8. Monetary Targets and Economic Policy

Control of Monetary Aggregates

26/9/1978 – 29/9/1978

Mr Bridgeman

cc Mr Atkinson
Mr Byatt
Mr Christie
Mr Cassell
Mr Shepherd
Mr Odling-Smee
Mr Britton
Mrs Lomax
Mr Wiggins
Mr King
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Mr Bell

MONETARY TARGETS AND ECONOMIC POLICY

1. I attach my note on monetary targets commissioned by the Fforde/Littler Group. Subject to your views, I should like to send it across to Charles Goodhart at the Bank so that he can see it when he gets back from the Money Study Group on Thursday. The paper, like his, represents my personal views. I have made no attempt to reach a concensus view among the economists in my area; most of them will be seeing the note for the first time. However, I think the conclusions are close enough to HF thinking for them not to cause you acute embarrassment in subsequent discussions with the Bank.

2. The paper, with its attachment for which I am indebted to Mr Grice - is rather long. I have been at pains not to argue the issues on the rather narrow ground in the Bank's paper. So I start with some obvious points which it seems essential to restate as part of any discussion of the issues. The economic sections are rather condensed. This is partly because the points are set out at length in the Grice note and thus I was able to point up what seemed to me to be the key issues. But it is also an attempt to place these arguments - important though they are - in the correct relationship to the other issues discussed earlier in the note.

3. I am not proposing to clear the note with Mr Littler before sending it to the Bank. We agreed that we would exchange papers as soon as they were drafted. Goodhart, in this spirit, sent

his draft without clearing it with Fforde. I would however propose to show both my paper and the Bank's paper to Mr Littler at the same time as it goes to the Bank.

4. The papers taken together seem to constitute a good basis for further discussion, which needs to take place both within the Treasury and the Bank, and jointly with them. We might in particular find it useful to have some discussion among Treasury economists more widely than in the financial sector. Mr Atkinson kindly said that he would chair a short discussion at one of his weekly economic under secretaries meetings - it is clearly relevant to another study the economists have in hand. I am accordingly sending copies of both my note and the Goodhart note to those concerned. I do not however want these papers too widely dispersed in the Treasury at this early stage, and certainly not before they have been discussed in the Fforde/Littler Group. Perhaps therefore the copies could be considered personal for the time being.

PEM

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26 September 1978

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28 September 1978

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Dear Charles

Monetary Targets and Economic Policy

I thought you might like something to greet you on your return from the Money Study Group, so I attach my draft paper on monetary targets and economic policy. It is the companion piece to the paper which you sent on 14 September for the MCR programme. Like your paper, it is a draft. It represents my personal views - some of which I am far from certain about. Senior officials and many colleagues whom I shall wish to consult have not yet had a chance to comment.

I might perhaps add a word about my approach. I have started with some rather simple issues which it seems necessary to restate before getting into the economics. The economic sections themselves are a little compressed, so I hope you will forgive the rather long accompanying paper. There is nothing in this which will be new to you, but I think it helps demonstrate how I am currently interpreting academic and other outside work in the monetary field.

I am also hoping to let you have a redraft of the note on the monetary implications of EMS before the end of the week.

Yours ever

Peter

P E MIDDLETON

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C.A.E.G. cc Mr Bridgeman

22/9 John Hoskyns's comments on Charles' Paper

I've now had a second read of your draft on monetary targets and macro-economic policy; and do not really have many points of substance to raise. But such as they are, here goes:—

1. On para 5 — 'the relationship between supply capacity...' Is it not also the case that the relationship between the pressure of demand and the rate of inflation is variable. So that even if one knew what pressure of demand was indicated by a particular level of u/e one would still not know what rate of inflation would result therefrom.

2. Para 5 again. Worth adding some (? little) 'demonstration effect', on expectations, of having a target at all. Is mostly 'discipline' but partly just appearance?

