1979.

Ian Plenderleith (4491)

---

\*In particular, I am not at all clear who would be the (unidentified) "secondary market purchasers" referred to in Warburgs' paper, other than the underwriters standing ready to buy in paper at the support price.



THE GOVERNORS

Copies to: Mr.Fforde  
Mr.McMahon  
The Chief Cashier  
Mr.Goodhart  
Mr.Coleby ✓  
Mr.George  
Mr.Quinn  
Mr.FootMONETARY CONTROL

1. It might be helpful to make two broad preliminary comments on the papers circulated on 12.12.79.
2. The first question concerns the general tone, style and status of the paper. Is it a Bank paper, or a Treasury/Bank paper, or a Governmental paper? Should it make recommendations, and how firmly?
3. Is there not a great question whether it can be a Treasury/Bank or Bank/Treasury paper - whatever that really means? Ministers are involved - must it not really be a paper sponsored by the Government? In this case, what the Bank recommends that the Government should put to the public in the paper has to be distinguished from the advice the Bank gives to the Government in private about the substance, i.e. future methods of monetary control.
4. On the latter question my general impression is that the Bank could devise a workable system that goes some way (I am being intentionally vague) in the direction of automaticity, and try to work it - provided that Ministers, on reflection, want to go in this direction. I am not sure we need to be more definite than this until Ministers have had time to consider the questions (which they have not, as yet). This implies a degree of caution in making recommendations to Ministers on the substance.
5. This would in turn have implications for what the Bank advised regarding public presentation at this stage. The paper would not be produced if Ministers were not attracted in general by this approach. On the other hand, it is plainly a difficult and technical subject. I suspect that public reaction is difficult to predict.

SECRET

- 2 -

Also, Ministers are unlikely immediately to be clear in their own minds about the issues, and public discussion after publication of the document will in fact help them to become so.

6. From this it would follow that the document should give the proposals a favourable run, but should ultimately be non-committal. This applies to the Government's stance. For the Bank, we would be doubly non-committed, since it would not be a Bank paper. The Bank would in effect take the posture of a willing servant - willing enough if the technical details are right, but leaving the choice to the Government.

7. This might well imply some changes in the drafting of the paper which perhaps inevitably at this stage is drafted somewhat as if it were going to be a report by officials.

8. The second of my main questions is that more needs to be said about international implications in general, and EMS in particular. This range of discussion seems, on first reading, not to be fully dealt with - but really needs to be faced and given reasonably full discussion.

9. I have tried very hastily to put down some first thoughts on some of the points that might figure. Since they are first thoughts, I have treated them as an annex to this note.

10. I think the implications are that the UK's membership of EMS could be left as an open question. This would seem to me right and defensible - it would require a separate paper to discuss the pro's and con's of UK membership - another large question. But discussion of these questions would be very relevant to a decision on that question. A discussion might also raise questions which other members of EMS should think about - and, perhaps, that the UK should seek to discuss with them if we contemplate membership.

17th December 1979.

Written by Mr. Dow and typed  
in his absence.

ANNEX. INTERNATIONAL IMPLICATIONS OF  
UK MONETARY POLICY

1. Most of the problems arise irrespective of the precise method of monetary control. They arise as a consequence of the UK following a monetary policy dictated by an internal goal - namely the rate of increase on money. Any such conflicts of policy are only sharpened by adopting more automaticity.
2. Such conflicts can arise in the following way. If money expands too fast we have to raise interest rates. If we raise them above those in other countries, this encourages "pressure for inflows" which, with free floating, drive the exchange rate up (progressively so long as the interest rate discrepancy persists). Or, with a fixed rate, the pressure results in actual inflows (and reserve gains) and a continuing expansion of the money supply.
3. The abolition of exchange controls increases this conflict, i.e. increases the degree of integration of the UK into international money/capital markets.
4. In the extreme, it becomes impossible for the UK to have interest rates different from elsewhere. It follows that it becomes impossible for us to have a monetary policy different from the "world average" monetary policy. An attempt to do so has only one result - indefinite appreciation (or depreciation) of the exchange rate.
5. This may not result in actual conflict. Other countries may want to follow monetary policies which dictate a level of interest rates in the UK very much what we would like for domestic reasons.
6. This must mean that all countries are very much concerned with the monetary policies of other countries.
7. They may be more involved than is generally appreciated. At the moment they tend to act as if they could determine events, each by itself. Their object nowadays tends to be that of having tight policies to defeat inflation. If this results in raising the exchange rates, so much the better. But collectively, this cannot of course happen. The results are (a) a general tendency to competitive tightening of policy, (b) a certain amount of untidiness, and erratic exchange rate behaviour, due to lack of co-ordination.

SECRET

- 2 -

8. For the EMS countries this is presumably kept within some limits by the limited commitment to fixed exchange rates. Might not one implication be that we could afford to join EMS, and might gain? Another implication is that monetary policy and exchange rate policy are becoming very much parts of the same animal - and that for EMS to work well consultation over monetary policies by EMS countries needs to be strengthened?

