MR BRITTON

MR MONCK

MRS LOMAX

MR GRICE

cc for information Mr Middleton
Mr Williams
Mr Foot (Bank)

MONETARY BASE CONTROL : SEMINAR WITH FOREIGNERS

I should be grateful for comments on the attached draft note of yesterday's Seminar. I have dictated it in rather a hurry.

2. The first section tries to record fairly dispassionately what the Gang of Five were advocating. After that, it becomes a bit more impressionistic. I have not tried to include all our reservations about the outsiders' claims.

3. The full note is intended principally for our own benefit. I hope we might have a word about the best way to report the Seminar to Ministers. Since the Prime Minister and the Financial Secretary have both talked to the participants, it may be suffident to add a fairly short account of the Seminar to Mr Foot's summary of the MBC consultations.

R P CULPIN
1 October 1980

MONETARY BASE CONTROL

NOTE OF A SEMINAR WITH FOREIGN EXPERTS ON TUESDAY, 30 SEPTEMBER 1980

The Seminar was attended by six foreign experts:-

Dr Karl Brunner	- Rochester University, New York
Dr H Dudler	- Deutsche Bundesbank
Professor Allan Meltzer	- Carnegie-Mellon University, Pittsburgh
Professor Mario Monti	- Bocconi University, Milan
Professor James Pierce	- University of California, Berkeley
Dr Kurt Schiltknecht	- Swiss National Bank

Five of the six were staunch advocates of monetary base control. The sixth, Dr. Dudler, said that the Bundesbank had tried it; found that it did not work; and saw no reason to change that judgement.

2. This note does not attempt a blow-by-blow account of the discussion. Instead it:-

i. Sets out the core of propositions to which all five advocates of monetary base control subscribed;

ii. Outlines Dr. Dudler's main objections;

iii. Sketches the response of the advocates to questions about the choice of a control target for monetary policy; and

iv. Records a miscellany of more detailed points which came up in discussion.

The Argument for Monetary Base Control

3. The five advocates of MBC were agreed on the following propositions:-

i. In principle, the authorities should set their monetary targets solely in terms of the monetary base. That is the only monetary quantity they can control. It is likely to be well related to final objectives - the price level and nominal income.

ii. Interest rates, the allocation of credit, and preferably the exchange rate should be left to the market. If the authorities attempt to stabilise any of these variables, unanticipated developments will be reflected in unplanned changes in the quantity of money. However good the authorities' intentions, many of these changes will be consolidated, and not reversed. All experience suggests that the net result will be for the money stock to expand faster than planned, and so for more inflation to be accommodated than was ever intended. If this is to be avoided, there is no alternative to letting unanticipated developments, such as overshoots in the borrowing requirement, affect interest rates rather than the monetary base.

iii. The Central Bank must lend only as a last resort, and not to defend a particular level of interest rates. Of course it must come to the aid of a bank in genuine danger of collapse. For the rest, it may lend strictly limited amounts at very short term, essentially to even out the <u>distribution</u> of monetary base between banks. It should do so only with strings, and at a prohibitive price, and must use open market operations, if necessary, to ensure that its lending does not cause unplanned increases in the <u>amount</u> of the monetary base.

iv. Interest rates in general would not necessarily be higher or more volatile if these prescriptions were followed. Very short term rates would have to fluctuate widely; but the longer the rate, the less the extra variability. Beyond a certain point in the term structure, rates might actually be less volatile, and if anything lower on average, because there would be greater confidence that monetary policy would remain tight, less uncertainty about the Central Bank's tactics, and greater assurance that inflation would be restrained. Moreover, the dividing line between more volatile and possibly less volatile rates could well come near the short end of the spectrum - perhaps somewhere between one month and one year rates.

v. Monetary base control would <u>not</u> be a panacea. There can be no certainty about the relations between the base and any of the monetary aggregates; or between the base and interest rates; or between the base and the price level. But there has been still less certainty about other policies which have been tried over the years. There have been no known cases of sustained inflations unaccompanied by rapid expansions of the monetary base. If the base were tightly controlled, runaway inflation could simply not be sustained. The many unpredictable developments in the economy, about which there is always going to be uncertainty, would not be allowed to feed through to the price level. Only in that limited - but very important - sense would MBC import more certainty into the economy.