3. Paras 21-28. The conclusion to 28 does not seem to follow readily from what goes before. If we had the conflict of weak monetary growth and a weak exchange rate, I can't see it would matter much whether we were on M_1 or M_3/M_5. Lowering interest rates or loosening direct controls would be equally 'conflicting' with the exchange rate objective, as would lowering taxes or increasing public expenditure. ~~Rather~~ i.e. there is a basic conflict between exchange policy & domestic macro-policy, & that's that.

With the opposite conflict — strong M and strong exchange — the same arguments seem to apply; and in both cases the relative distance between M_1 and short-term exchange flows is a help. In the summer of '77 being on an M_3 target rather than M_1 arguably made matters worse?

OVER

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If we had followed M1 we would not have lowered MLR as far or fast as we did; and for some time would have been prepared to see M3 rise faster (on a speculative inflows) without getting into a state about it. We would have said (if we didn't want the exchange rate to rise) What's the fuss? The current b of p isn't in surplus (yet), the rate of inflation isn't falling very fast, the money supply (M1) isn't growing too slowly, etc etc, so if people want to build up huge speculative M3 balances, let them. (and furthermore we won't encourage more & more inflows by adding interest rate expectations to exchange rate ones).

4. Similarly para 33.

5. Paras 35 & 36 seem to me to overstate the inability of debt management to help in the adjustment of M3/M5 from quarter to quarter, when the 'general level' of rates is determined from the M1 side. In particular the beginning of 36 seems to imply that the 'M1 policy' would not, through ~~partly~~ ~~the~~ its effect on the gilt market, help debt management to help guide M3/M5 in the right direction. This doesn't seem right. Nor, if there is ever anything to be gained from curve-fitting, tap stock tactics etc etc, does it seem correct to dismiss them as 35 does.

This affects the tenor of 36 quite a bit. Nor do I think the EMS question seriously affects the 'direct-controls' question. Some of the other EEC countries may have resorted to direct controls, to solve 'conflicts', but are they successful, and (given our 'financial centre' characteristics, would ours be?)

So: On the whole I agree with what the draft says, my substantial reservations being confined to the external/internal 'conflict' problem and the relevance of this to choice of aggregate.
I found the concluding section (39 onwards) particularly interesting — because newer than the rest. ~~the~~

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Mr Littler

cc Mr Bridgeman
Mr Wiggins
Mr Williams
(without attachments)

MCR: MONETARY TARGETS AND ECONOMIC POLICY

1. Charles Goodhart and I have now exchanged papers on monetary targets and their policy implications. Both papers represent our personal views. I have not attempted to reach a concensus view among the economists or the administrators in the financial sector, nor have I discussed the paper yet with other senior economists in the Treasury. I have however let Mr Atkinson, Mr Byatt and the economic undersecretaries have copies on a personal basis; Mr Atkinson has said he would like to have a short discussion of some of the economic issues.

2. I would not pretend my ideas are very firm. You will however see that I have attempted to put targets in a broader context than in the Bank paper. Some of the opening remarks might seem obvious, but they are essential to an understanding of the economics, particularly the effect of targets on expectations.

3. Mr Fforde has made some comments on the Goodhart paper which I also attach (with Mr Goodhart's agreement). He is clearly a very keen advocate of a change to M1.

4. Between them, I think these papers constitute a good basis for discussion of the theoretical issues.

P E MIDDLETON
29 September 1978

Enc

Comments in here still not taken in & you might want to at a later stage.

MONETARY TARGETS AND ECONOMIC POLICY

1. This paper considers the reasons for the adoption of monetary targets and their contribution to the formulation and operation of macro-economic policy.

<u>Background</u>

phenomenon

2. Targets for the growth of monetary aggregates are a relatively recent phenomenum. They have become widespread only since the mid 1970s. Now six of the seven largest OECD countries have targets; the table below summarises the present position. But some countries - generally the smaller more open economies - are extremely sceptical about the value of targets. And the ~~more~~ most successful of all OECD economies - Japan - does not relate its economic policies to published monetary guidelines of any description.