9. As I say, all these questions seem to arise whether or not we go in for base-money control in some form. The logic seems to be that we cannot follow a monetary target couched solely in domestic terms, e.g. M3. I think (without being quite sure) that there would be much less conflict, and perhaps no conflict, if we (and other countries) followed DCE targets (or would this only be true if all countries' DCE targets were reasonably "harmonious", i.e. do we need to consult with other countries to try to ensure that this is the case? How far is it useful to do this only in an EMS context - aside from the US?).

10. "Automacity" has I think to go with an M1 or M3 aim. The implication might then be that it would have to be "overridden" on occasions when M3 and DCE diverged?

11. The above are, I fear, more in the nature of questions than answers. But, scanty as it is, the above also suggests that there are basic questions difficult to avoid or skirt around, but also difficult for the Government to air, since they raise questions about the ultimate tenability of the present form of monetary targets. Perhaps however a way of presenting the issue could be found, e.g. by discussing the kind of world which we would hope to see that would facilitate monetary policy in the UK.

17th December 1979.

19.12.79

MR.FFORDE

Copies to: Mr.McMahon  
Mr.Dow  
The Chief Cashier  
Mr.Goodhart  
Mr.Coleby  
Mr.George  
Mr.Foot  
G.P.S.

2/12

MONETARY CONTROL

See 12.12.79

Having read the papers and listened to the arguments I do not find it easy to arrive at a view on how our proposal would be received by commentators if it were to form the main change in the consultative document. This is not to criticise the analysis which is impressive and far beyond anything the press will have seen, let alone written about. However, as I understand it, the argument turns importantly on how financial markets might interpret and react to changes in specified short-term interest rates triggered by movements in the selected aggregate; and if they have read the annex on the choice of aggregate they may be as puzzled and perplexed as me about how they should respond. Any such confusion would be compounded no end if seasonal adjustment problems or other technical difficulties affecting the weekly figures should emerge at an early stage of the game. Recent occasional episodes notwithstanding, the markets have been cast in a supporting role in London for so long they may find it very difficult to accept the lead. Perhaps this is what the consultative process is intended to reveal; but I would not be surprised to see a very mixed and uncertain press reporting of market views.

As for the pundits, the verdict may be mixed for different reasons. The monetary base purists, represented by the Banker, may complain about a side-step, particularly if no changes are to be contemplated in funding techniques. Disappointment on this latter score is likely to be expressed by the Financial Times, while Anthony Harris and, less predictably, Sam Brittan will also criticise the choice of trigger aggregate - whatever it might be. Since they do not have a known position it is more difficult to forecast the attitudes of the Guardian, Daily Telegraph or Economist; nor are the Sundays' preferences known. Broadly, I suppose the Guardian,

Observer and Sunday Times would oppose automaticity, and the two Telegraphs welcome it. The Economist might dodge and join the complainers about funding. Of course, the press may also expect to participate in some sense in the consultative process, and this is something to which some thought will have to be given before the document is issued.

One point which strikes me is that the great weight of our deliberations in the Bank so far has been on the technical aspects of any changes in the system of controls. I wonder whether we ought not to be standing back a pace and asking much broader questions in the same general category as the EMS issue. Mightn't we be concentrating on devising a system equipped to handle particular pressures that may anyway ease substantially well within the next decade and be replaced by others? For example, might not the fiscal/monetary policy imbalance disappear under the influence of North Sea oil revenues in the next five years? What would this imply for private sector credit demands and financial markets generally? If this or a subsequent Government should adopt protectionist policies - not a remote possibility in my view, - have we an idea how the financial system would be affected? Will large OPEC surpluses and no exchange controls bring different effects for UK financial markets from those which we saw after 1974?

The obvious retort to such questions is that they require that we should foresee the unforeseeable; and that one can only operate on the basis of existing policies. However, much of the criticism which the Bank has attracted on the consequences of Competition and Credit Control has been of precisely this nature - our failure to recognise the risks that a change in the financial structure would bring if this should be followed by a change in policy.

One particular criticism arising from that change sticks with me and may be worth recalling, namely that the Bank failed to appreciate that even a market-oriented Conservative Government would balk at raising interest rates to the levels needed to clear the credit market. Almost all the signs point the other way at present. Nevertheless there are also signs that rising interest rates are not

accepted with equanimity; and that there is a desire on the part of some Ministers to "get hold of the banks". Neither of these suggests that a scheme offering interest rate automaticity will suit all ministerial appetites; but it might commend itself to us for precisely the same reasons.

Brian Quinn (3030),  
Administration Department.

19th December 1979.

*Restricted Circ.*

Mr. George

SECRET

*DHS 24/12*  
*14.1.80*

BANK OF ENGLAND  
LONDON EC2R 8AH

20th December 1979

*see 4.1.80*

*14.1.80*

(Dear Geoff)

Draft Consultative Paper on Monetary Control

With the agreement of the Governor, I now enclose five copies of the completed draft. It consists of a main paper accompanied by three annexes with appropriate appendices. Unlike the others, Annex 3 does not yet contain the 'Summary and Conclusions' which it clearly needs. We will repair this omission as soon as we can.

