

MR. PFORDE

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I have had a shot at trying to set down the degree of disagreement or agreement between us on monetary policy, on the basis of the two meetings that we have held on the subject. Needless to say this is a rather difficult task and the attached should be regarded very much as a first draft. I should be grateful, however, for comments from all concerned on ways in which it could be improved. When I have these I shall circulate another draft and we shall see whether it will be appropriate to have another meeting.

I have not touched on methods and instruments of selling stock because I think that is better dealt with under a separate head and indeed as far as indexation is concerned is being tackled separately.

I have tried to say something about our views on EMS in relation to monetary policy. But whether what I have said there is adequate or not we shall I think have to consider separately and in its own right the question of joining the EMS. I am circulating a separate note on this.

Cwm

25th January 1980

Towards a Bank view on monetary policy

1. We take as our starting point that the thrust of monetary policy is properly measured in terms of movements of monetary quantities rather than in movements of interest rates. In this context, it is useful to distinguish between the value of such movements as information on both how policy, and the economy, are developing and likely to develop; and the value of such movements as instrumental policy tools to influence - either directly through economic relations or expectationally - inflation and activity.
2. As far as information about what is happening goes we should all wish to take account of the movement in a number of series ranging at least from M1 to say M5. There is, however, little disposition to wish publicly to target more than one series. There are the familiar dangers that commentators will always fasten on the one which is doing the worst; that implicitly or explicitly the authorities will gradually be forced to indicate a degree of priority between the aggregates; and there is the particular point that some forms of control - eg monetary base control - necessarily imply choosing one aggregate.
3. We all, however, see strong force in Goodhart's Law: ie that the act of publicly controlling one particular aggregate tends over time to decrease the value of that aggregate both as an indicator and as an instrumental variable. This reinforces the case for looking at several aggregates even while targeting only one. It also underlines the point that the form of any controls and the manner of their implementation should disturb as little as possible existing market preferences for the type of assets to be held and the channels within which funds are moved. Specifically, we all take very seriously the dangers of encouraging disintermediation out of

the domestic banking system into the euromarkets or indeed out of the banking system altogether. These considerations lead us all to wish to see an early end to the corset; and to wish to avoid the imposition of non-interest bearing reserve assets on the banking system on more than a very small scale.

4. There probably remains, however, some difference of view between those who feel so strongly about the inevitability and dangers of disintermediation and other avoidance that they would wish formally to abjure affectively from all methods of control other than ultimately - interest rates; and those who feel that in the world as it is there will probably have to remain the potential for imposing some forms of direct control for short periods in times of crisis.

5. The advantages and disadvantages of broad and narrow money (say M1 and M3) as a target variable are well known and are probably common ground between us. If we were starting afresh, and therefore could disregard entrenched views of commentators and markets, and if the Bank was in more or less sole control of operations to meet whatever targets had been laid down, most of us might incline towards an M1 target. The arguments which might be particularly stressed would perhaps include: the likelihood (maybe not very strong) that it is more amenable to control at least by monetary means than M3; that by distancing ourselves from the "counterpart variables" of the PSBR, bank lending and external flows, we might be spared the problems of slow reactions in these areas and especially the self-defeating phenomena of "buyers' strikes"; and the fact that, in the absence of exchange controls, complications from the external sector and especially the growth in euro-sterling might be less troublesome.

6. In the world as it is, however, most of us would probably settle for continuing with M3. Important considerations

influencing this view would include the danger that a change in targets would be bad for credibility, looking as if we had chosen a soft option, and leaving the commentators still likely to mark us down if M3 moved very differently; the fact that almost all British commentators believe in M3 rather than M1: the fact that the link to the PSBR can be regarded as helpful in putting some of the burden of anti-inflationary policy on the fiscal side; and the difficulty in any situation short of full control by the Bank, of persuading government always to undertake or countenance unwelcome interest rate movements on the basis effectively of an equation, which might well break down, as it has in fact done in the past.

7. Whatever target is chosen, it is generally agreed that with a given stance of fiscal policy a quantitative monetary policy works through variations in interest rates. ^{by large rates} This view has the important particular application that even a technique such as Monetary Base Control, in whatever version it is proposed, and however "quantitative" it looks at first sight, should ultimately be seen as working through interest rates. The important question raised by the family of techniques grouped under the heading of Monetary Base Control is the extent to which the relevant interest rate movements should be automatic.