<u>Table A: Monetary Targets</u>

Country	Aggregate
Italy	Total credit expansion
Germany	Central bank money stock
Switzerland	M1
Spain	M3
United States	M1 M2 M3
Canada	M1
United Kingdom	M3 Domestic credit expansion
France	M2
Netherlands	M2 Net national income
Japan	None

3. The one common feature about these targets is that they are <u>published</u> in advance. This apart:

a. Targets are directed towards different monetary aggregates.

b. They are expressed in different ways and apply to different periods.

government policies

c. Some relate to Central Bank objectives and policies, others to the administration as a whole.

d. Their ~~relationship to~~ implications for the various instruments of macro-economic policy vari~~es~~y greatly.

4. The other common feature about targets is that none of the major countries adopting targets has managed to meet the stated objectives with any precision or regularity. In one notable case, the United States, the target for the narrow aggregate M1 has been moved unequivocally in the opposite direction to the growth of the aggregate to which it was related.

Table B: Projected and Actual Rates of Monetary Growth

Country	Aggregate	Period	Target(a)		Outcome(a)	
			M1	M2	M1	M2
United States	M1/M2(b)	March 1975 - March 1976	5-7½	8½-10½	5.0	9.6
		1975 Q.2 - 1976 Q.2	5-7½	8½-10½	5.2	9.5
		1975 Q.3 - 1976 Q.3	5-7½	7½-10½	4.6	9.3
		1975 Q.4 - 1976 Q.4	4½-7½	7½-10½	5.7	10.9
		1976 Q.1 - 1977 Q.1	4½-7	7½-10	6.3	10.9
		1976 Q.2 - 1977 Q.2	4½-7	7½-9½	6.6	10.7
		1976 Q.3 - 1977 Q.3	4½-6½	7½-10	7.8	11.0
		1976 Q.4 - 1977 Q.4	4½-6½	7-10	7.6	9.8
		1977 Q.1 - 1978 Q.1	4½-6½	7-9½	7.3	8.6
		1977 Q.2 - 1978 Q.2	4½-6½	7-9½	7.5	
		1977 Q.3 - 1978 Q.3	4-6½	6½-9	7.6	
		1977 Q.4 - 1978 Q.4	4-6½	6½-9		
Germany	Central bank money	end-1974 - end-1975	8		10.0	
		Average 1975 - 1976	8		9.2	
		Average 1976 - 1977	8		9.0	
		Average 1977 - 1978	8			
France	M2	Dec.1976 - Dec.1977	12½		13.9	
		Dec.1977 - Dec.1978	12			
			M3	DCE	M3	DCE
United Kingdom	M3 sterling/DCE	Fiscal year ending April 1977	9-13(c)	£9.0bn	7.8	4.9
		Ditto ending April 1978	9-13	£7.7bn	16.0	3.4
		Ditto ending April 1979	8-12	£7.7bn(d)		
Italy	Total credit expansion	March 1974 - March 1975	Lit.21,800bn		19,600	
		March 1975 - March 1976	Lit.24,700bn		35,280	
		Dec. 1975 - Dec. 1976	Lit.29,500bn		33,280	
		Dec. 1976 - Dec. 1977	Lit.32,000bn(e)		35,652	
		March 1977 - March 1978	Lit.30,000bn			
Canada	M1	1975 Q.2 - 1976 Q.2	10-15		12.0(f)	
		Feb./Apr. 1976 - 1977 Q.2	8-12		6.5	
		1977 Q.2 - 1978 Q.2	7-11			

(a) Increase in per cent or absolute limit on outcome.
(b) M3 targets, which have little operational meaning, are not shown.
(c) Revised from 12 per cent to be consistent with DCE target.
(d) 15 months to mid-June 1979.
(e) Revised from Lit. 36,600 bn.
(f) 1975 Q.2 - Feb./Apr. 1976 (excluding effects of postal strike).