I think there are four additional comments to be made at this stage:-

- (i) Our exposition of the vital point about whether or not the Bank could or should refuse outright to provide all the cash needed to meet a mandatory requirement is still in process of evolution. The current version occurs in para. 38 of the main paper and in relevant paragraphs in Annex 3. We think that we have nearly got it right but will clearly want to go on refining it during the weeks before publication.
- (ii) The prior questions of exchange rate policy, and of full UK membership of the EMS, continue to loom rather large over the whole text. Some of us are inclined to think that it will suffice for the issues to be exposed and left open. But others worry lest the prospect of full entry into the EMS over the next year or two would make the consultative process seem somewhat academic to the bankers and others involved. Furthermore, the text has relatively little to say about how monetary policy would be targeted and conducted if sterling became linked to the other EMS currencies. We are accordingly looking over the ground covered in 1978 on this matter and will be drafting a fresh paper about it early in the new year.
- (iii) In discussions here of an earlier draft text, it was felt that the subject of funding through the gilt-edged market was rather conspicuously absent. Para. 16 of the main paper now attempts to meet this problem frontally. But the issue remains.

*DHS 24/12*



(iv) It is suggested in the main paper, and elaborated in Annex 3, that an appropriate degree of automaticity in the rate of interest at which the Bank supplies cash to the system could be arranged by linking that rate to a moving average of weekly money supply figures rather than to a moving average of the monetary base. Either way, the weekly money figures would come to acquire considerably greater operational significance; and we ought not to run away with the idea either that these statistics are yet in a fit state to come to the centre of the operational stage or that it will be plain sailing getting them to a fit state. Indeed this matter could prove to be a very important part of the consultations, if we wanted to proceed in the way suggested. The statistical side here are expressing concern about this and it is right that I should pass on this concern to you.

We will look forward to discussing the text with the Treasury after Christmas.

(Yours sincerely,

JOHN FFORDE)

J.G.Littler, Esq.  
(H.M.Treasury,  
Parliament Street, SW1P 3AG.)

THE GOVERNORS  
(3 COPIES)

MR.DOW  
MR.FFORDE  
MR.McMAHON

THE CHIEF CASHIER  
MR.WALKER  
MR.W.P.COOKE  
MR.QUINN  
MR.COLEBY  
MR.GEORGE  
MR.DICKS-MIREAUX  
MR.GOODHART  
MR.ATKINSON/MR.KENTFIELD  
MR.HOLLAND  
MR.J.FLEMMING (ON ARRIVAL)  
MR.HOTSON

The Consultative Document on Monetary Control

At Mr.Fforde's request, I attach numbered copies of the draft of this document, copies of which were sent to HMT, by Mr.Fforde, this morning.

Economic Intelligence Department,  
Monetary Policy Group,  
20th December 1979.

M.D.K.W.Foot (4315)

21-9 80/12

CONFIDENTIAL

MONETARY CONTROL

1. This paper first sets out the views of H.M.Treasury and of the Bank of England on the aims - and limitations - of monetary policy and explains the nature of the monetary control they are seeking to achieve. It then describes some of the practical difficulties that have arisen in operating such control and discusses - as a basis for wider consultation - some possible modifications in technique.

THE AIMS OF MONETARY POLICY

2. The official approach to monetary policy rests on the conviction - derived as much from practical observation and experience of economic management, as from any particular theoretical consideration

(i) that control of inflation is necessary for the achievement of the wider goals of economic policy; and

(ii) that monetary control - which is better defined as control over the trend rate of monetary growth since nominal interest rates in an inflationary environment provide only a highly uncertain guide to monetary conditions - is necessary to control inflation.

3. The relationship between monetary conditions and the rate of inflation is complex. In the short run it seems clear that inflationary pressures can be aggravated by external factors, such as a rise in import prices, including energy prices, or by wage and salary increases in excess of the increase in labour productivity, that may not be directly attributable to the domestic monetary situation. Even in the longer term, weaknesses on the supply side of the economy, when set against strong aspirations for higher living standards, can engender a lasting inflationary bias. But while monetary developments do not, accordingly, provide a total explanation of inflation, persistent monetary growth in excess of the productive capacity of the economy will tend to encourage inflationary pressures. Conversely, inflation will tend to moderate over time if the trend rate of monetary growth is held persistently below the expected rate of growth of nominal incomes.

4. The use of monetary control to bring down the longer-term rate of inflation cannot be a painless process. If, within a given restrictive rate of monetary growth, rapid cost inflation continues in the shorter term, then the burden of adjustment will necessarily fall initially on the volume of production, with damaging consequences for employment and investment. The possibility of these heavy costs is not under-estimated. But they are seen as the price that may have to be paid to bring inflation under control.

5. The process of adjustment can be easier if the longer term purpose of monetary control is clearly understood, and if there is conviction that it can and will be carried through. Then, expectations about the future rate of inflation would tend to abate, creating a climate in which more of the necessary accommodation to the rate of monetary growth could be achieved through an earlier fall in the inflation rate, leaving correspondingly more room for sustained real economic activity.