MONETARY BASE CONTROL

PART 4

7 July 1981 – 10 July 1981

12/80

Chancellor of the Exchequer

cc Financial Secretary
Chief Secretary
Minister of State (L)
Minister of State (C)
Sir Douglas Wass
Mr Ryrie
Mr Burns
Sir Kenneth Couzens
Mr Britton
Mr Monck
Mr Kemp
Mrs Lomax
Mr Turnbull
Mr H Davies
Mr Lavelle
Mr Peretz
Mr Riley
Mr Grice
Mr Shields
Mr Bennett
Mr Ridley

THE PRIME MINISTER'S SEMINAR ON MONETARY CONTROL

1. I attach a set of papers for the seminar on 31 July. They have been prepared in a working group, the members of which were:

Mr Britton
Mr Monck
Mrs Lomax
Mr Turnbull
Mr H Davies
and myself

Mr Fforde)
Mr George)
Mr Goodhart) B/Eng
Mr Coleby)
Mr Foot)

Mr Walters No 10

2. The steering note points up the issues which we think should be covered at the seminar. We have not attempted to come to conclusions on these issues. But we have got the papers ready quickly so that there will be time for discussion before the seminar.

3. The Bank are putting the papers to the Governor. You will no doubt wish to discuss these questions with him before the seminar - but I hope we can have at least one internal discussion first.

P E Middleton

ff P E MIDDLETON
10 July 1981

Encs

SEMINAR WITH THE PRIME MINISTER: NOTE BY OFFICIALS

1. In his Budget Statement the Chancellor said:

> "Discussions are now to take place with the financial institutions about these and other changes, including the future of the cash ratio. When they are complete, the Bank will aim to keep very short-term interest rates within an unpublished band, and in due course suspend altogether the practice of having an announced MLR, which would by then have lost its operational significance."

2. The purpose of the seminar is:

a. to take note of the new arrangements. Some elements are in place already; a further set of changes will come into effect on 20 August.

b. to consider how the unpublished bands should be determined.

3. There are 3 papers which:

I. Describe the new arrangements and explain how they work.

II. Discuss the role which the narrow aggregates could play in monetary policy decisions.

III. Explain how the considerations set out in the Budget Speech might be brought together in taking interest rate decisions.

The papers have been prepared by a Working Group of officials from the Treasury and the Bank. Mr Walters (No 10) was a member of the Group.

<u>The Arrangements (Paper I)</u>

4. The arrangements follow from decisions taken at the Prime Minister's seminar last November. They were first described in the Chancellor's November 1980 statement and were carried forward in the 1981 Budget. They reflect extensive discussions with the financial institutions culminating in the Draft Provisions issued by the Bank in June (and shown to the Prime Minister by the Chancellor on 19 June). The Draft Provisions are attached for the sake of completeness, but all the relevant points are covered in

the paper.

5. There is no dispute about the form of the arrangements which are due to go into operation on 20 August. The intention behind the changes is to give the market a greater role in determining the term structure of interest rates and to enable the authorities to exercise influence over short term rates in a more flexible and less prominent fashion.

6. There is, however, one unresolved issue - the timing of the suspension of MLR. Giving the market more of a role means giving the authorities less. Putting MLR into suspense is part of the new approach. But when this has been done the authorities will be unable to give such clear signals about their immediate interest rate intentions. In particular they will have considerably less direct influence over base rates and mortgage rates.

a. Retaining MLR for the time being would enable the authorities to give definite signals for a little longer - this might be desirable, for example, in the context of the current uncertainties in the foreign exchange market or to cap unwanted pressure on short term rates which might result if there is a sudden reflux of cash to the Government when the Civil Service strike ends.

On the other hand:

b. Suspending MLR with Immediate Effect on 20 August would gain the maximum presentational and operational advantage from the new arrangements. There would be a cleaner break from the past and the authorities role in influencing some of the more politically sensitive rates, would become less direct and obvious.

The issues are set out in paras 35-38 of Paper I.

Setting Short Term Interest Rates

7. The other two papers discuss the crucial issue of how we first set, and then change, the band within which very short rates (ie up to 14 days) are allowed to fluctuate.

8. The Government is presently committed to £M3 as the basis for its medium term strategy.

9. The Government also restated its annual targets in terms of £M3 in the Budget, while recognising that other factors needed to be taken into account in determining short term interest rates.