5. The impulse to publish monetary objectives of one sort or another seem to have been a response to two world developments:

a. The floating exchange rate system after the final collapse of Bretton Woods in 1973.

b. The widespread increase in inflation ~~and~~ over the same period.

Floating meant that there was no longer a fixed standard of reference against which people could judge the direction of macro-economic policy. Demand management policies became suspect in this period, and seemed if anything to contribute to inflation without being able to maintain either output or employment. Monetary targets thus filled a vacuum. First they supplied a simple test by which the public could appraise some or all of the authorities' macro policies. Second they emphasised the counter-inflation element of those policies.

Conveying Policy Intentions

6. It might be said that the public are asking for the impossible in looking for simple benchmarks against which to judge the direction of policy. But though those concerned with policy making inevitably complain about the lack of sophistication in the outside world in assessing the consequences of government actions, it is unrealistic to imagine that this can very easily be changed. Complicated sets of indicators will not convince those who want to know about policy. If the authorities do not provide simple guides, others will. It is better to offer one's own simple rule than to allow an inappropriate one to be invented.

7. Moreover it can be argued that even relatively sophisticated sections of the population have a need for such yardsticks. Operators in domestic and foreign markets, negotiators in the labour market, and others need a common framework of reference on which to form expectations about the future. It is to meet this need that published targets have become fashionable. They may not be aimed at the same audience in all countries, but the key reason for their publication must be to convey a simple statement of policy intentions.

8. It follows that the more aspects of policy which can be embraced in the published target, the more effective it is likely

to be in influencing expectations. The information which it has been most necessary to convey has been related to the intention of the authorities to combat inflation and, in the case of more open economies, to rectify external imbalances. It is widely accepted that restrictions on the growth of the money stock are a necessary component of a programme against inflation. A monetary target has therefore meant that someone - maybe only the Central Bank - was putting the reduction of inflation in the forefront of its objectives. It is also fairly well accepted that monetary instruments, interest rates and credit rationing are on their own insufficient to bring inflation back to acceptable levels. An appropriate pay and fiscal strategy is of equal if not greater importance. A target in which all three elements play a part is clearly likely to carry more conviction than an objective embracing only one. This conviction carries through to both the degree of emphasis on counter-inflation suggested by the target and the ability to take convincing measures to deal with deviations from it.

9. In some countries such as Germany and the United States the constitutional position makes it difficult to ~~envisage a widespread~~ use the wider monetary aggregates as targets. In these countries the monetary target is simply a statement about Central Bank objectives and policy - ie a signal about the circumstances in which interest rates may change. The government may agree or disagree with the objective of the Bank or it may not be known whether it agrees or not. If the government agrees its fiscal and other policies should tend in the same direction - though there is no reason why they should reflect final objectives in the same degree. And if the government disagrees there may be a clear conflict of policies and general uncertainty. The main objective of the target is lost and the target becomes a means of testing the resolution of the Central Bank in competition with the government.

10. Economic theory seems to me to have been a second order consideration as far as ~~targets are concerned!~~ the question of publishing targets is concerned. There is nothing in economic theory which suggests a monetary objective should be published, though developments in monetary theory undoubtedly contributed to giving increased emphasis to the supply of money in macro policy, especially insofar as it is concerned with inflation. There is no unanimity about monetary theory, even among those who

Targets Announced targets are likely to be of value in influencing the behaviour of price and wage setters, provided they believe the targets will be (is this true?

profess to believe in it; and there are a great number of eminent economists who do not believe in it at all. It is not easy to find a Central Bank governor who would claim to be a monetarist in any respectable academic sense, and it is quite impossible to find a finance minister with such beliefs. Treasury and Bank officials reflect the whole spectrum of views. Yet even those who are most sceptical about monetary theory can see a role for targets in the sense set out above.

