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Prime Minister

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I suggest you read  
this paper first and then  
the others as suggested  
in my note on the next  
one below.

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PRIME MINISTER

A handwritten signature in blue ink, appearing to be 'M. G.' or similar.

TZ  
11/10

.....

I attach a series of papers for our meeting on 13 October:

- (a) monetary control
- (b) the economic prospect
- (c) the underlying monetary position
- (d) the roll forward of the £M3 target
- (e) the exchange rate

2. You have already had a preliminary note on:

- (f) money supply, interest rates, the PSBR and the exchange rate

and the first of the regular series of notes on:

- (g) the CGBR, and the path of the PSBR for the rest of this year.

3. I have also sent you today a minute about public spending and pay. They form part of the background but I do not suggest that we consider them at Monday's meeting.

The Background

4. Since we came into office we have made great strides in removing distortions from the economy. These have included:

- the abolition of pay and price controls
- getting Clegg comparability out of the system

/ - abolishing

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- abolishing exchange controls
- switching some of the burden from personal tax to VAT

5. Just as we were setting out on our programme we had to cope with a further substantial increase in the oil price in 1979. One result is that the whole world is moving into recession. It is not surprising therefore that there have been some difficulties. In particular

- ① the exchange rate has been higher than we - or anyone -
- ② thought; the company sector, especially the part engaged
- ③ in international trade, has been hit harder than we hoped; and the money supply has grown faster than the target.

The Prospect

6. The prospect, based on the latest (though still preliminary) forecasts, is described in the note 1(b) above. The main points are:

(a) Inflation will continue to decline in the early months of 1981, but may get stuck before reaching single figures.

(b) Output is expected to fall in 1980 by 2½-3 per cent and may not start to recover until as late as autumn of 1981.

(c) The PSBR forecast has risen to £10¼ bn this year (the path is included in note 2(g) above) and £11¼ bn in 1981-82.

(d) Bringing the growth of the money supply back within the medium term strategy will be difficult and probably require continuing high interest rates.

/7. The most



7. The most pressing problem now is to sort out the monetary situation so that we can be confident that we can maintain our strategy. If we do not there is little or no prospect that we shall emerge from this recession without a further surger in inflation. So we must now bend all our energies to this end, and above all ensure that we make our policy actions consistent with it.

8. Our meeting on Monday must consider two key issues:

(a) Is the system of monetary control adequate to reduce monetary growth?

(b) Irrespective of the control system what measures do we need to take in order to get back on the track of the medium term strategy?

#### Monetary Control

9. The paper on monetary control by the Treasury is designed to help us answer the first question. It raises a lot of fundamental questions. They concern our attitude to fluctuations in monetary growth, the techniques to reduce monetary growth and the role which we are willing to give to interest rates and the market in controlling it.

10. This is not just an issue which has arisen since the corset. The present methods of control are plainly inadequate. We must make changes in order to have greater confidence that we can achieve our stated objective; but all changes have institutional implications and implications for sectors of the economy other than the banks. We must guard against forcing the pace so quickly that we create more problems than we solve. We need to discuss not only short term interest rates and the banking system, but also methods of funding and the possibilities for smoothing the path of public sector borrowing.

/Getting Back on Track



Getting Back on Track

11. If we are to get back to the path of the medium term strategy, we have to face up to the implications for interest rates and the exchange rate.

(a) If we stick to our monetary strategy there is no sure or easy way of doing anything about the exchange rate. As long as we are determined to reduce inflation the exchange rate, given by the market, is likely to be a high one. Moreover, if the exchange rate did fall substantially interest rates would probably have to rise, unless we were prepared to relax our monetary objectives.

(b) Interest rates will have to fluctuate more; they will almost certainly stay high for a considerable time and may even have to rise. If we are going to pursue an effective monetary policy, interest rates, like the exchange rate have to be determined more by market forces.

12. I remain convinced that if we are to both tackle industry's problem while sticking to the monetary strategy, it is essential to control the PSBR, and do what we can to adjust the fiscal balance in favour of industry. This route means tackling the two major imbalances in the economy, between the public and private sectors and within the private sector, between financial companies on the one hand and non-oil companies facing international competition on the other. The note on the economic prospect draws attention to these issues in para 4-7. Anything which we can do here will also ease the monetary situation.

/13. But tackling



13. But tackling the level and structure of the PSBT to achieve this objective will involve painful decisions:

(a) My minute on public expenditure shows that tough decisions will be needed if expenditure is to be held back to conform with our published plans. These decisions concern both the volume of expenditure and no less important, the pay element. Getting back to the July target would reduce the PSBR by something over £½ bn compared with the forecast. We must do better than that.