The Argument Against Monetary Base Control

4. The only foreign expert to argue against MBC was Dr. Dudler of the Bundesbank. He said that the majority of central bankers were against it because it would not work. The Germans had tried it between 1971 and 1973, but banks had simply not responded to reserve pressure by curtailing their lending and thus their deposit creation to the required extent. Reserve pressure could certainly have some helpful effects; but banks in Germany had reacted to MBC - just as banks in the UK had reacted to the reserve asset requirement and to the corset - by resorting to liability management and disintermediation first, and changes in lending policy last. This was not just a matter of studied evasion : it was almost a necessary product of the way in which banks must behave. If they could each forecast their cash flow precisely, and keep central control over their lending, they might then adjust lending to their predicted reserve holdings. But in practice, they could neither forecast their reserve holdings nor centralise their lending decisions to the necessary degree. Adjustments in reserve pressure could not, therefore, force bank lending to behave as a regulator of monetary expansion. MBC offered no substantial advantages over other control techniques.

5. Dr. Dudler went on to say that if the aim of the MBC advocates was to allow greater variations in interest rates to control the quantity of money, that could in principle be achieved under the present system. It could not be achieved perfectly, but it was not clear that MBC would be any more reliable.

6. MBC would not do anything about the other problems of monetary control in this country. It would not, for instance, change either the size of the PSBR or the sectoral distribution of its counterparts; nor would it be any more intelligible or convincing than the present system to the trade unions. It was not clear, therefore, what would be secured by the upheaval involved in a switch to MBC.

Choice of Target for Control

7. Because of their adherence to propositions i. and v. above, the five advocates of MBC were inclined to downplay a lot of the problems which have exercised the authorities in the United Kingdom. They were not much concerned, for example, about the choice between monetary aggregates such as £M3, M1, and so on, because they thought in principle that the only target should be for the monetary base. Similarly, they were not much concerned about disintermediation out of particular aggregates, nor about the time period in which it would be appropriate to control those aggregates. They answered a number of questions on these subjects by saying that, so long as the base was not allowed to grow too fast, errors of a few percentage points in targets for (say) £M3 or the price level would pale into insignificance beside the knowledge that inflation could not run out of control.

8. However, they did acknowledge that, while this might be true for the growth of the base, there would be a huge problem in the UK in setting the right level for the base in the first place. The authorities had no way of knowing whether the amount of base currently held in the system would prove too much or too little under an entirely different regime - and the error on this account could be enormous, completely swamping errors on the right growth rate. The advocates of MBC conceded that the authorities could only learn by trial and error, and that this would involve short term costs. But they suggested that the learning process might be quite quick, as responses in the system - such as movements of interest rates and of the established monetary aggregates - would tend to indicate whether base was too plentiful or too scarce. If the transition costs were not incurred, ultimate objectives might well be missed; and while there would never be a right time to incur them, it would be better to get them over sooner than later.

9. The advocates further acknowledged that - these difficulties aside - the Government could not move straight over to pure monetary base control and drop its commitment to £M3 targets, especially as those were embodied in the medium-term financial strategy. The uncertainty of the transition to MBC would unfortunately coincide precisely with the coverage of the strategy. This elicited a variety of suggestions:-

i. At least for the transitional period, the Government could adopt the sort of half-way house now being tried in the United States.

The public targets could continue to be set in terms of £M3, or something similar, but the authorities' internal objective could be to control the base as a means of controlling the target aggregate. The problem with this is that the authorities do not - and cannot without experiment - know the relationship between the base and the target aggregate. Indeed, they cannot even know whether there would be such a relationship.

ii. The authorities could announce short-term targets for the base, and retain the medium-term financial strategy, but drop the short-term public targets for £M3. The problem, again, is that the authorities have no way of knowing what short-term targets for the base would be consistent with the medium-term financial strategy; and to drop the short-term targets for £M3 could undermine confidence.

iii. The Government could announce short-term targets for the base and redefine the medium-term financial strategy in terms of objectives for the price level, or possibly for some monetary aggregate closely related to the base. The problem with this is that no-one can know what the relationship would be between the base and the price level in the UK, or between the base and any monetary aggregate.

The advocates of MBC acknowledged that there were large snags to each of these alternatives, but were a little inclined to dismiss them as technical or political - or at any rate, as domestic problems on which they, as outsiders, could offer no special expertise.

