7. Monetary Targets and Economic Policy

Control of Monetary Aggregates

Monetary Targets and Economic Policy Document

2514

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.

Background

2. Targets for the growth of monetary aggregates are a relatively recent phenomenom. 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 most successful of all OECD economies – Japan – does not relate its economic policies to published monetary guidelines of any description.

Table A: Monetary Targets

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 published in advance. This apart:

a. Targets are directed towards different monetary aggregates.

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

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

d. Their relationship to the various instruments of macro-economic policy varies 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	7.5	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 or 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 1978.
(e) Revised from Lit. 36,600 bn.
(f) 1975 Q.2 - Feb./Apr. 1976 (excluding effects of postal strike).

Source: OECD Secretariat and national publications.

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 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 target. 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 - 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. 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

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.

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. Once Ministers have decided on a particular set of objectives for the period ahead, these instruments have to be combined in a way consistent with those objectives.

18. There may still be reasons which are examined later why we should 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.

Formation 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 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 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 formation.

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

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 element of rationing.

28. The £M3 target therefore has very good credentials in assuring markets that appropriate policy changes can take place if we move out of line. It also scores very well in providing 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, for which a satisfactory set of counterparts could undoubtedly be devised. Here the problem is the unknown nature of the aggregate and the difficulty of getting the market to take it seriously.

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.

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 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 **chiefly** directed to particular external objectives.

35. £M3 is a useful single indicator of the general stance of government policy because it has **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.

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.

Economic Theory

41. The reasons which drive us to give primacy to one particular aggregate at any one time have already been discussed. The need for a single target variable however inhibits our most natural and correct response - to say that all the various indicators give us different information and therefore we should take them all into account both in the formulation of policy and when deciding on the use of policy instruments. We can do this internally if we regard the various measures simply as indicators - though we still need to decide what exactly they are indicating. But the need to choose a single indicator which, when published, assumes primacy remains.

42. It is not possible within the scope of this note to examine what monetary theory suggests might be the impact of the various aggregates and the effects of controlling them on the economy. Such an examination is however necessary because the theoretical basis is an important consideration - though as we have seen, certainly not the only consideration - in the choice of target variable. I therefore attach a separate note which examines these issues from a theoretical point of view at some length.

43. There would probably be general agreement that the more policy is directed towards particular exchange rates, the more important domestic credit expansion becomes. Equally, the more policy is directed towards domestic objectives the more important is money as represented by one of the M's. Since policies have to be directed towards both ends we need to be prepared to direct attention to either of these.

44. The issue to be decided is which of the various M's is most

relevant. Given the structure of our financial institutions there are no clear cut divisions to be made in the range of liquid assets from notes and coin at one end stretching through a spectrum of more or less liquid assets towards local authority and government debt at the other. Notes and coin and current accounts are more concerned with transactions - but not exclusively so. Holdings of less liquid assets are more related to wealth - but not exclusively so. There are blurred edges between the motives for holding different assets.

45. Within this spectrum, £M3 is encompassed by the banking system. Transactions balances clearly form an important part of it as do interest bearing deposits with the banks. It is a sort of compromise indicator in the middle of the spectrum containing elements of both a transactions measure and a liquidity measure. It also has a very obvious accounting relationship with the credit measure, DCE.

46. But does this necessarily mean that £M3 is a good variable to control, combining the main features of most of the spectrum - or is it really a sort of bureaucratic compromise - neither one thing nor the other? If money affects prices and activity either through transactions balances, and interest rate effects or through liquidity and total monetary demand, perhaps we should decide which it is and choose at either end of the spectrum. In other words, we should concentrate on either M1 or M5.

47. It should be noted in passing that either of these courses would mean that new measures of the money supply would be required: an M1 without an interest bearing element and an M5 embracing a comprehensive selection of liquid assets.

48. It is argued in the accompanying note that to be of value for control purposes an aggregate must have 2 properties:

a. The authorities must be able to control its supply. Targets are essentially a statement about the supply of money and not just the demand for it.

b. The demand for it must be reasonably stable.

The questions raised in para 46 are considered in relation to these criteria in the next section.

The Demand for Money and the Supply of Money

49. A great deal of work has been done around the world on demand for money functions. One prominent member of an overseas central bank was recently heard to refer to them as arriving in bucketsfull, newly estimated as circumstances change. They may show "stable" relationships at particular points of time for particular aggregates. But the relationships have a tendency to be short-lived and require frequent replacement by new equations showing a new sort of stable relationship. I am very sceptical about the value of empirical work in this area as a guide to choices between different indicators. This major caveat applies to the work in the Bank of England that suggests a form of relationship between M1 and nominal incomes which has been more stable than any which it has been possible to derive for £M3. Though work is planned, more has yet been done on M5.

