MR SCHOLAR MH

Econ Pol

20 October 1981

ALAN WALTERS

PRIME MINISTER

GORDON PEPPER ON MONETARY CONTROL

1. Pepper's description of the "new arrangements".

Although Pepper does not say anything which can be construed as wrong, he does fail to give an adequate description of the new arrangements. He is, however, perfectly correct in saying that the Bank has not changed to a system of control over banks' reserves. This we never intended. We envisaged the new arrangements as a way of allowing market forces to impinge more directly on the determination of short term interest rates. We also thought that it would be an intermediate stage on the road to some form of monetary base control. Pepper has been talking to the Bank and presumably the Treasury and has got the firm impression from them that they do not think that any move to a monetary base control, that is a control of the Bank reserves, will be forthcoming. I am sure that the Bank are strongly of this view. They would like to use an exchange rate EMS type of mechanism. In other words they would like to control, by direct intervention, the exchange rate and allow the money supply and bank reserves to be determined endogenously. Pepper does not say that the Bank would prefer exchange rate targets, but I believe he is substantially correct in that part of the story.

He is wrong, however, in asserting that the "new arrangements" are to a large extent cosmetic and I believe also he is wrong to assert that the Bank is effectively a lender of "first resort". The point is that the Bank does give whatever quantity of overall assistance the market wants; but not at an almost fixed rate - as it did under the MLR system. Now the rate can move up very rapidly as we saw in September. The general interpretation then, which appeared in the Financial Times just before Pepper made his speech, was that the market had pushed up the rates and the Bank had let the market do its work. This would never have happened under the old system. Moreover, I think we should be looking shortly towards widening the bands within which the market does determine the interest rate. The essential point is that the market operators can no longer count on getting assistance at a fixed rate. They have to judge the risks of paying a substantial penalty for being short of reserves.

/In my view

In my view, the rapidity with which the market interest rates moved up, and were seen to be driven by market forces and not Government policy, was one of the main new features of the last significant movement in rates.

2. The Exchequer surplus and its implications for the banking system.

Pepper is certainly correct in that we expect the Exchequer to be in considerable surplus during the unwinding of the dispute and the tax paying season. I believe he is correct also in identifying the fact that the banks have very limited holdings of public sector debt. Pepper, however, goes on to imply that we'll have a re-run of 1980. The drain of sterling deposits will mean that the Bank will be forced to supply additional assistance. Instead, however, of supplying it through the discount window it will, on Pepper's prediction, be buying huge amounts of eligible bills.

I think this situation is different from mid-1980 in two important ways. First, interest rates do respond much more quickly to the market forces than with the old MLR system. We have not delayed raising interest rates on this occasion. Secondly, the liquidity of the corporate sector is fairly high. It is the personal sector that is the main borrower. There is no "distress borrowing" likely in the next few months, as there was in 1980. Third, much of the additional borrowing is likely to be business which was hitherto outside the banking system, such as trade consumer credit, moving into the banks. The extent of this, however, has yet to be determined.

I suspect it is more likely that sterling M_3 will grow somewhat over the target rate, say about 12% in the year ending March 1982, in which case the banking sector's domestic surplus will be almost eliminated. But these facts should emerge when we have finished discussion of the various special factors which emerged because of the new competitive aggressiveness of the banking sector. (I doubt very much whether the recent rises in interest rates will have any substantial effect on the growth rate of M_3 during this financial year.)

AW

20 October 1981

ALAN WALTERS