9. A Monetary Targets and Economic Policy

Control of Monetary Aggregates

19/10/1978 – 20/10/1978

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MR MIDDLETON

cc Mrs Lomax
Mr Odling-Smee

MONETARY TARGETS AND ECONOMIC POLICY

Thank you for sending me a copy of the paper you sent to Michael Bridgeman on 26 September. I cannot claim to have thought very much about the choice between M1 and M3 as targets, but I was reminded of the note I wrote to you on 22 March after a discussion with Marcus Miller at the AUTE. In that note I suggested that M3 would not be an appropriate monetary target if it were determined according to the demand relationship implied by the monetary model. Perhaps I could amplify the argument a little and fit it into the present context.

2. According to the monetary model the demand for M3 is by no means a simple relationship with the value of transactions. It is determined as part of the general process of allocating a given stock of financial wealth between a whole set of competing assets. Indeed it is treated as the residual in that allocation. In a mathematical sense there may be no special significance to be attached to the treatment of one asset as residual, but nevertheless it may not be entirely an accident that this role has been given to M3. It would be appropriate if M3 is in fact treated rather in that way by investors. They may use their bank accounts (and other very liquid assets) as a place to put resources for which they see no immediate, more profitable, use. This sounds plausible enough and, if it is a correct description of behaviour, it would make M3 a very unsuitable target for control, whether in the interests of reducing inflation or for any other purpose.

3. It would be unsuitable for control because the demand for M3 would vary with the state of financial confidence in an erratic and unpredictable way. Suppose for example that the stock market was expected to fall: as investors pulled out of equities their liquid balances, in M3, would increase, but this would hardly be a

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sign of inflationary pressure, rather the reverse. If confidence were weak in the gilt-edged market the situation could be much the same: M3 would indeed rise, but it would rise because (at the existing level of interest rates, prices and everything else) the demand for M3, as well as the supply of it, had risen.

4. But the problem is not only the variability of the demand for M3, there is a further problem created by the relationship between the demand for M3 and private sector wealth (one must stress that it is wealth, not income or transactions). Any change in the PSBR, and therefore almost any change in fiscal policy, must change private sector wealth. Indeed it will change not just the level of private sector wealth, but its rate of growth. A budget package which, say, cuts taxes by £1 billion a year, adds to private sector wealth by £1 billion each year, and, unless the whole of it is spent on non-durables, these additions to wealth will cumulate over time.

5. According to the theory described above this tax package will increase the demand for M3. It will increase it at a given level of prices and interest rates; and it will increase it cumulatively year by year for a very long time, if not for ever. It will also increase the supply of M3 cumulatively at a given level of prices and interest rates, unless the authorities get a deliberate target for sales of gilts and other illiquid debt. There will be a cumulative increase in the quantity of M3 irrespective of the effects of the fiscal expansion on activity or the rate of inflation.

6. No-one should be happy with an M3 target in this situation. The expansionist would obviously be unhappy since he would be prevented from carrying out an expansionary fiscal policy irrespective of its effects on inflation. The contractionist (if there is such a word) would be equally unhappy because his policies could bring about a progressive reduction in M3 and perhaps a higher level of unemployment without in fact reducing inflation at all.

7. There may be some narrower definition of the money supply for which the demand does have a simple relationship with nominal income or transactions. Suppose for the moment that M1 fits this description - although I sometimes wonder if we are not really talking about notes and coin. Anyway, control of this aggregate, if it exists, would not be open to the same objections as those applying to M3. When the authorities operated on the supply of M1 they would not simultaneously be changing the demand for it, except of course to the extent that they were successful in changing nominal income (or perhaps interest rates).

8. Your paper brings out very clearly the distinction between controlling the supply and controlling the demand for money. I agree that the aim must be to control the supply side, but that does not seem to me to point necessary towards M3, rather than M1. Other countries control M1, with perhaps rather less angst than we require to meet our M3 targets (I rather liked Charles' Goodhart's paragraph 19 on this). To the extent that policy influences the demand for money directly that is in fact a handicap. The main point I want to make is that the handicap is likely to be greater for M3 than for M1.