10. The question still to be resolved is the relative importance attached to the annual £M3 target and other factors in setting short-term interest rates. In particular, the role of the narrow aggregates, M1 and the wide monetary base, has still to be settled. The group has concentrated on immediate changes which, to quote the Budget Speech are:

> "Desirable in their own right and consistent with a gradual evolution to monetary base control."

11. The new arrangements are consistent with a widening of the interest rate bands and moving to monetary base control. But none of us is advocating an immediate move to a monetary base regime which would exclusively determine short-term interest rates.

12. The immediate issue, as we see it, concerns the determination of the band for short-term interest rates. Broadly speaking there are two options:

a. Make this decision depend primarily on one or other of narrow aggregates - essentially the choice is between M1 and the wide monetary base. This would mean abandoning the annual £M3 target. We do not regard the option of dual targets - eg for M1 and £M3 - as viable.

b. Retain an annual target for £M3 & set the interest rate band on the basis set out in the Budget Speech. This said:

> "Decisions about short-term interest rates will continue to take account of the whole range of monetary indicators referred to earlier and other factors that affect the significance of the numbers, especially the progress of inflation."

The other factors included: the narrow aggregates, the exchange rate and the real cost of borrowing.

With either approach it would be neceesary to clarify the considerations which the Authorities were taking into account. But we all agree that it would also be necessary to retain some discretion - to depart from the criteria set - in special circumstances.

The Narrow Aggregates (Paper II)

13. The paper sets out the implications of moving to the narrower aggregates:

a. the narrow aggregates are not demonstrably inferior to £M3 in predicting long run trends in inflation. Like all aggregates, however, they show large and erratic short-run variations which are not closely associated with movements in nominal incomes.

b. M1 would be easier to influence by changes in the level of short term interest rates than £M3. But it does not have the same obvious links with expenditure and tax policy. And the response of M1 to interest rates is still subject to a margin of error.

c. M_0, the monetary base, would be more difficult to control by changing the level of interest rates than M1 (and possibly than £M3).

d. It would be possible (subject to the qualification in b above) to relate interest rate decisions to a quantitative objective for the growth of M1 over 6-9 month periods.

e. An immediate move to M1 would mean either adopting figures which seem high both in relation to the £M3 targets and to nominal incomes, or accepting high real interest rates.

f. Such an objective for M1 would make it difficult and sometimes impossible to meet, at the same time, an annual target for £M3. There might also be some conflict with the medium term £M3 targets; these would cease to have much day to day operational significance though they would remain very important at Budget time.

g. In the event of a narrow aggregate deviating from target, the presumption would be - much more clearly than with £M3 - that the initial response should be to change the level of short-term interest rates. This instrument would not, therefore, be available to meet other objectives, without adverse implications for achieving the target for the narrow aggregate.

£M3 Plus Other Factors (Paper III)

14. The paper explains the implications of retaining the annual

£M3 target and the associated considerations set out in the Budget Speech:

a. It follows directly from the Budget Speech, and is more obviously consistent with the MTFS. It would not need a new announcement, though we might wish to give more explanation of how the various factors were to be taken into account.

b. It proivdes a less clear guide to changes in the interest rate bands. £M3 responds to the structure of interest rates as well as the general level of interest rates. It can be unpredictable in the short term, and can take a long time to respond.

c. The additional factors to be taken into account are difficult to quantify.

d. Decisions would be taken with a longer forward timescale in mind, and in practice are likely to be taken less frequently.

e. It appears to be more flexible because it gives the authorities greater discretion, whereas an M1 approach might look more rigid. This flexibility will however be seen as a disadvantage by those who want to give maximum weight to preventing shocks coming through on to the money supply.

15. In one way or another a range of factors will be taken into account in arriving at decisions on interest rates; this has been stated repeatedly by Ministers since the Green Paper on Monetary Control. The choice between the two approaches is one if emphasis in determining the bands - primacy to M1 or primacy to £M3.

PEM
9 July 1981

THE ROLE OF THE NARROW AGGREGATES

SUMMARY AND CONCLUSIONS

1. There are two broad ways in which the narrow aggregates (M1 and Mo) could be given a greater role in monetary policy decisions: we could set explicit targets for them, or they could be used more informally as indicators, alongside £M3 and other variables, to inform interest rate decisions.