(b) Tax policy will have a crucial role:

(i) I am reviewing the North Sea tax regime to see whether more revenues can be raised, especially in the vital next few years.

(ii) In one way or another we shall have to raise some of the money we need from persons. Officials are urgently looking at actual possibilities including increasing the employees NIC and the National Health contribution as a step along this road.

(iii) I am investigating the scope for both obtaining a contribution from the banks to the cost of fixed rate export credit at times of high interest rates and of transferring more fixed rate export credit paper to the banking system.

/They will



They will thus help finance the public sector. This seems a more attractive route than taxation - although this could raise more revenue and I have still not ruled it out.

(c) Although public sector prices will certainly need to rise we shall have to be very careful about future Government measures which add to the RPI until the money supply is more closely under control. This applies to both public expenditure and tax.

14. Extra revenue will clearly have to be directed in the first instance towards reducing the PSBR in order to relieve the pressure on interest rates. But it would be desirable to have something in hand to help the company sector directly, e.g. through the revised arrangements for stock relief which we shall in any case need to bring in as a first step in adjusting the corporation tax for inflation accounting.

15. The balance between the sectors can also be helped through our funding policy where greater reliance on National Savings will relieve pressure on the capital markets though at some risk to mortgage rates.

16. By this approach we should be able to mitigate some of the effects of a high exchange rate without removing the incentive to companies to control their own costs. Cost increases are responsible for most of the loss of competitiveness which has taken place. I shall not miss any opportunities to move in this direction in the run up to the Budget, but there are limits to what can be done in advance of that.

Rolling Over the Monetary Target

17. Perhaps the single most immediate question is whether to roll over the £M3 target. We face the continuing

/uncertainties



uncertainties following the removal of the corset - brought out in the note on the underlying situation. There is also uncertainty about this year's PSBR though we are still confident that it will fall sharply in the first quarter of next year, as is brought out in the note on this subject. As the note on the roll forward itself says, one obvious option is to stick with the existing target to the Budget. We can then reassess the whole position in relation to the medium term financial strategy at Budget time.

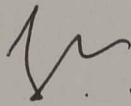
18. There is a lot to get through, at our meeting on Monday. Though we shall not be able to take final decisions I hope that we shall emerge with a clearer view about the way forward in 2 respects:

(a) on questions of monetary control where the consultations following the Green Paper are now complete and an indication of Government policy is awaited.

(b) On the immediate issue of rolling forward the monetary target.

19. The Governor and I will both have to make major speeches at the Mansion House on 16 October in which we shall need to say something about monetary policy.

20. I am sending copies to Sir Robert Armstrong and Robin Ibbs.

(G.H.) 

10 October, 1980

PM

MONETARY CONTROL

SUMMARY AND CONCLUSIONS

The paper discusses alternative techniques of monetary control on the assumption that the authorities target the money supply, and allow the exchange rate to be determined by market forces.

2. Under the present system, the main monetary policy instrument is the power to administer MLR. There are a number of problems:

(i) it is difficult for the authorities to know what path of MLR is consistent with the target growth in the money supply. Underlying monetary trends are often hard to discern, and relevant economic relationships are only imperfectly understood;

(ii) the highly political nature of discretionary changes in MLR gives the system a bias towards delay, especially when interest rates need to rise;

(iii) if short term interest rates are changed only infrequently unexpected changes in incomes and prices will lead to fluctuations in the money supply. This may increase the risk that inflationary shocks will unwittingly be accommodated;

(iv) the authorities have no direct control over long term interest rates. Present methods of selling gilts rely on changes in short term rates (and hence the general level of interest rates) to influence expectations of future interest rates, and hence the expected capital gains from holding gilt edged stock. In principle, this technique is both inefficient and highly uncertain, though in practice it has proved consistent with very large scale funding of the PSBR in recent years;



(v) The central Government has no short term debt instrument with enough appeal to non-banks to be used to mop up the monetary effects of short term swings in the public sector's accounts;

(vi) the banks are not actively involved on the side of the authorities in controlling the growth of their deposits. Their behaviour may sometimes be positively unhelpful to monetary control eg. the use of windfall profits due to high interest rates to underprice advances.

With present techniques, the prospects of meeting the monetary targets depend critically on getting fiscal policy right. The contribution of monetary policy instruments is unreliable. And while in the long run fiscal policy must be consistent with the target for monetary growth, excessive reliance on fiscal policy for short to medium term control is a serious weakness. In consequence there can be no assurance that the targets for  $\text{M}_3$  or the MTF targets will be met with any precision.