AJCB

A J C BRITTON
3 October 1978

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Mrs Lomax
Mr Wiggins

At the meeting with John Fforde yesterday, the Bank were much clearer about what they had in mind. The idea is that monthly and weekly changes in short rates should be determined by changes in M1. Quarterly changes in a new £M5 series should signal the need to change fiscal policy. In the light of this there are a number of specific pieces of work which it might be useful to set in hand - quite apart from a general discussion within FEU and HF which I hope will take place when Mr Bridgeman and I are away:

a. How good would M1 be as a guide to month by month changes in interest rates? Taking the argument on control, could we expect to control any aggregate on a month by month basis? Looking wider, what effect would this short term control imply for the economy? Presumably interest rates would remain fixed in PESC - what part then of the economy if any are we affecting?

b. How would we attempt to relate the short M1 control over interest rates to the longer term M5 control on fiscal policy? And how would we set them in the first place? Can we backtrack to see how this would have worked in the past.

c. Do we think that the present system has become unworkable. The Bank's reason seems to be that we have had to use the corset. Can we finish the HF note on the corset and perhaps amplify it to examine this unlikely proposition.

d. Can we take a critical look at the Bank's demand for money relationship. Is it sufficiently robust or well formulated to stand the strain which is likely to be imposed on it?

PEM.

P E MIDDLETON
4 October 1978

Folio

MONETARY POLICY: FUTURE WORK

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NOTE OF A MEETING IN MR LITTLER'S ROOM, HM TREASURY, ON TUESDAY 3 OCTOBER 1978

Those present:	Mr J G Littler	(in the chair)	
	Mr J M Bridgeman		
	Mr P E Middleton		
	Mrs R Lomax		
	Mr A J Wiggins		
	Mr M L Williams		
	Mr J S Fforde	)	
	Chief Cashier	)	Bank of England
	Mr C A E Goodhart	)	
	Mr E A J George	)	

The meeting considered the timetable of future work for the Prime Minister and the Chancellor, and reviewed some of the issues arising out of work done in the MCR.

Mr Littler noted that the PM wished to be consulted before a decision on the new rolled-forward monetary target was taken. A paper discussing the options would therefore be needed to be put to the PM between 25 October when the Autumn NIF would be ready, and 20 November, which was for planning purposes the latest date for publication of the Industry Act forecast. At the same time, a report on the current state of and prospects for the gilt market could be made, and a response given to the questions raised by the PM concerning the operation of the gilt market and possible new initiatives therein. Following a brief discussion, it was agreed that this response should largely draw on the work done for the report on the gilt market that was submittted to the Chancellor in July. No changes in the broad conclusions would be suggested, although some proposals, such as that for a convertible stock, might be developed a little further. Mr Littler asked that this material be prepared for submission to the Chancellor in the first week of November.

EMS

Mr Littler asked the meeting to consider whether any assessment could be made at this stage as to how the EMS affected current consideration of the techniques and objectives of domestic monetary policy. In discussion the following points were made:

(1) Although work on the EMS was proceeding quickly, little had emerged on the operation or structure of the proposed

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European Monetary Fund. There was no clear idea of what would be required in the way of monetary cooperation between members. The best working assumption might be that the EMS would operate along lines similar to the snake.

(2) EMS might have some relevance to the choice of monetary aggregate for which a target should be set.

(3) The technical problems of monetary management were likely to be increased as the EMS might give rise to substantial capital flows over a short period. The possibility of new techniques for managing the capital account might need to be considered.

(4) Our own choices were likely to become increasingly affected by other countries' objectives, but the implication of this would not be clear until the system developed.

It was agreed that the papers put to the Prime Minister should include no more than a passing reference to the EMS, and that the EMS could, for the moment, be treated separately from the issues being considered in the MCR. It was pointed out that comments on the paper attached to Mr Bell's minute of 29 September should be made to Mrs Lomax or Mr Goodhart in the next week, so that it could be ready for submission when required.

~~The~~ Monetary Control Techniques and Target Aggregates

It was noted that there were difficulties in deciding how to proceed during a period of election uncertainties. It might be possible to produce, for publication before Christmas, a consultative paper on possible changes in the control system, but Ministers may not wish, or might be unwise, to take a public initiative. As an alternative, the Bank could issue a largely academic document, without Ministerial endorsement of specific proposals. It was agreed that, for the moment, the need was to produce the necessary papers that could be used as the basis for such consultative documents as might be required.

