DRAFT

AGENDA FOR MEETING TO BE HELD AT 3.30PM
ON WEDNESDAY, 13 JANUARY 1982

I MONETARY AGGREGATES AND INTEREST RATES

A. Operating Policies

a. Interest Rates and Monetary Aggregates

The main conclusion we should reach is that we must shift from the primus status of £M3 to the narrow aggregates. Although, de facto, we have paid little attention to £M3 movements in recent months (although partly this neglect may be alleged to be due to the strike) £M3 is still formally the most important aggregate for interest rate policy.

Because (i) £M3 is insenstive to changes in interest rates whereas M1, MO etc are not,

(ii) £M3 is very much influenced by structural and other changes in credit markets, and

(iii) we have not (rightly) been motivated in practice by £M3 for many months,

we should place greatest emphasis on MO, M1 and retail M1. £M3 should be demoted as an aggregate "taken into account".

b. The Exchange Rate and Interest Rates

The main role of the change in the exchange rate should be as a subsidiary indicator of changing monetary conditions. We used it as a main signal in the absence of reliable aggregates during the strike, but it should now be relegated to its subsidiary role as correlative evidence. Changes in the exchange rate often are not due to UK monetary changes (eg political factors, changes in monetary policy of the USA, Germany etc, real effects, such as oil prices, etc) and need very careful interpretation.

[This is related to the EMS question which is a subject for later discussion.]

B. Strategic Decisions

a. Targets

We should consider replacing £M3 by a target which we can achieve such as M1 and MO. We should express our targets as percentage increases only over 3-year periods and with many caveats about revision for possible "structural changes". [For example we may provide that if interest rates fall dramatically then we should be prepared to tolerate a higher growth for M1 during the fairly short adjustment period.]

Further work is needed to give a 3-year target for M1, but I should have thought that about 6% [in principle starting at 8%, as now and declining to 4%, the average value in the 1960s, is appropriate] over the 3-year period.

The other aggregates Ms, £M3, M3, PSL1 and PSL2, should be used to shed light on monetary, and particularly credit conditions and may be used to modify the long run targets.

The exchange rate has no role for long run strategy: the value of sterling will, in the long run, be determined by our monetary/fiscal policy and the real performance of the economy.

b. Money GNP as "target"

This has been suggested as an alternative to the monetary aggregates [by Sam Brittan, James Meade, et al]. Although it is easily understood and interpreted the main disadvantage is that it treats increases in real output in the same way as increases in inflation. Even among Treasury Ministers and officials, this causes confusion.

I cannot see that a statement of intentions in terms of money GNP is superior to a general statement in terms of a projected target rate of inflation.

Real output is bound to fluctuate with the trade cycle. (And in general movements in output and in prices are positively not negatively associated - so giving a wide amptitude of oscillation for money GNP). We might associate this statement of projected inflation with a projected trend rate of increase of output - but again if we did that it would be wise to enter many caveats.

II FUNDING

i. Overfunding

This is the standard technique for attempting to reduce the £M3 figures when there is a boom in bank lending to the private sector and the PSBR is well contained. But if we overborrow long we have to lend more at the short end and increase the Bank's portfolio of bills.

I believe that we should only fund the PSBR and not try to offset the boom in private sector borrowing.

ii. Instruments

a. Indexed Debt

It is essential that we do not issue conventional long term debt at 16 or even 17 per cent, if our long term inflation is expected to be less than 10%.

The issue of indexed debt is restricted - and so the secondary market is also restricted.

There is a powerful case for issuing unrestricted indexed gilts and making these instruments widely marketable. The objections, apart from some tax arrangements, are that the debt will be bought by foreigners (OPEC) and that this would violate our (informal) agreement with other industrialised countries.

As a counter argument it seems unlikely that any substantial amount of debt (at say 2-2½% real yield) would be bought by foreigners when they can get 16 per cent or so tax free.

b. Auctioning Debt

The Bank would prefer to return to the conventional methods. We have agreed, however to auction the next issue of restricted debt.

III EMS

The main questions are:

i. Would exchange rate be more stable?

Answer:

There would be more short run stability, but not in the long run; the exchange rate would move in jumps, on realignment, rather than smoothly.

[Note: Short run stability can be bought anyway on the forward markets.]

We would also need on average more reserves for intervention. In general the EMS calls for considerably more intervention with attendant monetary effects which depend on how the purchase/ sales are financed.

ii. Would EMS "discipline" substitute for or reinforce our counter-inflationary operations?

Answer:

EMS would not substitute for our strategy (both Germany and France have money supply targets). The evidence, quoted in Bundesbank Bulletin October 1981, is that economies in EMS have diverged not converged since 1979, so it is unlikely that joining EMS will do anything to reinforce our conter-inflationary strategy. On the contrary it may stymie our strategy: consider if we had joined EMS in 1979, we would have intervened and increased the monetary aggregates to keep the rate from appreciating in 1980.

iii. Is the EMS a step towards a true Central Bank of Europe?

Answer:

If the EMS were a stepping stone to a true Central Bank of Europe and an integrated currency, there would be a good case for getting in now, but it is virtually certain that no such result is even remotely possible, especially in view of the increasing divergence of France and Germany. This divergence will cause increasing strain in the EMS which may lead to a breakdown. In general the EMS involves an increase in the politicisation of exchange rate changes, particularly on realignment meetings. Our objectives have been to restore free prices, rather than controlled prices, to markets and to eliminate, or at least reduce, political influence.

2 would it be inimical to monetary control
(esp if we had to intervene heavily to hold rate down
– or even to prop it up)

2 puts an unrealistic weight on the mechanism – you can't use it
~~as~~ an excuse for a minibudget: it won't stand the
weight, ~~as well as~~.