11. If we approach targets from this standpoint, it is rather absurd to expect them to do anything very precise.

12. First, it is almost impossible for a government to pursue any one objective to the complete exclusion of all others. If things do not turn out as expected when the target is set - say developments in pay are very different, the choice between final objectives may have to be rethought and some alteration in monetary and fiscal policies promulgated. This flexibility has been brought about in practice by a variety of devices - base drift, rolling targets or simply failing to meet the targets stated.

13. Second, no matter how good economic relationships seem to be, there is no method of economic management which will guarantee specific effects on inflation and activity. It is obviously desirable that the policies and policy responses implied by the target should be in a direction which the authorities have cause to believe, and can cause others to believe, is in a direction which furthers the general objective of controlling inflation. Stability of relationships between the aggregates to which policy is directed, a theory about how they are formed and evidence about their robustness are important. But it is futile to imagine that there will be any concensus within or without government about precise relationships. And it would therefore be misguided to be over influenced in the choice of target variable by either particular relationships or by the ease with which it is thought a particular variable might respond to particular instruments. I see the role of targets as of much wider importance, conveying the assurance of a comprehensive response in broadly the right direction which would be accepted by a wide spectrum including those who do not place much value on purely monetary relationships.

I do not think that it is any criticism of targets that the record in sticking to them throughout the world is not outstandingly good. And we must avoid starting a reconsideration of our own targets from the assumption that the way forward is to look for narrower, more easily met targets which are more comfortable to live with for the authorities. The reverse is more likely to be the case.

Monetary Targets in the United Kingdom

14. I now turn to the development of monetary targetry in the United Kingdom in the light of the general considerations set out above.

The Constitutional Position

15. In many countries the choice of aggregate has been related to instruments which the Central Bank has - according to the constitution - at its disposal. Such reasoning about instruments leads the Bundesbank to set its target in the form of Central Bank money. M1 targets are particularly relevant in the case of a Central Bank in a fully independent position with authority over interest rates. They serve as a guide to action by the Bank and enable it to explain its policies. This is perhaps the main reason why emphasis is placed on M1 in the USA. delete all £ from M1

16. As was suggested earlier, looked at from the point of view of economic policy making as a whole, this has some unfortunate results, to say the least. £M1 has been under continuous attack for its narrowness and seeming lack of relationship to the policy of the government in the USA. This culminated recently in the President attacking it in a speech as though it were an unpredictable enemy sent to destroy him. On the other hand the Fed Chairman has been urging counter-inflationary fiscal and other policies on the President, even though he cannot point to a very clear relationship to his monetary targets.

17. There is no reason why we should run the risk of such confusion in the UK. All the key macro policy instruments are the responsibility of the Chancellor of the Exchequer and the government. Though we may dislike the direction of policy on which Ministers decide, their instruments have to be combined to ~~meet their~~ desired objective. in a way consistent with those objectives

18. There ~~may still be~~ are reasons (which are examined later) why we ~~should~~ might wish to have a target reflecting interest rates alone. But there is certainly no presumption that this is desirable.

Final and Intermediate Objectives

18. Guidelines for monetary growth are intermediate objectives of policy. They might be seen as contributing to various final objectives - full employment, price stability etc. They also exist alongside other intermediate objectives with which they are intimately related - exchange rate policy and pay policy are examples. It is too much to expect the government to have an absolutely clear cut set of priorities for any length of time between either its final objectives or its intermediate objectives. But it is desirable that the targets must convey information about the mix of its objectives currently being pursued. And this is broadly speaking what we have done so far.

19. Monetary targets were introduced in the UK at a time when the crucial aim of policy was to restore external balance, though continuing to bring inflation down was a vital element in this. A credit objective is the most powerful indicator of such policies, and following the agreement with the IMF our first published objective was in fact a ceiling for DCE.