10. Four further points were made about the relation between the base and monetary aggregates:-

i. It would always be necessary to monitor a range of aggregates, and control of the monetary base could not be put exclusively on automatic pilot. Although one would expect radical breaks in the relationships to be rare, they could occur. The classic case was the great depression, when the monetary base expanded but the money supply contracted. Over particular periods, and especially in the uncertain transitional period, the base might fall but the money supply expand. The medium-term growth of the aggregates must always be a check on short-term control of the base. (Brunner and Meltzer)

ii. For most of the time, however, the growth rate of a broad aggregate such as £M3 would be nearer to being a consequence than a cause of the rate of change in nominal national income. (Pierce)

iii. Experience in other countries suggested that the relation between the monetary base and the price level might be more predictable than the relation between the base and any of the monetary aggregates. (Meltzer and Monti)

iv. The velocity of circulation of the base might also be more stable than that of the monetary aggregates, because it would be less affected by shifts in the holdings of different types of bank deposits. (Meltzer and Pierce)

Other Points

11. In the course of discussion, the following more specific points were made:-

i. The choice between mandatory and non-mandatory forms of MBC was less important than that there should be stability in whatever requirements were adopted. (Meltzer)

ii. There was no reason why the monetary base should not be tightly controlled week by week, but this was not essential. Control over a two to three month period would be sufficient. (Brunner and Pierce)

iii. The Swiss no longer sought control over anything less than 6 months, partly because the relation between the monetary base and the money supply had proved less stable under floating exchange rates than it had been with fixed parities. The Swiss authorities preferred to judge monetary growth over still longer periods, of (say) 2-3 years. (Schiltknecht)

iv. The incentive to disintermediation under a mandatory MBC system could be kept to a minimum by paying market interest rates on required reserve holdings. (Monti)

American experience suggested that banks would be unlikely to hold large excess reserves. It was cheaper for them to borrow in the interbank market. (Pierce)

v. Banks would adapt quickly to changes in their environment. Their current domestic behaviour was conditioned by the UK's control regime. In international markets, British banks behaved much more competitively, and adjusted much more quickly to shifts in interest rates. (Pierce)

vi. If interest rates were allowed to go high enough, the decline in the demand for bank credit would be sufficient to choke off liability management and offshore disintermediation. (Pierce)

vii. The Green Paper's emphasis on fiscal policy, debt management and interest rates was misplaced, because these were instruments of credit policy. They could not be used to achieve adequate control of the monetary base. (Brunner)

viii. The authorities should not seasonally adjust monetary quantities, because this only introduced another element of noise into the statistics. (Meltzer)

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THE DEPUTY GOVERNOR has seen @ 22.10.80 Copies to Mr Fforde
Mr Coleby
Mr George
Mr Goodhart o/r

THE MONETARY BASE CONTROL SEMINAR WITH OVERSEAS EXPERTS AND A SUMMARY OF THE OTHER CONSULTATIONS

1 You requested, for the Governor, a summary of Tuesday's meeting with overseas experts on monetary control. I attach what I consider an excellent summary by one of the HMT team at the meeting, though two points are worth making by way of explanation:

(a) Paragraph 3 - the summary of the arguments put in favour of MBC - does not make it clear that a non-mandatory form of MBC was the implicit model underlying much of what was said by Brunner, Pierce, Meltzer and Schiltknecht. The note however does point out that several of the above would find a mandatory system 'acceptable' so long as it did not impose taxation upon the banks (and thus encourage disintermediation).

(b) Paragraphs 7-9 captures very well the rather relaxed attitude of our visitors to "semi-political" and technical problems that exercise many of us much more strongly. In this context, paragraph 9(1) - the suggestion of a half-way house - should be understood to refer to a system in which we switched immediately to a non-mandatory system but set a ceiling and floor to short-term interest rates (initially quite close to existing rates but widening as experience was gained) to limit the damage from initial errors in setting the appropriate level of base. There was little support for a half-way house that involved setting a mandatory requirement first and then trying to move towards the desired non-mandatory long-term goal.

2 It is also worth recording that the Financial Secretary and Terry Burns were among the persistent questioners of our guests on

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the problems of transition to a new system and my impression was that they did not find the answers reassuring.

3 You will remember that about 10 days ago, I circulated a summary of the consultations as they then stood. This note seemed to be accepted in the Bank and HMT as a reasonably fair statement of the position then and I attach a copy of it in case you think the Governor would like to see it. A revised version, incorporating the main points of both the domestic and the overseas seminars should be available late on Monday (6 October); preparation of our own internal paper has had to take precedence. There is an HMT summary of the domestic seminar available now but it is long, disjointed (a fair reflection of the debate) and inaccurate in some respects, so I have not offered it with the papers attached.

Economics Division
3 October 1980

Michael Foot

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