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MR LITTLER

cc Mr Barratt
Mr Hancock
Mr Middleton
Mr Unwin
Mrs Gilmore
Mr Riley Mr Ridley

Mr Fforde
Chief Cashier
Mr Goodhart

copies attached for:

Chancellor
Financial Secretary
Chief Secretary
Sir Douglas Wass
Sir Lawrence Airey
Sir Fred Atkinson
Sir Ken Couzens

PS/Governor

MONETARY POLICY

This submission is primarily directed to the two issues - the roll forward of the monetary target and the future of the SSD scheme - on which decisions might best be announced on 15 November. It also deals with some of the factors affecting a decision on MLR, although that decision will be affected significantly by what happens in the markets in response to yesterday's eligible liability figures, and this submission therefore does not reach any recommendation on that.

2. The submission has been discussed in draft with the Chief Cashier. But it is not agreed with the Bank and on one issue - the SSD scheme - we understand that the Governor takes a different view.

<u>The Prospect</u>

3. The submission should be read with Mr Middleton's parallel submission on the prospect as it has been reassessed following the October figures.

4. Events have meant that it is necessary to deal with the roll forward and the future of the SSD scheme at the same time as it has become clear that the monetary situation requires immediate corrective action. The problem with the present situation is that:-

i. the PSBR this year is now much more likely to be in excess of £8¼ billion than below it - the central estimate probably now lies between £9-9½ billion;

ii. the CGBR figures already published, are already causing the City commentators concern: the cumulative figures will soon confirm this unease, even if a higher figure were not published in the Industry Act forecast;

iii. the risesin world interest rates, and in inflationary expectations here, have meant that UK domestic interest rates are not a severe deterent to borrowing: it is difficult to argue that monetary and credit conditions are tight in present circumstances;

iv. bank lending is still high, and while there will almost certainly be a fall due to the recession, we may not yet have passed the peak - since Mr Middleton's note was prepared we have heard that the clearing bank economists variously expect the peak to be in Q4 1979 or Q1 1980;

v. these, and other factors - notably the prospect on pay and market fears about the PSBR and/or taxation next year following the Public Expenditure White Paper - have contributed first to hesitancy, and now to gloom in the gilts market which has meant that we have not achieved significant gilt sales since September, and there is little prospect of that situation changing of its own accord;

vi. the cumulative effect of these factors has been to leave the growth of £M3 at much the same level as was inherited, and to cause market rates to move up to a level at which MLR at 14% has been left behind.

5. The time lags are such that most of any immediate relief can only be achieved by creating conditions in the gilt edged market in which substantial sales can be resumed. The successful sale of two tap

stocks beyond those allowed for in the forecasts (say £1 billion long, £800 million short) could affect the growth of the money supply by 2% or more in the next few months. Such a turn round is partly a question of gilt tactics and pricing. But it also requires some action to dealwith the underlying concerns in the market: this certainly means raising short term rates so that they are again a deterent to borrowing and create tight conditions. The latest estimates on the PSBR may cause the Bank to re-open the question, which was touched on on Monday, of action on it through the regulator - although that raises issues which go much wider than this submission. The problem with the regulator from our side is that the effect of prices and inflationary expectations on interest rates will offset, largely if not even more, the effect of the lower PSBR on interest rates.

<u>The Roll Forward System</u>

6. The last Government adopted a system of rolling targets, similar to the then American practice, although not identical to it as the periods were longer in our case. A 6 monthly roll forward of a target set for 12 months forward was thought to have a number of advantages over a sequence of targets for each financial year, set in the Budget of that year, namely:-

i. in the second half of the financial year it gave the market some reassurance about the Government's intentions for the beginning of the next year - there is always a target for at least 6 months ahead;

ii. on the other hand, it meant that if there was a perturbation in the money supply in the second half of the financial year, the authorities had longer to get back on track - it is totally impracticable to reverse, before the end of the financial year, a significant change in trend which becomes apparent in January;

iii. the authorities had the option as to whether to "base drift", or not, but had to give an explanation of their decision;

iv. there was an occasion, between Budgets, for the Chancellor to reassess monetary policy, to decide on whether any corrective fiscal or monetary action was required, and to make a public exposition of his policies.

7. Some of these arguments will be affected if there is a medium term financial plan. It would be appropriate to look again at the form of the roll forward system at the same time as we look at the way in which the monetary objectives are specified in the medium term financial plan, if Ministers decided in principle to have one. But we would recommend that in the meantime the Chancellor should continue the roll forward system: given the October figures, a restatement and extension now of the Government's monetary targets would seem to be most desirable.