20. As the external position improved, and reducing inflation remained a major objective of policy, it was possible and appropriate to give greater emphasis to one of the indicators of money supply - thus £M3 gradually assumed the key position.

21. The same sort of considerations will arise in relation to a more fixed exchange rate in an EMS, but these are explored at length in a separate paper. According to how much emphasis we wish to give to UK exchange rate objectives and depending on the arrangements within the EMS bloc, different monetary objectives might be appropriate.

22. During the whole of this period, the monetary and credit objectives have been related to fiscal and pay policy. Had these been different or quite independent, the nature of the target and the severity of its impact would have reflected the different policy mix.

23. This short experience does therefore serve to illustrate the undesirability of attempting to lay down in a definitive sense ~~for all time~~ that any particular aggregate is superior to others; the ultimate choice depends on priorities within primary and intermediate objectives and these are bound to change from time to time.

Formulation of Policy and the Use of Policy Instruments

24. It could ~~not~~ be said that £M3 and DCE had been satisfactory target variables if either:

a. They were not related to the other elements of policy on which they impinge when the targets were formulated.

b. Other instruments could not be adjusted if money supply gets out of line with the target, in a direction calculated to bring monetary growth back towards it.

25. Both the £M3 target and the DCE ceilings have performed quite well in relation to these two tests. The process of policy formulation ~~formation~~ is never perfect. Given the complexity of final and intermediate objectives it is unrealistic to expect an intermediate objective for any monetary aggregate to be the sole or always the dominant consideration in the formation of policy. Moreover our internal arrangements for relating monetary and non monetary considerations will have to be developed. ~~are also less than perfect.~~ But this should not be allowed to obscure the great strides which have been made over the past few years in bringing all these conflicting considerations together and giving monetary considerations an important role in overall policy formulation.

26. Basing discussions on £M3 has played an important role in achieving this. Though we are very unsure about precise relationships, both fiscal and intervention intentions have been limited by - among other things their possible effects on £M3. And both have been closely tied in with pay policy. These relationships are plain to see as the published forecasts and the monetary guidelines are available simultaneously.

27. Policy conflicts are bound to arise during the year. But £M3 targets have been given additional credibility because it has been seen that we have been prepared to use all our policy

to restrain monetary growth when overshooting the target.
instruments ~~at various times of serious deviation in an endeavour to approach the target.~~ In 1977 when the attempt to maintain a stable exchange rate was in conflict with the monetary objective, the exchange rate was allowed to float upwards. In the 1978 budget when the fiscal stance seemed incompatible with the monetary target at what appeared to be feasible rates of interest, the government changed fiscal policy in the most difficult political circumstances. Though fiscal policy cannot be changed as regularly as purely monetary instruments, it can be changed sufficiently often to be considered a possible reaction to major deviations from the published target. We have also been willing to use the SSD scheme with its ~~progressive~~ element of rationing.

28. The £M3 target therefore has very good credentials in assuring markets that appropriate policy changes ~~can~~ will take place if we move out of line. It also ~~scores very well in~~ providi~~ng~~es a basis through which those interested in monetary issues can have a significant influence on the formation of other relevant policies.

29. Would other aggregates do this as well? Narrow aggregates such as M1 almost certainly would not. There is no very satisfactory way of relating this aggregate to other aspects of macro-economic policy. It is true that fiscal policy can put great strains on monetary policy. But the danger in moving to an M1 target is that it will be seized on by some as an opportunity to get rid of what they see as the shackles imposed by monetary considerations on other policies. This is surely the greater danger. It carries the risk that underlying conditions may be such that the chances of actually being able to influence economic conditions significantly within conceivable changes in interest rates - less still meet an ambitious monetary target - would be notably lessened. The objective is not just to set the target which can be easiest met. It is to have a real impact on prices and expectations about prices.

30. These objections do not apply in the same measure to £M5. Here the problem is the unknown nature of the aggregate and the difficulty of getting ~~either policy makers or~~ the market to take it seriously.