3. Monetary Base Control, in one form or another, has the important advantage of allowing interest rates to be determined by the market in a way which is consistent with policy objectives for a relatively narrow monetary aggregate. Interest rates are more likely to move promptly and in the right direction than under the present system.

4. All short term interest rates would be more volatile under MBC; if some interest rates remained sticky, financial flows could be seriously distorted. This would have far reaching implications for building societies as well as banks. At the same time, of course, Ministers would have to give up effective control of interest rates, including mortgage rates.

Monetary Control.

- ① Smooth PSBR
- ② Selling more to persons.
- ③ Increased fall to U.K. institutions: - minus life.
- ④ More flexible marketing of long term debt.
- ⑤ Redefine under deposit restriction - improve
- ⑥ Modify debt to Reserve Bank to exclude Treasury Bills.

5. We do not think that it is possible to devise a system of MBC which, on its own will offer effective monetary control over the broader aggregates including  $\text{£M3}$ , without causing disintermediation on a scale which would impair the authorities' ability to interpret and control underlying monetary conditions.

6. If more flexible techniques for selling public sector debt could be developed however it might be possible to combine targets for  $\text{£M3}$  or even PSL1 with some form of monetary base control.

7. A switch to MBC would necessarily involve a major institutional upheaval affecting the role of the discount market, the gilts market, the terms on which banks and building societies would lend, and the instruments available to finance central and local Government. Some of these changes might be welcome, some are in any event necessary for better monetary control. But a major change inevitably has unpredictable side effects, as the earlier experience of Competition and Credit Control testifies. Some shifts in the demand for money and other financial assets can be expected, which will temporarily complicate the task of monetary management, perhaps seriously.

8. There would therefore need to be a period of transition to minimise the risk of a breakdown in control. This implies that MBC cannot help with the problem of monetary control over the next year. We cannot even be at all confident that it would significantly improve the Government's chances of meeting the targets set out in the MTFs.

9. Ministers may like to consider three broad options. The objective of achieving a steady reduction in the growth rates of the monetary aggregates is taken as given.

*preferably excluding*

Option A: A gradual move towards targeting the monetary base  
(~~broadly defined to include notes and coins~~). In this option there are no compulsory reserve requirements. The essential role of MBC is to generate short term interest rates. The main parallel is with present Swiss arrangements.

Option B: A gradual move to a flexible mandatory system of monetary base control, targeted on M2 (a new aggregate broadly equal to £M3 less wholesale deposits ie. large deposits bearing money market interest rates). This would be closer in spirit to the system recently introduced in the US. Annex 1 contains an illustrative blueprint for such a scheme.

Option C: Improving the flexibility of present methods of control, principally by reforms designed to achieve more precision in the timing of debt sales. Measures to smooth the seasonal pattern of the PSBR would also be relevant, as, conceivably, might an attempt to use the existing reserve asset system more aggressively.

10. Many of the measures which might be taken within the present framework of control would of course be equally relevant in the event of a switch to MBC; this applies particularly to changes in debt selling techniques.

11. The attached table summarises the key features of the present system, and of the main monetary base options identified above.

MONETARY CONTROL: SUMMARY

Control System	MAIN FEATURES:-					Comments
	Short term Interest Rates	Monetary Targets	Monetary Base/ Reserve Assets	Reserve Requirement	Lender of last resort facilities	
<u>Present System</u>	Discretionary control of MLR	£M3	Call money, Treasury bills, gilts (with less than 1 year to maturity) LA bills, commercial bills (up to 2% EL's)	12½% eligible liabilities 1½% cash ratio (London Clearing Banks only)	Unlimited, at given MLR	Unreliable; not capable of delivering short term control. Could be improved by more flexible techniques for selling public sector debt
<u>Monetary Base Control</u>			<u>either</u>			
A. <u>Non-Mandatory</u>	Market determined (possibly subject to ceiling)	Monetary base, £M3 (or? PSL1)	Notes and coins, plus bankers' balances <u>or</u> (preferably) bankers' balances	No mandatory requirement	only available i. in financial crisis or (possibly) ii. on penal terms	May not contribute much to control of money supply. No incentive to disintermediation cf. Swiss approach.  Improved debt selling methods needed to control wider aggregates (£M3, PSL1)
B. <u>Mandatory</u> (as in illustrative scheme, see Annex I and table III)	Market determined subject to ceiling set by authorities	M2, £M3 (or? PSL1)	Bankers' balances	Mandatory requirement to hold base assets equal to x% retail deposits	only available i. in financial crisis or ii. at penal rates	Short term control over M2; but some incentive to disintermediation. cf. US arrangements. Improved debt selling methods needed (as above)