50. The research on M1 needs to be assessed in relation to the first criterion set out in para 48. For given real income, wealth, price level and interest rate, there is no reason why the money supplied by the authorities should equal the demand for money. Suppose the supply exceeds demand. Any one individual can remove his excess money holdings by spending them. But if the authorities refuse to take the excess money out of circulation, then society as a whole cannot get rid of the excess in this way. One individual spending his excess money holdings merely passes on the money to another individual whose disequilibrium is therefore made worse. As all individuals try to spend their excess balances, there is a process of competitive bidding for resources. If the economy were initially at less than full employment there may be a transient increase in output to meet this new demand but the final result will be an increase in the price level proportionate to the initial excess supply of money. Only at this position will the supply of money and the real demand for money be in equilibrium and there will be no further tendency for the economy to react.

51. In this framework, the role of the monetary target is to control the money supply. It should be set in such a way that, given money demand, the resulting demand/supply disequilibrium will react back on to output and prices in a way which is considered desirable. It is for this reason that the first criterion set out in para 48 is so important; it must be possible to control the supply

And it is this criterion which seems to rule out M1 as a suitable aggregate for targetry.

52. Under a £M3 (or M5) regime, by contrast, the authorities can influence the supply side. The PSBR can be changed by expenditure and fiscal policy. Bank lending can be controlled by credit rationing devices or by reserve asset pressure. Gilt sales can be controlled subject to the authorities' ability to adjust prices and interest rates. The control may not be complete, and it may be more limited in some areas than others, but the possibility certainly exists.

53. In the £M3/M5 approach, whereas the authorities determine the supply of money, the demand for money is controlled by the (non-bank) private sector. It can be taken that it is the real volume of money which is important whether the motive for holding the money is as a transactions balance or as a store of value. Demand can be taken as positively related to income and wealth and negatively to nominal interest rates. Income canbe taken as a proxy for total transactions in the economy, thus determining transactions demand for money while wealth measures the total portfolio available for holding in assets and thus relates to the store of value demand for money.

54. There is an added dimension depending on exchange rate policy. The authorities have imperfect control over changes in the reserves and this limits their ability to control £M3 - though they can still control domestic credit (£M3 - change in the reserves) hence the importance of DCE indicated earlier. This means that any disequilibrium between the money supply and demand may be resolved in two ways: the price level may change and/or the disequilibrium may disappear across the exchanges. If supply is below demand, there will be a tendency for foreign funds to flow in, while if the money supply exceeds, funds will tend to flow out.

55. The suggestion that M1 would be a suitable target variable seems to proceed from the Keynesian approach that the authorities either cannot or should not contract the money supply direct but instead should use interest rates to control the demand for money. By controlling the nominal interest rate, the authorities thereby

automatically lose control of the money supply because they have to supply government debt passively at whatever interest rate they deem appropriate. Since both money demand and supply are then determined by the private sector, there is no possibility of their diverging. There are therefore no disequilibrium effects on either prices or output.

56. In this situation, the sole function of a monetary target seems to be to establish the general level of interest rates and guide the authorities in changing them. Any effects on the rest of the economy must therefore operate primarily through changes in interest rates. There is nothing wrong with this position but it does seem a very weak one on which to base a target from which much more is expected:

a. If monetary policy really operates only through interest rates why not set the interest rate target direct at some level deemed to be optimal, rather than go through the roundabout route of a monetary target;

b. Empirical evidence suggests that interest rates have very little effect on the real economy, certainly over the range of variation we have seen in the past. Quite intensive searches for interest rate effects on expenditure function, both inside the Treasury and outside, have failed to reveal any substantial influence. On the evidence we have, the effect on the price level of interest rates must be minuscule. If this is the case, why should we expect a target for M1 to have much effect of any description on the economy, beneficial or otherwise. Given this and for the reasons set out in section , M1 is unlikely to have much effect on expectations or convey a very effective message.

57. M5 does not exhibit the deficiencies of M1, in respect of controlling the supply. Indeed there is a logical case for bringing a more representative selection of liquid assets within the control mechanism. But as there is no series yet for M5 we do not know whether its demand function would be more or less stable than M3. Moreover, as is argued in the next section, the fact that neither M1 nor M5 have yet been subject to controls and targets means that their behaviour might change significantly if they did become so used

We might lose their current value as indicators of conditions at either end of the monetary spectrum without gaining much in terms of stable relationships.