The Choice of Target Range

8. The existing target range is 7-11% pa for the 10 months, mid-June 1979 to mid-April 1980: the centre is equivalent, given the higher rate of growth in banking May and June, to 10.2% in the 12 months to mid-April 1980. The October figure brings the increase in £M3 in the first 4 months to 4.5% equivalent to 14.2% pa, rather than the 2.9% which would be equivalent to the centre of the target range.

9. The choice now is:-

i. whether the range should again be 7-11%, or something lower, say 6%-10%;

ii. whether the period should run 12 months from mid-October (which would "base drift" by including the high figures so far in the base) or for 16 months from the original date of mid-June, so avoiding base drift.

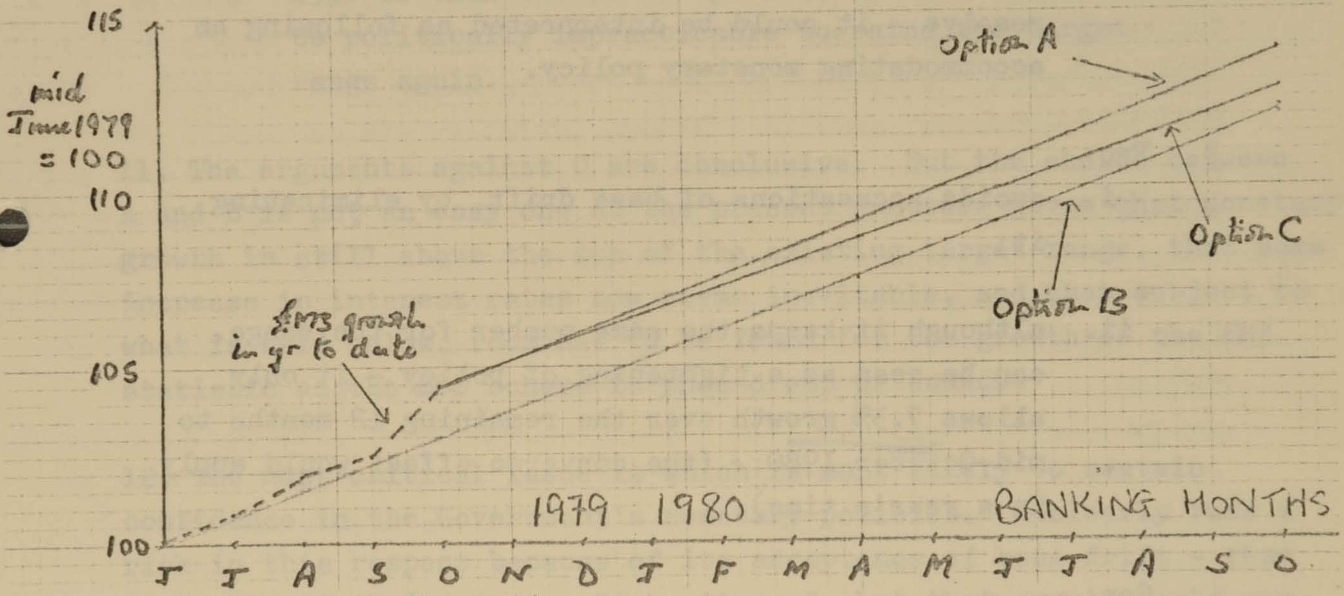
This gives the main options:-

a. 7-11% to apply for 12 months from mid-October 1979;

b. 7-11% to apply for 16 months from mid-June 1979;

c. 6-10% (or 6½% to 10½%) to apply for 12 months from mid-October 1979.

The graph below shows the choice in somewhat exaggerated form:



In tabular form the options are:-

mid-June 1979=100

Level of money supply if growth is in middle of range

Option	(a) at mid-April 1980	(b) at mid-October 1980
A	109.1	113.9
B	107.4	112.2
C	108.6	112.9

10. The respective pros and cons (some of which tend to be two-edged) are:-

A Pro:

i. probably requires lower interest rates than others;

ii. even this could be presented as a significant tightening; if the SSD scheme were ended since, after allowing for reintermediation, a substantial fall in the underlying rate of growth would be required.

Con:

i. the extent of base drift (some 1.7%) over 4 months would cast severe doubt on the Government's resolve - it could be interpreted as following an accommodating monetary policy.

B Pro:

i. avoids accusations of base drift, by eliminating it;

ii. although it keeps the same number for the range, can be seen as a tightening of policy - it only allows 7.3% growth over the remaining 12 months to mid-October 1980; (the converse effect would apply in a year's time).

