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MR TURNBULL

MONETARY POLICY

1. The Bank's Indicators of Monetary Conditions
In addition to booming bank lending, the Bank cites "high business confidence" and increases in unit labour cost as cause for concern about inflation. Two questions arise for the Bank:

i. is not high business confidence a function of expectations and low and stable inflation - this is the evidence one gets from many interviews?

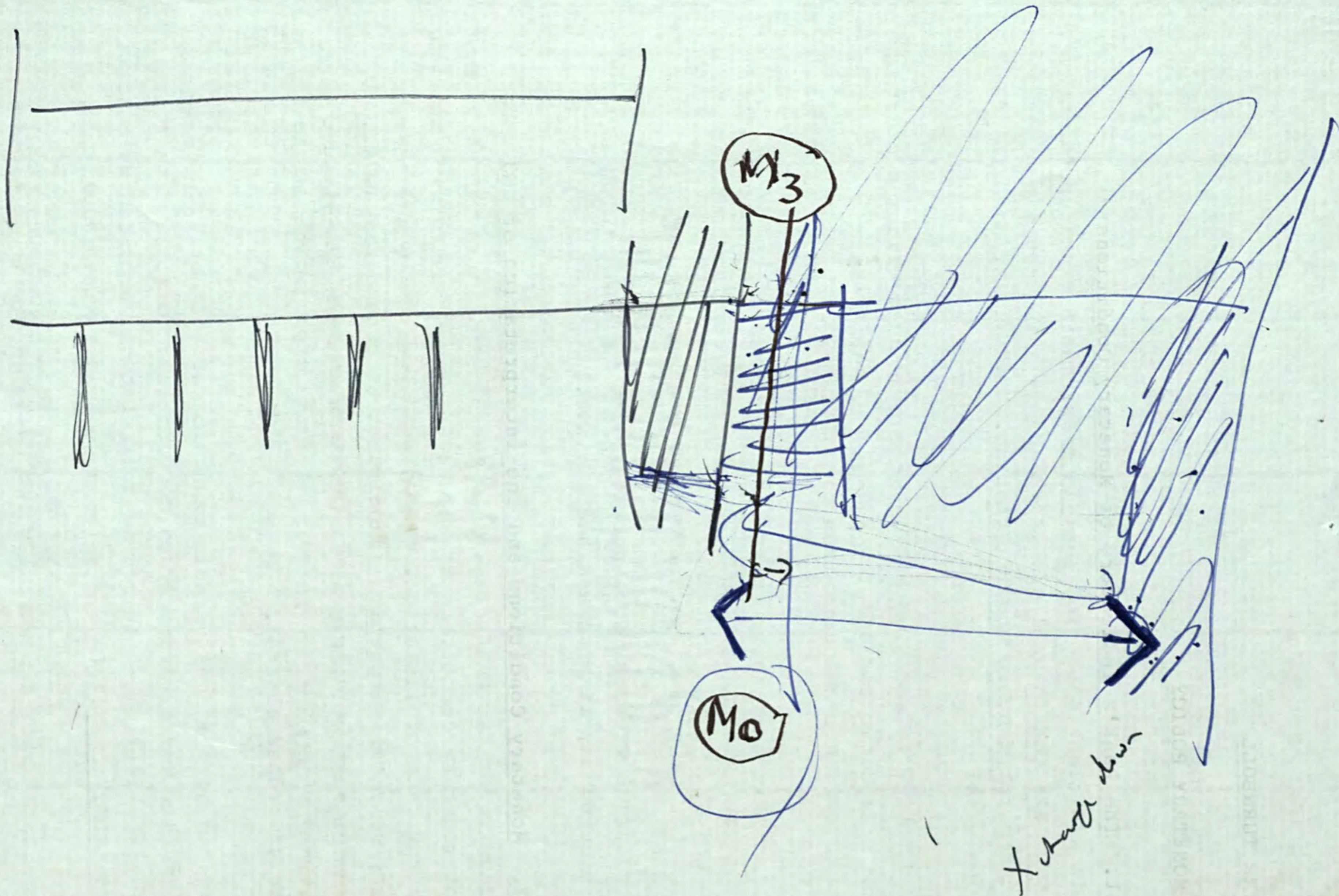
ii. unit labour costs increased rapidly in 1979/80. This preceded a great credit disinflation from the end of 1980 onwards.

[The Treasury does not deal with either of these points; you may like to ask their views.]