8. As for automaticity, it is unanimously rejected in its extreme form; there is full agreement that whatever system might be put into place it would be necessary to envisage some form of override for the authorities. There is a general recognition that the points at which to set the override and how to operate it would be very difficult empirical questions to decide in advance of any move to greater automaticity, even on the basis of extensive consultation. Unfortunately, the questions are crucial as well as difficult because if the override is set too far away nerves

may break, while if it turns out to be set too close frequency of use will tend to make a mockery of automaticity.

9. The main virtue of automaticity as seen by outside proponents of it is, in its strong version, that the authorities never will or can know where interest rates should be. This would imply no override and is as already said rejected in the Bank. In a weaker version the argument is that political and institutional rigidities and inhibitions mean that in practice interest rates are adjusted too slowly and too little.

10. On this weaker proposition there is some disposition to agree that a faster movement in short-term rates, if it could be achieved, would represent a modest improvement in short-run control. And there is a rather stronger feeling that faster movements in longer-term rates would be beneficial. It is these considerations that lead to some people's feeling that proposals on the lines of those envisaged in the Bank's consultative document could have some advantage over the present situation. This view, however, was subject, of course, to the proviso that detailed consultations with market participants allowed one to have reasonable confidence that the scheme would operate as hoped. It is perhaps fair to sum up at this point, however, by saying that there would be fairly strong agreement that any potential improvements are likely to prove fairly small - certainly smaller than the more enthusiastic commentators would expect.

11. Hesitations about any major move towards automaticity are reinforced by consideration of the external dimension.

12. There is some spectrum of views on the practical compatibility of monetary and exchange rate targets. Everyone agrees that at least potentially they are incompatible. It would certainly be impossible to give overwhelming continuous priority to

both. But beyond that point there is some difference of view on how far in practice and for most of the time one could "pay attention" to both an exchange rate and a monetary target. Some feel that given the difficulty of achieving reasonable short-run control of the money supply it will be asking for trouble to expose oneself to the additional hazard of substantial official intervention - and a fortiori interest rate manipulations - in the interests of the exchange rate. Confronted by the fact that a number of countries in the EMS have serious monetary targets, those who hold this view would stress the lack of sufficient credibility in the UK authorities' anti-inflationary stance as yet.

13. There is, however, perhaps a majority view which would wish to give some weight to an exchange rate target, believing that these exist, and will remain, possible situations when the authorities will believe that the exchange rate is "too high" or "too low".

14. The strongest case for holding this belief arises when purely external developments cause a shift in the exchange market's view of the relative attractiveness of sterling compared with other currencies: the "refuge currency" problem. But many of us would wish to reserve the possibility of influencing the exchange rate in ways that might adversely affect the implementation of monetary policy, even when the reasons for the unwelcome level of the rate were internal. In such circumstances while the rate might intellectually be said to have "emerged" from the ruling monetary policy - and indeed form an important element in the working of the monetary policy - it might be decided that movements had been unpredictably great and that it was too difficult to alter fiscal or other policies.

15. We have not yet attempted to reach a consensus on whether joining the EMS exchange rate regime would in itself be a desirable

policy for the UK in 1980. The following, however, might perhaps be generally agreed. First, that granted the way in which the EMS is operated, with not infrequent realignments, membership need not at least in the medium term necessarily be incompatible with appropriate monetary targets. Secondly, since the average level of inflation in the rest of the EMS is considerably below that in the UK, there is a prima facie case that adherence to the EMS could be considered in its own right a useful anti-inflationary policy. Thirdly, as regards possible entry this year, however, much would depend on whether the underlying pressures on our exchange rate looked likely to continue upward rather than downward; and more specifically, on the exchange rate at which we entered and whether or not we chose to begin with 6% margins.

16. There is, however, probably unanimous agreement that it would be dangerous both to the Government's credibility and to the subsequent implementation of sensible policies, for the authorities to announce within a short space of time both a decision to join the EMS exchange rate regime and a decision to move to a method of monetary control which appeared to depend centrally on a significant degree of automaticity in interest rates.