Con:

i. it is tight and will require a deceleration of growth to a rate below that which an MTFP might envisage for another year or more;

ii. there must be a severe danger that it will not be met if there was doubt about it being achieved.

C Pro:

i. can be seen as a progressive reduction in the figures for the ranges;

ii. is not so tight as B in the coming year.

Con:

i. will be criticised as "base drifting" and to some extent as a spurious tightening;

ii. sets a precedent for downward shifts in the numberical range of each roll forward, a precedent which may not be sustainable;

iii. in practice requires a lower rate of growth in 1980-81 than the other options, because it would be politically impracticable to raise the target range again.

11. The arguments against C are conclusive. But the choice between A and B is not an easy one at the present juncture given that monetary growth is still above the top of the existing target range, that some increase in interest rates now seems inevitable, and that subject to what is said below, room has to be found for the growth of the £M3 statistic as the SSD scheme is phased out or ended.

12. The most critical issue is which is most likely to sustain confidence in the Government's monetary policies. A clearly runs a risk in this respect because of its acceptance of base drift - that might be attributed to the "inheritance", but that excuse would run thin, given the earlier decision to start the previous target in June. B also runs a risk since the market could fairly soon come to the view that the sharp deceleration in underlying monetary growth could not be achieved without further fiscal action. (We could get a repetition of the situation after the 1978 Budget.) On the other hand, if it were achieved it might be at the cost of driving the economy further into

recession. (This depends in part on how far the recession already in train will of itself lead to a deceleration in monetary growth.)

13. This can only be a matter of judgement, and there are differing views among us in HF and FEU. On balance, mine is reluctantly in favour of B because I doubt whether the markets would accept A.

The SSD Scheme

14. The present guideline for the SSD scheme ends with the 3 month average for the make-up days in October, November and December. It is therefore necessary to announce soon whether it is to be extended or ended: this can be most logically done in the context of the roll forward of the target.

15. The paper "Direct Monetary Controls" attached to my submission of 1 October made the point that, with the ending of exchange controls, disintermediation through offshore banking would be added to the existing ways round the SSD control. This point has not unexpectedly been seized on by outside commentators. The SSD scheme has therefore now lost much of its remaining credibility (and so its ability to reassure the markets) in the eyes of most, but probably not quite all, commentators. But it may not yet have done so with the markets. It does seem to have lost its efficacy in exerting a squeeze on the banking system as the banks have discovered how easy it is to get round it eg through acceptances: from outside at least, it appears that on this, its third appearance, it has had less effect in causing the clearing banks to constrain low priority lending in accordance with the directional guidance - eg to persons.

16. Because of the risks of the ending of the SSD scheme being misinterpreted as a weakening of the authorities' stance - particularly by overseas exchange market operators, the Governor will probably propose continuation of the SSD scheme at its present guideline of 1% per month. This would be coupled with a request to banks not to facilitate offshore disintermediation. But in our view the arguments against this are very strong indeed:-

i. given that domestic avoidance would continue, it would not affect underlying monetary conditions;

ii. it is doubtful how far such an appeal to banks would stop disintermediation offshore, particularly by multinational companies, and we would not have the statistics monitor it;

iii. it would cause the Government to be accused of having its head in the sand, believing that it was controlling monetary conditions when it controlled the £M3 statistic through the SSD scheme;

iv. alternatively it would be accused of its monetary policy being merely a front, controlling a statistic rather than the reality;

v. while there will be problems about the unwinding of disintermediation due to avoidance, referred to below, whenever the scheme is ended, and events of the last month make us less sanguine about dealing with them than we were at the time of the exchange control decision, the fact remains that the next 6 months appear likely to be as good as any for the foreseeable future for absorbing the effects as far as the PSBR is concerned: even after the increased estimate it is likely to be lower in the second half of 1979-80 than it has been so far, or is likely to be for some time to come. (The position on bank lending might on the other hand be somewhat easier later);

vi. moreover the amount to be re-absorbed would probably grow over time if the SSD scheme were continued, even relatively loosely (eg 1% per month).

17. Some of the criticism might be met, if it were announced that this would definitely be the last 6 months of the scheme. The authorities

would not be accused of ignoring completely the defects of the SSD scheme. But even if the guideline were somewhat eased, it would lead to the continuance of much of the existing stock of disintermediation: as that stock was rolled forward it might take less desirable forms of disintermediation - notably offshore banking, notwithstanding the request to banks. The stock of outstanding disintermediation at the end of the 6 months, would then have to be reabsorbed into the statistic, at a time which would be even more difficult than the next 6 months.