2. Monetary Conditions and the interpretation of £M3
I believe that the Treasury is correct in its interpretation of monetary conditions as relatively tight and consistent with a low rate of inflation. The growth of broad money - more strictly called credit - should not be considered as either undesirable or a "problem", provided we have suitably low growth of narrow money and that those expenditure balances are under proper control.

We can have a considerable expansion of bank credit, as in 1980/81, where hard-pressed corporations borrowed from flush households without affecting disinflation, provided we control spending money. (Where M3 [handwritten: MO] is a good approximation.)

The Bank makes a powerful point that the financial markets attach much importance to £M3 (para 12 - the Treasury does not deal directly with this point). But the Bank should be asked:



M3
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i. why did not the markets attach much importance to £M3 expansion in 1981 with inflation falling?

ii. what part of the importance that the financial markets attach to £M3 is due to the fact that the authorities, and particularly the Bank, themselves attach great importance to £M3? If the authorities eschewed £M3, would not the markets also?

Even if we agree with the Bank's views that bank credit must be restrained, raising interest rates is neither a speedy nor effective way of controlling it. The lags are long (more than a year). The effects are uncertain (they might be perverse as the Financial Times delightedly pointed out in 1980/81).

3. Overfunding and the Bill Mountain

The overfunding solution in what is thought to be "excessive" bank lending, is essentially quite a short term cosmetic. Overfunding creates a shortage of cash, as payments are made to the Government for the gilts. The Bank supplies the cash on demand at the fixed bill rates. It is like the Government borrowing medium to long at fixed rates and lending long (not short, since the bill mountain gets ever higher) at floating rates of interest. The Bank's defence is that overfunding raises long yields and reduces short term interest rates, so deliquifying assets held by the private sector.

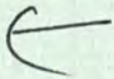
The Bank should be asked to explain first why the yield curve of the United Kingdom is nevertheless flatter or downward sloping compared with the rising yield curves of other countries, for example Switzerland, the United States and Germany, which do not practice overfunding?

Secondly, the Bank should be asked to question why the excessive Government borrowing at the medium to long end does not simply crowd out corporate and other borrowers who are then tempted instead to issue bills for the Government to buy?

It is doubtful if overfunding has any substantial direct effects on the real economy, but the bill mountain has certainly introduced great rigidities in monetary control, generated opportunities for bill arbitrage distortions and, I believe, engenders great uncertainties in the market. Clearly something must be done, and the markets are uncertain both what is to be done and how it will affect them. Such uncertainty is not a good basis for policy.

4. **Monetary Control: Next Steps**

The Bank and the Treasury agree that we should get back to the largely successful 1981 arrangements; but the Treasury wants to stop overfunding and the Bank does not. Unless one places extraordinarily high value on short term cosmetics, I do not think the Bank's defence of overfunding stands up to critical examination. From 1982 our policy was to fund only the PSBR, and this is still the right policy (as in Germany, the USA and Switzerland). This, however, will not much reduce the bill mountain. It will be helpful in stopping it growing. Some additional technical measures, which the Bank agrees, are needed (such as the ECGD transfer, direct deposits by the public sector in the banking system).



5. **Monetary Base Control (MBC)**

In 1981 we agreed that the arrangements should envisage a steady improvement in monetary management towards a system similar to the successful ones in Germany, the United States and Switzerland. In these systems the banks find it profitable to hold considerable deposits at the central bank in order to avoid having to borrow at a penal rate. In Britain per contra the Bank supplies all demands for cash at the prevailing bill rate. Thus, the banks find it profitable to hold virtually no non-mandatory balances at the Bank. This absence of bankers' deposits at the Bank seriously inhibits monetary control. In other countries they are the most sensitive of believers of monetary management (foreign central bankers find it difficult to understand how we can run our system without such deposits).

The Bank is most reluctant to take this step - which it rightly sees as the road to MBC - and has elaborated arguments in para 25 about all the "unknowns", particularly about the "starting point". (And I agree that these are unknowns.) But this should not prevent us taking a first small step to:

why not just raise Bank's dealing rates?

i. under-supplying the expected deficit on the money market by, say, £30m-£35m a day; and

ii. operating an afternoon penalty rate for any additional funds needed.

This would encourage deposits at the Bank, perhaps quite small initially, but they would serve as a basis for further development. The Bank and Treasury should be asked to study this as a next step.

ALAN WALTERS
24 June 1985