Targets

2. The alternatives are:-

(a) a single target for one of the narrow aggregates in place of the existing annual and medium term targets for £M3;

(b) a short term (6-12 month) operational target for M1 or Mo, with £M3 remaining as the medium term target for MTFS purposes;

(c) a short term target for either M1 or Mo as an adjunct to both the annual and medium term targets for £M3.

3. The case for replacing £M3 depends on whether either M1 or Mo is judged preferable to £M3 on control grounds, and in terms of its relationship with prices. A case can be made out for M1, but Mo does not look a strong candidate because, unlike M1, it would be difficult to control by varying the level of short term interest rates. But it would be difficult to abandon £M3 entirely without damaging the credibility of the strategy. A target aggregate like M1, which can in principle be controlled by varying interest rates alone, might also fail to act as an effective constraint on fiscal policy. (See paras 7-20).

4. There are strong objections to multiple targets (options b and c) which have special force where targets for both broad and narrow aggregates are annual. Different aggregates have not tended to move together over periods as short as a year. Measures taken to control one aggregate

could throw the other further off course. We could well end up missing both targets, (see paras 21-27.)

Indicators

5. A more low key approach would be to take systematic account of the information contained in the narrow aggregates, alongside £M3, in taking interest rate decisions. This could be done without setting formal targets for the narrow aggregates if the forecasts were used as a benchmark to identify unexpected developments in M1 and Mo. The narrow aggregates have not on average been reliable forward indicators of movements in broad money but on occasion they have signalled when interest rate movements have become excessive (eg. 1977) and provided an alternative measure of monetary conditions in periods when the broad aggregates are known to be distorted by special factors (eg. the early '70's and 1980). But this does not point to any very simple rule. (See paras 28-34.)

Outlook for 1981/82 and 1982/83

6. The narrow aggregates are likely to grow fast relative to both £M3 and nominal incomes as inflation decelerates, unless interest rates rise in real and possibly nominal terms. This is because the velocity of M1 tends to vary with nominal interest rates and thus with the rate of inflation. A target for M1 which accommodated some fall in velocity over the next few years would probably have to be over 10%. It might not be possible to meet a single figure target without high real interest rates, given the fiscal framework set out in the MTFS. (See paras 35-39)

THE ROLE OF THE NARROW AGGREGATES

Introduction

This paper summarises and updates some of the work done before the Budget on the choice of target aggregate and considers whether there is a role for one of the narrower aggregates (M1 or some measure of the monetary base) either as a target in its own right or as a less formal yardstick for taking short term interest rate decisions. The Budget reaffirmed the Government's commitment to £M3 as the target aggregate both for medium term (MTFS) and annual purposes. The paper discusses how far a role for one of the narrower aggregates would be compatible with this position. It concludes by reviewing the prospects for the different monetary aggregates in the next two years as implied by the Budget forecast, and by the latest internal forecasts and describing how we might set about choosing a numerical target for a narrow aggregate, should we want to adopt one.

I. The Monetary Aggregates

(a) M1

2. UK statistics currently identify three measures of money: £M3, M3 (which differs from £M3 only by including residents foreign currency deposits) and M1. The most obvious function of money is to act as a means of payment and the aggregate which most closely corresponds to money in this sense is M1, which consists of notes and coins and £ sight deposits. Most of these deposits do not carry an explicit rate of interest,* but there is a small, though quite rapidly growing, interest bearing component, including accounts which are clearly not primarily a means of payment, but provide a temporary home for funds eventually destined for the gilt edged market. But M1 does not include all the assets which can be effectively used to make payments and

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*though current accounts do bear an implicit rate of interest because of the way offsets to bank charges are calculated.

financial innovations of the sort recently introduced in the USA are likely to make it even more difficult to unambiguously identify a set of assets which performs this role. There are also statistical problems with M1; for example, the seasonal adjustments are prone to much larger revisions (in percentage terms) than are the adjustments to £M3 and short term movements in the series do tend to be rather erratic.

(b) £M3

3. Sterling M3 includes all the assets that are in M1, plus a large interest bearing component (£ time deposits and CD's) whic fulfill another, wider function of 'money'--to act as a store of value; But there are a wide range of other short term financial assets which serve the same purpose - LA deposits, Treasury bills and deposits with finance houses. The main feature which distinguishes time deposits from these other assets is that they are capital certain. Like other short term financial assets, however, they become more attractive when the level of short term interest rates is expected to rise, relative to longer term rates. The fact that 60% of £M3 is interest bearing is the reason why £M3 is primarily responsive to relative rates of return rather than, like M1, to the level of short rates alone. While a rise in short rates will unambiguously depress M1, it may or may not reduce long term rates, and the expected capital gains to be made from holding gilts.