18. It has to be accepted that there would be problems with an abrupt ending of the SSD scheme. It has been estimated that disintermediation amounts to about 3% of the money supply. If the SSD scheme were just abolished, that disintermediation might come back into banking channels, and so the £M3 statistic, over the coming months at a rate which is not predictable, but could be rapid. If monetary growth, after allowing for this, was allowed to be at the top end of the target range, it could be explained that this was merely the working into the statistic of an increase in "money" which had already taken place. This explanation would - or ought to - satisfy those critics of the SSD scheme who have pointed to the present distortions resulting from it. But it would not necessarily be apparent to observers further removed from the United Kingdom - such as foreign exchange dealers overseas. But even achieving growth at the top end of the range would require the underlying growth to be near or below the bottom end of the range - a tight stance on any of the options above, but especially so for option B.

19. Indeed, it might be possible to justify option A on the target on the grounds that it was not allowing "base drift", but including provision for reintermediation, and so bringing within the statistic monetary growth which had not been recorded as such. The SSD scheme has led to three main identifiable forms of avoidance which increase liquidity and credit without affecting the £M3 statistic:-

i. bank acceptances held outside the banking system. (These increased by £290 million in the 6 months to mid-June, and by a further £820 million in the 4 months since then);

ii. Treasury Bills held outside the banking system (the respective changes were £360 million and minus £230 million);

iii. local authority short term debt held outside the banking system. (These increased by £770 million in the 6 months to end-June: we do not have figures for a more recent period).

The main unquantified form hitherto has probably been sale and repurchase agreements in respect of other bank assets (eg short term gilts) over make-up day. We will be able to monitor i. and ii. and to comment on it when the £M3 statistics are announced month by month. But we can only obtain local authority statistics quarterly and 3 months in arrears. (Indeed, if it had not been for this last point it might have been worth adopting temporarily a £M3½ statistic incorporating those 3 forms of disintermediation and setting the target for it for the period mid-June 1979 to mid-October 1980.)

20. The balance of argument would seemto point to ending the SSD scheme now, recognising that it will allow reintermediation which will bring liquidity at present outside the £M3 statistic within it, explaining this in advance and monitoring it as it happens. It will probably require aiming for underlying growth at about the bottom of the target range in order to keep the growth of the statistic at the top. If it is felt that this is too restrictive, my preference would be to have option A on the target and ending the SSD scheme, rather than the tighter option on the target and retaining the SSD scheme.

Other Methods of Control

21. An alternative method of monetary control, such as one of the variants of monetary base, would not get over this problem of having to

allow this reintermediation following the end of the SSD scheme. It is common ground between those who have been working on possible schemes in the Bank and the Treasury and outside advocates, such as Pepper and Griffiths, that any continuing scheme should not impose a significant penalty on the UK banks in relation to their competitors, domestic or foreign - to do so would only cause similar disintermediation problems to the SSD scheme, with the added complications now of disintermediation through offshore banking.

22. The ending of the SSD scheme, without having a monetary base system to put in its place, would not represent a lacuna. Any monetary base system, which did not impose a penalty on the UK banking system, would work by generating changes in market interest rates generally and to at least some extent automatically, rather than leaving so much of the determination of the timing and amount of the changes in interest rates to the authorities. In other words, if a monetary base system had been in operation in recent months, the increase in interest rates discussed in the next section might already have taken place - it would not have provided any alternative to that change.

23. I should perhaps add that considerable work has been done in the Bank and the Treasury on alternative schemes and a submission should be ready shortly. We have severally had discussions on detailed points with Messrs Pepper and Griffiths. It is far from clear that there will at the end emerge a scheme which is workable, which will have the desired effects and will be acceptable to all concerned. But this will only be conclusively established when one or two of the schemes, which look most promising, have been put out for technical consultation, particularlly with market operators, eg the discount market and the clearing banks. (Mr Pepper seems to have stolen our clothes on this.) Such consultations might be conveniently timed in relation to the papers on reserve asset ratios and on future prudential liquidity requirements which the Bank will probably want to issue about the turn of the year. If a particular monetary base scheme then proved justified, it would have to be refined and introduced over a period of 6 months or a year.

MLR

a. Timing

24. There would be considerable advantage in being able to announce a decision next week:-

i. it would enable a more considered assessment to be made of the amount of the move necessary, and in particular give longer to observe the domestic market reaction to the eligible liability figures;

ii. it would enable the change to be presented as part of a monetary policy package;

iii. in particular it would enable the market to assess the implications of the MLR change and the ending of the SSD scheme together, and avoid the risk of an adverse reaction to the latter if it were announced separately a week after the MLR change;

iv. it would avoid the change coinciding with a Building Societies Association council meeting, although this time there is probably little risk of a "snap" move.