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Conveying Information

31. To be suitable for conveying information a target must be based on a concept which:

a. Is readily accepted as relevant.

b. Gives the most widespread assurance about the direction of policy.

c. Has a reasonable theoretical basis and can be controlled by the use of policy instruments.

32. The present aggregates to which policy is directed, DCE and £M3, score well in terms of the first two considerations, and reasonably well in terms of the third.

33. £M3 is well known. Statements about monetary policy are taken to be statements about £M3. Though there have been occasional suggestions that another monetary aggregate would be more appropriate, policies directed towards controlling £M3 have satisfied market and other opinion as appropriate. On occasions when we have attempted to give more emphasis to another aggregate (~~see~~ for example the Bank's attempts to direct attention to ~~£~~M1 in 1973), markets have remained unimpressed and continued to monitor £M3. So entrenched is that aggregate that it would be difficult or impossible to direct policy to another aggregate to replace £M3. For a considerable time at least any other aggregates would be additional.

34. DCE is perhaps less well known, but is easy to relate to £M3 and following the IMF standby is generally thought to be appropriate if policy is ~~strongly~~ chiefly directed to particular external objectives.

35. £M3 is a useful single indicator of the general stance of government policy because it has ~~accounting~~ clear links with all the key areas of policy. There is a link with fiscal policy through the PSBR; with the authorities' open market operations; with bank lending to the private sector; and with external flows and exchange rate policy. These links are not of course as straightforward as the accounting relationships tend to lead one to think. But they are closer and better understood than those with any other aggregate.

36. Looked at from this standpoint other monetary aggregates suffer from serious disadvantages:

a. £M1, the narrow aggregate, would be mainly about interest rates. It would offer no assurance about fiscal policy and have no very clear relationship to pay policy. It might indeed lead people to believe we thought that monetary policy could be pursued independently of fiscal policy which the authorities were free to pursue unrestrained.

We should probably be driven towards some independent measure of fiscal policy. It is exceedingly unlikely that we should regard the PSBR as the relevant indicator - its main importance is as a monetary indicator of fiscal policy; its relevance lies in its relationship to money understood in the sense of £M3. The PSBR has no very clear relationship to £M1. We may as a result of a £M1 target arrive at a better indicator of fiscal policy, but it is unlikely to help contribute to the impression of coordinated policies - especially as the PSBR like £M3 is likely to remain important in the eyes of markets regardless of what we do.

M3 is ok because (direct links ~~with~~ with PSBR above) but now the PSBR is a poor indicator of fiscal stance?

b. £M5 is moving into the unknown. We do not even have a series though one could no doubt be constructed. It could involve changes in the system eg of controlling the building societies and the NSB which may have unpredictable effects. It seems to be more likely to constrain than to free the use of some policy instruments (eg interest rates if the link with building societies becomes explicit) than direct them more rationally. It is unlikely to carry conviction for some time and we could not be very confident in using it.

37. It might be asked why not have more than one indicator. The answer is that this is more likely to confuse than to help clarify the direction of policy. Government policies are not viewed in an academic way. Doubling the number of targets doubles the potential criticism if one fails to meet either or both. And in particular very strong arguments would be needed before moving to two untried aggregates and abandoning the one which we and everyone else has got to know.

38. These arguments are reinforced by the prospect of entering into new European Currency Arrangements at the end of the year. We should be hesitant about making other fundamental changes at the same time - we do not want too many unknowns. We shall wish to be able to assure the markets in relation to what they think they

know and understand.

39. EMS also means that we should be very careful in moving towards aggregates which depend for their efficacy essentially on interest rate adjustments. Under the new arrangements we may need to use interest rates primarily to convince the markets that day to day decisions are primarily directed towards exchange rate stability.

40. The main doubts about £M3 are concerned with its theoretical basis and our ability to control it. These issues are considered below.