(c) M2

4. The Bank are now in the process of constructing a new monetary aggregate, M2 to fill the gap between M1 and £M3. Unlike these other measures of money, which are based on subsets of the deposits distinguished in the banks' own balance sheets, M2 is an attempt to give statistical content to a purely economic concept - money balances which are primarily used to finance transactions. It will include interest bearing accounts below a certain size, as well as current accounts, and may include deposits outside the banking system which can be used to make payments. It will be sometime before the usefullness of the new series can be properly assessed. The first data should be available by the end

of the year, but it will be a matter of years before we have enough understanding of its seasonal and other properties to use it as the basis for taking monetary policy decisions.

(d) The Monetary Base (Mo)

5. Other measures of money can be derived from the published statistics, though they are not identified as monetary aggregates in their own right. One of the narrowest measures is base money* (designated Mo for the purposes of this paper) which include notes and coins held by the public - 85% of the total - and bank cash and bankers' balances at the Bank of England. From a theoretical standpoint, it is an interesting concept because it measures the money which is created directly by the monetary authorities (sometimes called 'high powered money'). Money assets which are the liabilities of the banking system (bank deposits) are excluded altogether. Looked at another way, base money is equal to that part of the Central Government's borrowing requirement, including its net acquisition of foreign assets (via EEA), which is not funded by selling non-money assets to either the banks or the non-bank private sector. Unlike other measures of money, information on the monetary base is available on a daily basis.

(e) Growth of the Different Aggregates

6. Over long periods of time the various aggregates tend to move broadly in line with one another: between 1964 and mid-1980 for example the trend growth of Mo was 8½% of M1 8¾%, while £M3 grew by about 10¾%. If the years 1972-75 are excluded in calculating the trend (on the grounds that £M3 was distorted by the aftermath of Competition and Credit Control, round tripping etc.) the correspondence is even closer, with a trend growth of £M3 of 8½% a year. But the year by year growth rates in broad and narrow aggregates have often diverged very sharply - indeed, over the 1970's,

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*The monetary base can be defined in a number of ways. The definition used here is the wide base including notes and coins and bankers' balances at the Bank of England, but not other deposits at the Bank (eg. by Bank staff, and overseas customers). Different definitions of base money were discussed in an article in the March 1981 BEQB.

(b) Control Issues

12. On the second issue - controllability - the differences between the various aggregates are more pronounced. The instruments available to the authorities are variations in the level of short term interest rates and fiscal policy. They may also, on occasion, be able to influence relative interest rates, through operations in the gilt-edged market, though-in our present state of knowledge - not reliably and possibly not to any great extent. Changes in short term rates may often have powerful effects on £M3 by changing expectations about future interest rates and encouraging asset holders to switch between money and gilts. But the net effect on £M3 depends on how long rates move as well, and this is not easy to predict. Short term interest rates also directly influence the growth in gross wealth, which includes bank lending- though this effect takes a year or two to build up. In general, therefore, the relationship between £M3 and the level of short term interest rates is neither very reliable nor very well understood certainly over periods as short as a year. The authorities cannot, therefore, depend on controlling £M3 by manipulating short term interest rates alone. A supportive fiscal policy is necessary. But since fiscal policy is cumbersome to change, relatively slow acting, and its effects are specific to the precise measures taken, this makes control of £M3 over periods of less than a year a distinctly chancy business.

M1

13. By contrast the narrower aggregates are less likely to be affected by fiscal policy changes and to be more responsive to changes in the level of short term interest rates. The link with fiscal policy is a matter of degree. The demand for M1, like the demand for broad money, seems to be related to gross financial wealth as well as income, and it too is likely to be influenced by fiscal policy - though to a rather smaller extent than the demand for £M3. The relationship between M1 and the level of short term interest rates seems to be reasonably well defined and stable. Recent work suggests that the direct effect of a 1 percent

point rise in short rates is to depress the demand for M1 by about 1½% after one year, and about 2% in the longer term. Indirect effects through the impact of higher interest rates on income and wealth tend to increase the effect, especially in the longer term. These effects are not instantaneous, of course, and they are subject to a margin of error so they cannot guarantee very precise control. They may still mean that unacceptable fluctuations in interest rates are needed to control M1, especially over relatively short periods when, for other reasons, the demand for M1 is growing strongly relative to its desired path. But they provide some basis for thinking that M1 might be relatively easier to control, on an annual basis, than £M3.