Mr Littler suggested that the issues to be considered in the MCR would include:

(1) A monetary base system of control. This was largely a self-contained issue: the Bank agreed to forward their recent work to the Treasury.

(2) The future of the reserve ratio system and arrangements for day to day monetary management and control. These problems were largely technical and could be handled independently (assuming that there was no shift to a monetary base system). The Bank had not yet completed their work on the subject.

(3) M5: Technical issues. The Bank had sent the Treasury a paper on this.

(4) The choice of aggregate. Two papers had been prepared - Mr Goodhart's of 14 September and Mr Middleton's of 26 September.

Choice of Aggregate

Mr Fforde said that, in the Bank's view, the present sterling M3 system had too many defects and was no longer viable. The fundamental reviews of monetary policy to which repeated funding crises gave rise, considerably complicated the Bank's operational problems. The use of the SSD scheme to control sterling M3 had an increasingly harmful impact on the banking system and meant that the published figures were increasingly artificial and tended to call the system into disrepute. A target system whereby the operational focus would be on monthly movements in M1 and, say, quarterly movements in M5, was likely to prove more durable. Mr Fforde noted that a shift to a M1/M5 system would require consideration of present credit rationing techniques, ie HP controls and controls over building society lending as well as the SSD scheme.

In discussion, the following further points were made in favour of a shift to a M1/M5 system:

(1) The fiscal policy links with sterling M3 were recognised, but in the short term, which was the focus of commentators, and the market, interest rates were the only available policy instrument. But these could not be used to control sterling M3. Monthly fluctuations in the CGBR and other counterparts made short term control of sterling M3 by fiscal measures impossible. Movements in M1 provided a better indication of the appropriate changes in interest rates and M5 could be linked over a rather longer horizon to credit and fiscal policie

(2) Interest rate changes acted more quickly on M1 than on sterling M3, and their effect was not perverse. The market had failed to be convinced that the perverse impact of such change on sterling M3 was of little importance. A long term operational focus for M5 was more likely to be acceptable if the authorities were acting to control M1 in the short term.

(3) There was no short or long term robust relationship between sterling M3 and nominal income. Sterling M3 was primarily an indicator of fiscal stance, but operationally, it was not being treated in this way.

The following arguments were made against a move towards targets for M1 and M5:

(1) It was desirable to have a concept of monetary control that could be related to other policies, and could be used as part of the framework, looking ahead over the next twelve months or so, for taking macro-economic policy decisions. Sterling M3 provided this link. Although in time M5 might replace M3, this was impracticable immediately, so that M1 would effectivel become the primary operational target. The fact that M5 was only being looked at longer intervals would also tend to push it into the background. Meanwhile, the links between fiscal policy and M1 were less direct and as a result a M1/M5 system was likely to provide less leverage over fiscal policy decisior Indeed, a M1 target might lead to perverse fiscal policy decisions if Ministers tried, for example, to offset the effect of high interest rates by increasing public expenditure.

(2) Although the authorities were in a position to act on the demar for M1 by changing interest rates, there was no comparable mear through which they could act on the supply of M1. Moreover, it was not clear how the transmission mechanism was intended to work: attempts to control M1 might cause the relationship with nomin income to breakdown. (The Bank's representatives said that they would wish to discuss these points further at a technical level.)

(3) It was accepted that the SSD scheme created distortions, and had a harmful impact on the banking system, but this was inevitable with a system of physical controls. It was not clear how essential the SSD scheme was to the present system; physical controls (possibly acting on the assets side of the

financial intermediaries
~~banks~~' balance sheets) might be required under an alternative regime.

(4) There was no reason to suppose that the market would find acceptable a switch to a M1 target. They had chosen to focus on sterling M3 at a time when our formal objective was defined ~~determined~~ in terms of DCE.

(5) A longer term M5 target offered a number of advantages over sterling M3 as an indicator of fiscal stance, but there were a number of statistical difficulties in its implementation. Before a target could be adopted, a series needed to be prepared and tested. There would also be problems in controlling M5, particularly if no monthly figures were available.

(6) Different movements in the aggregates might carry conflicting policy implications. It was however pointed out that such movements would probably be associated with structural distortions, which could be monitored.

Conclusions

Before he closed the meeting, Mr Littler said that he would prepare a note of some of the questions that would need to be covered in the paper that would be submitted to the Chancellor. Mr Fforde said that the Bank would put together the available material to provide a basis for the papers that would be required.

