

Chancellor of the Exchequer

cc Financial Secretary
Sir Douglas Wass
Mr Ryrie
Mr Monck
Mr Britton

MONETARY CONTROL

1. I understand that the Prime Minister is likely to devote most of the time at your meeting with her this afternoon to a discussion of monetary control. She apparently had a long session with Mr Walters on the subject last Friday and he has apparently provided her with a brief for this meeting. So far as I can tell from conversation with him he is more or less content with the administrative arrangements which the Bank is negotiating with the banking system. But he wants the companion discussions which we are having on the factors which determine interest rate decisions to take place under a Ministerial directive that primacy should be given to the monetary base. He does not see this as incompatible with achieving the £M3 objectives for the medium term strategy.

The Latest Position

2. The Bank's talks with the banking system are now virtually complete. The clearing banks yesterday accepted the proposals set out in the Bank's paper "Monetary Control: Next Steps". This elaborated the proposals put forward following your November statement last year and was issued in March, two days after the Budget. There are a few minor loose ends, but these will be tidied up pretty quickly and will not hold up progress.

3. The Characteristics of the System you know. But I repeat them to give you a self-contained note to draw on. They are:

- a. there will be no Reserve Asset Ratio for the purposes of monetary control: it will have a transitional role as a prudential norm.
- b. Access to the discount window will be less freely available - and then - apart from exceptional cases - only at a penal rate.

- c. MLR will be abolished or suspended.
 - d. Bank operations will be conducted mainly in bills.
 - e. The Bank will operate to keep interest rates within an unpublished band.
4. There are a number of points to be resolved about how the system will operate. These are of two sorts.
5. First there are some outstanding questions on the operation of the new arrangements. These were set out in my minute of 14 May. We are already discussing them with the Bank. Mr Walters is taking part. Briefly these are:
- a. the question of whether and when MLR should be abolished or suspended.
 - b. the new prudential arrangements.
 - c. the size of the penalty element in discount window lending.
 - d. movements of interest rates within the band.
 - e. presentational issues; how to get this system off the ground so that we depoliticise interest rates - despite the large element of continuing discretion - and make it easier to move them rather than the reverse.

We expect to resolve these issues in the next 4-6 weeks.

6. Second there are questions concerning the determination of interest rates. We have sent a paper to the Bank and Walters for discussion. A meeting is to take place this week. There are a lot of issues to resolve if we are to formalise things sufficiently to provide a clear presumption about when rates should move. This work includes considering the role of the monetary base which is relatively undistorted by the Civil Service strike and the other narrow aggregates - plus the other factors mentioned in the Budget Speech. There is a separate paper on monetary base control, which is being discussed with the Bank though Walters has not seen it yet. But we shall want to avoid anything which looks like a move away from £M3 at this stage. We intend to make a report on this work in the next 4-6 weeks also.

Timetable

7. In your minute of 18 May, you suggested that we should aim to have another round up on where we should go before the summer recess so you could report to the Prime Minister. The Bank - and Mr Walters - have agreed with this objective.

The next steps are:

- a. about 5 June: a revised and expanded draft of "Monetary Control: Next Steps" to Ministers.
- b. 19-24 June - draft sent to banks and LDTs by Bank - only marginal changes will be possible at this stage.
- c. 16 July - definitive provisions sent out.
- d. Now to mid-July - report to Ministers on the outstanding issues set out in 5 and 6.
- e. August - new system becomes operational.

Tactics

8. Everything is set on the timetable you suggested. There will be plenty of time for Ministerial discussion. It would not however be helpful to have just now a seminar with the Prime Minister of the sort we had last autumn. I suggest you say:

- a. You will report the outcome of the Bank's discussion with the banks this month. This is in line with previous decisions and does not pre-empt decisions on the key issue of the basis for interest rate changes. Mr Walters is fully informed. Much of it is very detailed and is not appropriate for a seminar. We will of course be happy to explain the arrangements in detail to the Prime Minister - if she so wishes, but she might be content to leave this to Treasury Ministers.
- b. Talks on the points in para 5 and 6 are in the early stages. Mr Walters is taking part. When Treasury Ministers have considered them, on the timetable you set out, you will report to the Prime Minister. It would then be appropriate to hold a seminar type discussion if she so wished.

Funding

9. This is rather separate - and the ball is in your court

to discuss Sir Douglas Wass's submission with us. But:

- a. the tranchettes of stock issued last week represented a more flexible approach to funding.
- b. the next issue is expected to be a further tranche of indexed stock.
- c. the funding programme - including National Savings - has been going very well, though savings inflows are now much smaller.

Points to Make

10. I attach a note of points you might make if you get drawn into an extended discussion. It is familiar stuff.

B. K. Clarke

PP

P E MIDDLETON
2 June 1981

Points to Make

1. The Government is committed to EM3 as the basis of the medium term strategy. The Prime Minister agrees with this. (Remember her comments on Walters minute). It would be a mistake to let it be thought that this question was to be re-opened.
2. MBC is therefore virtually ruled out as a means of medium term monetary control. In any case we would not now wish to contemplate, as would some pure monetarists, fixing the growth in the monetary base at a particular figure as the sole means of bringing inflation down, and keeping it down, some time over the next century or so. Policies with this cosmic time dimension are of very limited value.
3. But there is an issue concerning the value of monetary base control as a way of improving short term control. Walters still starts from the assumption that MBC is an obviously superior method of control. But we are a long way from establishing that. In this connection:
 - a. we have already agreed with Walters that controlling the base over periods of less than 6 months would be undesirable.
 - b. There is also agreement that the techniques to be used to control the base would be those we are presently developing.
 - c. So the base is really being looked at as an alternative monetary aggregate.
 - d. But work so far suggests that it has some serious drawbacks. It is in many ways inferior to other narrow aggregates such as M1. Only the currency component of the base appears to show any systematic relationship to money incomes or prices, but since this is entirely demand determined, it provides no firm evidence of a causal link. It is also currently a good deal higher than Walters would wish. 5% is the figure he mentions compared with a 6 monthly rate of 8% at present.
 - e. The relationship of the base to interest rates is not well determined and looks to be pretty unstable; in any case

there would be far reaching implications for building societies and mortgage rates.

f. And it is certainly not possible to use MBC on its own as a means of controlling £M3 or any other wide aggregate.

4. This certainly does not rule out taking the base into account among the other factors which determine interest rates. We now have a series and shall wish to monitor the base and its components. It might be of particular value this year as other aggregates are distorted by the strike. All this is being discussed currently with the Bank and Mr Walters. But this is not the same as basing policy exclusively on targeting the base.

5. The line we took in the Budget was in this sense a step away from MBC. It was a move away from excessive reliance on any one aggregate and an attempt to bring other factors - including a range of monetary aggregates - to bear on the determination of interest rates.

6. The discussions taking place at present (Bank, Walters, Treasury) are an attempt to reconcile these various factors and turn them into operational rules. Best to let them go further without prejudging the issue at this stage.