The Monetary Base (Mo)

14. The wide monetary base (Mo) would probably be more difficult to control than M1. Even though base money consists only of the monetary liabilities of the monetary authorities, controlling the base is no different in principle from controlling M1, whether the Bank's operating instructions are set in terms of interest rates or quantities. This is because 85% of base money consists of notes and coins in the hands of the public. Quantitative rationing of the physical supply of notes and coins is not a serious option - the main effect would probably be to distort monetary conditions, rather than control them.

15. The Bank can only act directly on the banking system's holdings of cash through its money market operations. But these are tiny compared with the public's holdings. It will often not be practical to offset shifts in the public's demand for notes and coins by contracting or expanding the supply of cash to the banking extent by a matching amount. Nor would this be necessary if control of the base were only sought over a period of about 6-12 months. In practice, the Bank would have to react to a rise in the public's demand for notes and coins by driving up interest rates far enough to reduce the public's demand for cash to the extent needed to bring Mo back on track within the target period - ie. several months later. Control of Mo would therefore be based on judgements about private sector behaviour and would raise similar issues to those raised by control of M1 or £M3.

16. The problem is that the relationship between the wide base (Mo) and interest rates seems to be considerably weaker, less stable andmore poorly determined than that between M1 and interest rates. We have found no relationships capable of explaining past, very volatile movements in bankers' balances at the Bank of England, nor would past experience necessarily be a good guide to future behaviour, given the changes to money market tactics and the cash ratio now in prospect. Banks holdings of notes and coins (about 10% of the total) do seem to be (rather poorly) related to bank deposits and short term interest rates. The most important component of the base - notes and coins held by the public - are supplied on demand and, not surprisingly they seem to be well related to consumer prices and real personal disposable incomes. Evidence drawn from the fifteen years prior to about 1978 suggests that they are not much influenced by the level of short term interest rates. However, one explanation for the very low growth in the base in 1979 and 1980 is that notes and coins were more responsive to interest rate levels than past relationships would have suggested.

17. Estimates of the interest rate sensitivity of the demand for notes and coins therefore depend on how much weight is attached to very recent experience. This implies that the response to interest rates is unstable. On the basis of the last 15 years' experience including 1979 and 1980 one might guess that a 1 percentage point rise in short rates would reduce the demand for cash by about ½%, within a year. But ignoring 1979 and 1980, experience since 1965 is consistent with a very small response indeed - less than ¼% in a year. Both these estimates are subject to disturbingly large margins of error, relative to their size.

18. In our present state of knowledge, we could not hope to control Mo with any reasonable degree of precision within a year by manipulating the level of short term interest rates - and, conversely, movements in Mo could not provide as good a guide for setting interest rates as M1.

Since we are so uncertain about the size of the short term response to interest rates, it would be extremely difficult to know how much to move interest rates if Mo was growing either too fast or too slowly. The small size of even the largest estimates strongly implies that very large movements in interest rates would be needed to correct over or under-shoots within a period as short as 6-12 morths. So, on the evidence now available, Mo looks decidedly inferior to M1, on control grounds.

(c) Why £M3?

19. If M1 is easier to control over relatively short time periods than £M3, and is not demonstrably inferior to it in terms of economic significance, why was it decided to re-affirm the commitment to £M3 as an annual target at the time of the Budget? One important argument was continuity: the need to demonstrate that, following a serious overshoot of the 1980/81 target, the policy of controlling the money supply had not been abandoned or diluted. Equally important was the desire to avoid - and be seen to avoid - achieving monetary control solely by means of unduly high interest rates. This route can put a disproportionate share of the burden of adjusting to lower inflation on the compary sector leaving the public sector relative unscathed. Fiscal restraint must play a full part (though of course the net effect on industry depends on how this is achieved).