M L WILLIAMS
6 October 1978

DISTRIBUTION:

Those present
Mrs Gilmore
Mr Taylor

VA

c Mr Bridgeman 29/10

cc: Mr Wiggins
Mr Grice
Mr King
Mr Riley
Mr Williams
Mr Bell
Mr Prust

MR MIDDLETON

MONETARY CONTROL REVIEW

Following the last meeting of the Littler-Fforde Group, Mr Wiggins and I commissioned the following pieces of work from HF3 and FEU:-

1. Mr Grice is preparing a critical note on the Bank's work on the demand for M1. He is also hoping to 'back-cast' with this equation over the last few years to simulate the path for interest rates that might have resulted from fairly strict adherence to a plausible M1 target (eg. growth in M1 over any six month period equal to growth in nominal incomes over previous six months? less 1%). If this looks interesting, he will try running the N.I.F. over the past using these assumptions about interest rates.

2. Mr King is producing a more informal discussion of what the implications of the Bank's proposals about targetry might have been over the last few years.

3. Mr Williams has already completed the note on SSD's and IBEL's.

4. Mr Bell is going to look at the relationship between fiscal policy and the different monetary aggregates (with special reference to the Bank's proposition that there is no very substantial difference between the linkages).

Mr Grice has already revised his note on M1 and demand/supply disequilibrium, and we have discussed it with Mr Goodhart. Mr Wiggins is letting you have a note of this interesting encounter.

I imagine much of the remainder of this work must await the end of the forecast next week.

RL

RACHEL LOMAX

19 October 1973

MR MIDDLETON

cc Mr Littler
Mr Bridgeman
Mrs Lomax
Mr Grice
Mr King
Mr Riley
Mr Williams
Mr Bell

THE BANK AND THE CHOICE OF MONETARY TARGET

1. Following the Littler/Fforde meeting on 3 October, you asked FEU and HF3 to give further thought to some of the arguments for and against possible alternative monetary targets. Mr Bridgeman suggested that we might also have some further discussion at a lower level with the Bank, with a view to determining more exactly the areas of agreement and disagreement between us.

2. Accordingly Mrs Lomax and I (with the rest of FEU and HF3) talked on 16 October to Messrs Goodhart and Price. We took as an initial basis for discussion a revised version of Mr Grice's money supply and demand note, which Mrs Lomax had previously sent over to the Bank.

3. Mr Goodhart clearly understands Mr Grice's analysis perfectly well, but he wants to argue that the difficulties of achieving supply side control over M1 are not the knock-down argument against an M1 target that you suggested in your paper. He made two essentially debating points:-

(i) the supply of M1 could <u>in principle</u> be controlled under a monetary base arrangement. We are prepared to acknowledge this, subject to the institutional difficulties which would be involved: but there was no suggestion that the Bank are proposing monetary base control as part of the package when (and if) we switch to an M1 target.

(ii) the exact supply side control of £M3 as allegedly portrayed by Mr Grice in his note was a myth. In practice, the Government cannot control the take up of gilts, even if it is prepared to see large fluctuations in interest rates, because of the importance of expectations in persuading investors to remain liquid. And in any case intervention to influence gilt sales and bank lending involved the manipulation of interest rates which affected the demand as well as the supply of money. (Of course, this line of attack caricatured Mr Grice's note. It is no part of our case to suggest that the authorities do (or ought to) have precise control over M3 in the short run.)

The Bank therefore concluded that the Grice analysis exaggerated the difference between the factors influencing M1 and £M3; in fact, the same factors (fiscal policy, bank lending, current balance) affected both aggregates.

4. At a more serious level, Mr Goodhart seems prepared to admit that the deliberate creation of monetary disequilibrium is easier to envisage in the case of a broad aggregate, though he obviously takes exception to stark statements to the effect that the supply of M1 <u>cannot</u> be controlled, while the supply of M3 is <u>completely</u> within the authorities' control. He quizzed us on why <u>we</u> are so concerned with disequilibrium analysis, and pointed out (quite fairly) that Mr Grice's approach is not traditional Treasury orthodoxy, and is not easy to reconcile with the Treasury model - monetary and NIF. The monetary model is based on the notion that money is a residual asset, and that there is no stable demand for it at least in the short run. While the empirical basis for assuming that changes in interest