

Chancellor of the Exchequer

cc Financial Secretary  
Sir Douglas Wass  
Mr Bridgeman

MONETARY BASE

*- Practical  
unhelpful -*

1. I attach a paper for the Prime Minister's seminar on 18 July. The paper is by Treasury economists in the financial sector, and it considers the economic rather than the institutional implications of monetary base schemes.

2. The present system of control seems to be existing increasingly unhappily alongside a tight monetary target regime. The SSD scheme in particular is approaching the end of its useful life. The more importance the Government places on achieving its major objectives through control of the money supply, the more important it is to be sure that at the end of the day the targeted growth can be delivered if it is so desired. Monetary base control offers the prospect of a simplification and an improvement of the existing system. Therefore we must take it seriously. This means directing the discussion to a small number out of the multitude of potential schemes and exploring them in detail to test exhaustively their practical implications. We cannot, given the difficult task ahead, risk losing control by setting loose forces which we can neither understand nor control.

3. The paper assumes that the main use of the monetary base would be as a means of achieving a given £M3 target after fiscal policy had been determined within the context of a monetary target. This might be the right way to proceed in the first instance if a MBC scheme proves viable. So the Government still have to make the same strategic decisions about the PSBR and intervention in the foreign exchange markets when deciding on its monetary target. In particular:

a. Monetary base is not a substitute for an appropriate balance between monetary and fiscal instruments. If the PSBR is too high, if its composition is unhelpful and if the inflation rate is high in relation to the target growth of the money stock, interest rates will be high.