20. A target for a narrow aggregate which can, at least in principle, be controlled by manipulating short term interest rates offers no assurance that fiscal policy will play a supporting role. In practice, however, interest rates might not have been very different, on average, in recent years, if we had been operating an M1 target. Moreover, the fact of very high interest rates, if they prove to be necessary, may itself force a change in fiscal policy. The US, where policy is largely focussed on narrow money, provides one illustration of these problems. Despite the difficulties of achieving short term control, therefore, the fact that £M3 can only be controlled if fiscal policy is consistent is sometimes considered a positive virtue, if one of the objectives of policy is to meet money targets without undue reliance on interest rates.

III Targetting a Narrow Aggregate: the Options

21. These arguments do not rule out some shorter term role for M1, or even Mo, in taking decisions about interest rates providing it can be assumed that fiscal policy is in fact consistent with the MTFS. The possibilities are:-

(i) a single target for a narrow aggregate in place of the existing targets for £M3, annual and medium term - possibly (though not necessarily) alongside some objective for the PSBR; this option was discussed in the preceding section;

(ii) a short term (6-12 month) operational target for one of the narrow aggregates, with £M3 as the medium term (MTFS) target;

(iii) a short term target for a narrow aggregate as an adjunct to the annual and medium term targets for £M3.

(iv) using the narrow aggregates to interpret or predict monetary conditions alongside £M3, without adopting a formal target for them.

(a) Multiple Targets: options (ii) and (iii)

22. The objection to options (ii) and (iii) is that measures taken to control the narrow aggregate may jeopardise the already difficult task of achieving the target for £M3. This has most force if there are annual targets for both £M3 and one of the narrow aggregates, but it may be serious even if the £M3 target is only a medium term one. The problem arises because both broad and narrow money are responsive to interest rates and fiscal policy instruments, though to different degrees. If we knew, with some precision and confidence, exactly how each instrument affected each of the different aggregates, and fiscal policy could be manipulated as flexibly as interest rates, it should,

in principle at least, be possible to offset the unwanted consequences for £M3 of interest rate changes made primarily with an eye on the narrow aggregate by altering fiscal policy. Even if this were not feasible, it might still be possible to vary gilts sales so as to smooth the path of £M3, before the necessary fiscal changes were implemented and took effect. In other words, two (and possibly three) policy instruments should in theory allow the authorities to hit two intermediate targets at more or less the same time.

23. But whether there is, even in theory, scope for multiple targets is debatable. Even though the relationship between short term rates and the level of £M3 is unreliable, the authorities may need to use them to control bank lending, if they are to control £M3 over a run of years without distorting banks' balance sheets in a way which may sooner or later prove destabilising. If so, they may have less room for manoeuvre on interest rates than the simple "two instruments two targets" proposition suggests. If bank lending is growing strongly for example, control of £M3 will involve overfunding the PSBR, unless and until bank lending is reduced. This will tighten money market conditions and the authorities will be confronted with a choice between allowing short term interest rates to rise and providing possibly substantial amounts of money market assistance eg. by buying commercial bills, or forward swaps. If short rates are allowed to rise, the growth in bank lending should in time be corrected, and a more balanced pattern of bank lending to public and private sector will be re-established. But if short term rates are held down - because they are determined by other considerations - banks will find themselves increasingly short of public sector assets.

24. It is difficult to know how banks would react in such a situation. If they are indifferent as between commercial bills and public sector assets, there may be no real problem. But they may not be. Cutting lending is likely to be a last resort. In the short run, banks could respond by bidding liquid assets

away from non-banks, driving down their yields and encouraging the non-bank private sector to switch into money. Whether, in this situation, the authorities would be right to allow a rise in the money supply rather than put up interest rates, depends on why bank lending is growing so fast. If it represents a structural shift away from other non-bank forms of borrowing for example, it may be appropriate to accommodate at least some of the increase in the money supply. But it if reflects a sharp rise in activity, it would probably be preferable to increase interest rates.

25. If the theoretical case for multiple targets is not clearcut, the presentational and practical difficulties are obvious. Multiple targets may reduce the credibility of monetary policy. Commentators will be tempted to focus on the aggregate which is performing worst relative to target, as the authorities will usually want to point to the one which is most nearly on track. Even if one target is de-emphasised and called a medium term target, both markets and the authorities would find it almost impossible in practice to ignore short term developments. This is not unreasonable, since even short term fluctuations may contain some information about longer term trends among the inevitable "noise".