25. There is one argument for acting this week rather than next, namely it would give an opportunity for greater gilt sales in banking November, and so produce an earlier improvement in the statistics. But I do not consider that this argument outweighs those above.

26. I understand that at present - thanks partly to good briefing by the Bank Press Office - neither domestic nor external markets are expecting a move this week. So, unless there is an unexpected change in the exchange market in the next few hours, it should be possible to

defer a decision until then without undue cost in terms of either intervention or the exchange rate. But clearly the Chancellor will want to consider the Governor's and OF's latest assessment of this at the meeting this afternoon.

b. Amount

27. A final decision on this should clearly wait until next week. But at present the signs are pointing to 16% rather than 15%:-

i. a move to 15% would barely validate existing changes in market rates, and so would not have much effect on confidence;

ii. indeed the prospect for reducing monetary growth in the next few months depends critically on achieving substantial gilt sales, and so on restoring confidence in the markets; there is therefore a need to establish the authorities' determination to deal with the continuing high growth;

iii. the upward drift since the Budget in inflationary expectations means that the effective real rates of interest have fallen: the prime borrowing rate (base rate + 1% = 15% at present) is below the current inflation rate;

iv. the ending of exchange control, and the resultant pressures on sterling, have meant that we have had to pay more attention to movements in international rates. These rates have been rising recently and, if allowance is made for differing rates of inflation, our short term rates may be lower than most others;

v. it will be necessary to offset the ending, or phasing out, of the SSD scheme in two respects;

a. fears by some that it represents a relaxation of control;

b. reintermediation leading to an increase in the £M3 statistic.

(Even if it is accepted that £M3 should grow at the upper end of the target range, it will be necessary to have PSBR/interest rate such as to keep the "underlying rate" at near the bottom end of the range.)

28. The factors pointing to keeping to 15%, if market rates next week are not still above it, are:-

i. there are good reasons for expecting a downturn in bank lending and the PSBR in due course;

ii. any increase will probably need to be sustained for several months - an increase next week may not affect the outturn for banking November very much, so at best it would be early February before there could be two months good figures sufficient to justify any relaxation;

iii. building society receipts have been bouyed up recently by investment of tax rebates: but their rates (other than term shares) are already badly uncompetitive, and they will be concerned about their inflows in the early months of 1980s. (This could be turned into an argument for a sharper increase now, as giving a better chance of rates being lower by February/March next year);

iv. a further rise in interest rates could affect industrial confidence at this juncture to an extent which is disproportionate to the effect on companies' cash flow.

The Gilts Market

29. As mentioned above, one of the main aims of the monetary package must be to re-establish confidence in the gilts market: this is as much a question of dealing with the markets' fears, so far as possible at the present juncture, on the Government's resolve in relation to the other determinants of monetary conditions - the PSBR and bank lending - as bringing about a "Duke of York" style upward shift in the yield curve. But it will be necessary to consider with the Bank how any mo in MLR can best be exploited in relation to:-

a. repricing existing taps (we have just under £400 million of the medium tap left) and

b. the timing and terms of new taps - we will probably need both a long tap and a short one.

30. We will face a familiar dilemma over long stocks. It is often argued that the downward sloping yield curve encourages institutions to hold funds short, and that we should therefore be ready to see long rates rise substantially. But stimulating a rise in long rates means that the real cost of borrowing becomes formidable, if inflation comes down on anything like the path hoped for by the Government. In present circumstances we can probably do little but accept that potential cost. (The option of borrowing more for medium term periods is not there - experience with the last taps suggests that that is a limited market.)

Conclusion

31. To sum up, I recommend that:-

i. the new target range should be 7-11% for the 16 months to mid-October 1980;

ii. the SSD scheme should be ended, rather than continued or phased out;

iii. the MLR change should be deferred until next week, if exchange market conditions permit.

If the combined effect of i. and ii. is thought to require too tight a squeeze on the underlying rate of monetary growth, then I would opt for starting the target from the mid-October base, rather than for retaining the SSD scheme.

32. While it would be premature to reach a final decision on the size of an MLR change now, the balance of argument does at present seem to point to a change to 16%, rather than one to 15% which would merely validate the change that had already taken place in the market.

J.M.B.

J M BRIDGEMAN
7 November 1979