26. There can be no guarantee that both targets would in practice be met, certainly on a year by year basis. Our knowledge of the effects of different policy instruments is inevitably imprecise, and the fact that policy takes time both to change and to take effect adds to the problem. In recent years it has proved difficult to meet even one target, with all the instruments at the authorities disposal. Two would certainly add to the problems to put it no higher.

27. It would be difficult to make £M3 a purely medium term target in the current financial year, without risking a serious loss of credibility in the overall strategy. The fact that last year's target was so seriously overshot makes it particularly important to achieve the 1981/82 target if at all possible. Adopting an additional annual target for M1 or Mo could jeopardise the £M3 target, without significantly adding anything to the credibility of policy. This risk would still be present if there were a move to multiple targets after the end of the current target period- say in the 1982 Budget.

(b) Narrow Aggregates as Indicators: option (iv)

28. A less formal way of giving a role to the narrow aggregates would be to treat them as early warning devices, rather than explicit targets. This would be worth doing if there was reason to think that movements in the narrow aggregates systematically 'led' developments in £M3 or other broad money aggregates. But in fact this does not seem to have been the case, on average, over the last decade or so, judging by the statistical relationships between M1 and £M3. On the other hand, one can certainly point to individual episodes where, with the benefit of hindsight, the narrow aggregates seemed to be giving an earlier - or more accurate - signal about monetary conditions than £M3.

1977/78

29. The clearest example is 1977. In the first half of 1977, MLR was reduced by stages from 15% to 5%, as the authorities tried to hold the exchange rate down. This was reflected in an acceleration in the growth of M1 from 0.6% in 1976 Q4, to 5% in 1977 Q2 and 7.2% in the third quarter. Despite heavy intervention, £M3 growth never exceeded 3% even in 1977 Q3. This dramatic fall in interest rates did however fuel the growth in bank lending in 1978, which was largely responsible for the target overshoot in that year. If the authorities had taken more

account of the narrow aggregates in early '77 - as some commentators advocated at the time - they might have abandoned the policy of trying to reconcile incompatible exchange rates and monetary objectives sooner, thereby increasing their chances of meeting the £M3 target in both 1977 and 1978.

1980

30. Last year provides an example of a case where the narrow aggregates may have been giving a more accurate picture of underlying monetary conditions than £M3. On our own analysis the rise in £M3 reflected a rise in financial wealth, as consumers reacted to the inflationary shocks of 1979/80 by saving more, relative to their income, in order to rebuild the real value of their holdings of money-fixed assets. Since the rise in financial wealth represented a move back to some preferred position, not a temporary switch which will be reversed, the increase in £M3 to which it gave rise is likely to be held, not spent. It was a response to past inflation, in other words, and is unlikely to fuel a future rise in the price level. The narrow aggregates, which are less responsive to financial wealth, were more affected by the sharp rise in interest rates in both nominal and real terms. The effect of interest rates on activity is uncertain, but it is difficult not to believe that they were a factor in the savage destocking that took place last year, and, indirectly, in the deceleration in inflation that occurred.

31. While there is therefore some reason to think that the narrow aggregates may have been a better indicator of monetary conditions last year than £M3, the evidence is not conclusive. We cannot be sure, at this stage, that the growth in broad money will not fuel future inflation. Our analysis rests on the assumption that there is a stable demand for wealth relative to income. If the rise in financial wealth was not planned, or is only temporary, the associated rise in £M3 could still find its way into extra spending, and finance future inflation. In fact, however, little is known directly about the demand for gross financial wealth. The evidence is indirect and largely based on the behaviour of the personal sector saving ratio in the 1970's.

32. Secondly, £M3 was only a misleading indicator, even on our analysis, if the Government's concern is about the future rate of inflation, rather than the price level itself. If the worry is the price level itself accommodating past inflation is not acceptable: the appropriate response to the £M3 overshoot was not to ignore it, but to claw it back in future year to correct for the inflationary shocks that took place in 1979/80 which were unwittingly accommodated by the expansion of broad money in 1980/81.

1972-74

33. There is one notable episode when, it is often asserted, the narrow aggregates provided a misleading indicator of underlying monetary conditions and future inflation - the period 1972-4. Over this period, the authorities justified their failure to tighten policy in the face of an explosive growth in £M3 partly by reference to the more moderate growth in M1. Some of the difficulties in interpreting this episode have already been mentioned. £M3 was known to be heavily distorted by the aftermath of Competition and Credit Control and in 73/74 by round tripping, and there were good grounds for looking at other monetary indicators. (though there were also fears that M1 was distorted too, to a lesser extent). Moreover, the decision not to adopt a more restrictive stance on fiscal policy as well as interest rates was in part a deliberate one, not just a by-product of inadequate information. As the charts show, both real Mo and real M1 rose sharply relative to past trends between 1972 and mid-1973. Yet fiscal policy remained very lax until late 1973 and the authorities did not push MLR above 9% until July 1973. Thereafter the growth in the narrow - though not the broad - aggregates did decelerate sharply as interest rates were raised in stages, to 13% by November.

34. The simple view that the narrow aggregates always lead movements in broad money does not stand up. But M1 and Mo have sometimes contained useful information about underlying monetary conditions and future trends which are

obscurred in the broad aggregates, for structural or other reasons. It would be unwise to ignore sharp divergences in the growth of broad and narrow aggregates. But equally, there seems no case for relying on either Mo or M1 entirely, to the exclusion of other factors (including broad money) in taking decisions about interest rates. The moral seems to be that no rule can remove the need for the authorities to form their own interpretation of events before changing policy instruments.

IV. Outlook for the Monetary Aggregates in 1981/82 and 1982/83

35. In 1980/81, £M3 grew twice as fast as M1 and Mo. The forecast underlying the MTFS suggested that this position may be broadly reversed over the next three years, if the assumptions on which it was made are correct: £M3 growth was assumed to fall from nearly 18% in 1980/81, to 8% in 1981/82 and then to decline steadily by a percentage point each year to reach 6% in 1983/4. With the PSBR falling relative to GDP, this was consistent with a gradually declining path for interest rates. The narrower aggregates were expected to grow relatively rapidly, however, at around 14-15% a year, principally in response to the decline in interest rates and some recovery in activity.

36. The latest forecast shows a somewhat different picture. Higher and rising short term interest rates are now thought to be necessary if the £M3 target is to be met; the average level of short term rates is put at nearly 14% in both 81/82 and 82/83. As a result, the forecast growth of the narrow aggregates is rather lower than in the MTFS, though still above the assumed growth in £M3. M1 is expected to grow by about 11% in both financial years, while Mo may grow by about 10½% this year, falling to about 8% next.

V. Setting Targets for the Narrow Aggregates

37. While the forecasts are subject to a wide margin of error, the broad conclusion they point to is plausible: namely that a target for M1 or Mo which is in single figures will require higher real interest rates than would otherwise

be needed to meet the MTFS targets for £M3. This reflects a general problem with targetting a narrow aggregate when the rate of inflation is changing. The demand for M1 depends, inter alia on the price level and the level of nominal interest rates. If nominal rates are constant as inflation comes down, the demand for M1 will grow broadly in line with nominal incomes, though the deceleration in the rate of inflation will itself cause real interest rates to rise. If, on the other hand nominal interest rates fall in line with inflation to keep real interest rates constant, the demand for M1 will tend to grow faster than nominal incomes. In other words, the fact that the demand for M1 is sensitive to the level of nominal interest rates means that velocity is likely to vary with the rate of inflation. This makes it difficult to reconcile a smooth growth in M1 with stable real interest rates during periods when the rate of inflation is changing.

38. There have been pronounced changes in M1 velocity over the past decade, as the rate of inflation has varied. M1 velocity rose steeply between 1972-75 when the rate of inflation accelerated, although real interest rates fell. When inflation decelerated from 1976 to 1978, M1 velocity fell sharply, although real interest rates became less negative. Between 1978 and 1980 inflation accelerated again, and M1 velocity again rose sharply, while real interest rates tended to fall until the end of 1979. The increase in M1 velocity as inflation decelerated through 1980 was, associated with a marked rise in real interest rates.

39. Over the next few years, a target for M1 which would avoid the need for high real interest rates would probably have to be above the growth in nominal incomes - that is, the target would have to be set to accommodate some fall in velocity as inflation comes down. That would mean choosing rather high numbers - certainly above the current £M3 target

and probably in excess of 10% for both 1981/82 and 1982/83. If the target were a public one, this would be presentationally very difficult, though it would be consistent with using M1 as an indicator, for internal purposes, in the sense discussed in section III(b) above, to interpret movements in £M3.

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