Controllability

58. It has always been recognised that though targets had many advantages and were perhaps essential in the circumstances in which they were introduced, there were also disadvantages. In particular, though monetary targets have been thought of by the authorities and academics as indicating the broad thrust of policy:

a. Their effect on expectations might lead the markets to look for more fine tuning on a month by month basis to meet target growth than was thought by the authorities to be necessary or desirable.

b. These expectations might be self fulfilling; by refusing to buy debt temporarily or leading and lagging against sterling the markets could, in some circumstances, force a policy response from the government. And the response might have to be more severe than would have been necessary without such co-ordinated expectations.

59. Targets which successfully influence expectations, can thus in practice also be a cause of instability in money markets.

60. These problems are perhaps at their most severe when the authorities, as they must, use interest rate adjustments as the most readily available means of smoothing the growth of the £M3 aggregate. When £M3 begins to grow above target, there is an expectation of upward movements in interest rates. Because our ability to control long rates is thought to be very limited, adjustments take place first and most at the short end. Yet this can have the effect - temporarily at least - of increasing £M3 by attracting funds into the interest bearing part of the banking system from other financial institutions and from overseas. Thus the response of £M3 to changes in interest rates is lagged and slow.

61. No aggregate is capable of being fine tuned on a month by month basis. Our objective should be to move away from objectives

which provoke changes in response to very short run considerations.

62. In the case of M1 (even without its interest bearing element) we would from econometric evidence expect a quicker response to adjustments in the general level of interest rates. But the difference between M1 and £M3 in this respect is not so great as to constitute a case for a change in policy. Moreover in countries where M1 is subject to control, the short term volatility of M1 is itself regarded as a serious disadvantage. In this country we just do not know how volatile M1 would be if we announced an M1 target, thus concentrating expectations on it. It is quite possible that a move in this direction would convince the market that the Government was committed to very short term fine tuning by means of interest rate changes. Far from being a useful guide to the authorities, a narrow aggregate could in these circumstances force them into more volatile shifts in short term interest rates in the face of strongly held expectations about the size of adjustment required to keep the growth of the money supply under control.

63. Moreover it is difficult to believe that the structure of interest rates could be left to take care of itself simply by moving to an M1 regime.

64. The SSD scheme has been developed as a device for creating a favourable interest rate structure in the context of a £M3 target. Its impact on M5 could only be fully understood after experience had been gained in operating it. In principle, its effects should be somewhat slower acting: a large part of the initial effect of an SSD scheme is to cause financial institutions to switch out of assets included in £M3 to assets included in M5; such a switch would not change M5. The longer term impact of an SSD scheme is to ration credit, and this would also happen if policy was directed towards M5. However, the scheme would need modification if operated in conjunction with an M5 target and the changes are too speculative to merit discussion here.

65. The SSD scheme is criticised in the context of a £M3 target because it causes less efficient financial intermediation and because its impact is apparent rather than "real". As far as the first objection is concerned, all methods of control involve costs and it does not seem unreasonable that some of these should fall on the banking system. With regard to the second, if market expectatior

have themselves become unduly pessimistic and the market can be satisfied by devices which restore confidence but have a limited impact on the economy, so much the better. Looked at in this light the SSD scheme is a useful instrument; its initial optical effects counter excessive expectations and its longer term effects in rationing credit are in the right direction so far as reducing the supply of money is concerned. It would be wrong to regard the present target as unsatisfactory because we have to use the SSD scheme from time to time.

66. We should not in any case concentrate too much on the authorities problems over interest rate responses. In an open economy these can never be clear-cut or dictated by a single monetary indicator. The essence of a wide aggregate is that the policy response to deviations need not be one of monetary instruments - it may be in fiscal policy, pay policy, external policy, policy for the supply of credit or the supply of debt. Without the use of these other instruments it may be impossible, as we have argued earlier, to exercise much control over activity or prices or carry any conviction that the target would do so. To expect the target to indicate the exact mix of instrument response and thus give a precise guide to the use of particular instruments, is to ask the impossible.

67. It was argued in the previous section that there is no evidence that interest rates are so important in this array of instruments as to make it a prime requirement of a target that it should give this specific information about them. And it was pointed out in para 62 that to give the impression that we placed too great reliance on them could be harmful. So we certainly cannot argue that M1 is an appropriate target variable solely or mainly because there is a chance that it might prove more easy to control it by the general level of interest rates.

68. The problem with M5 in this, as in other, contexts is that we are uncertain how it will behave. In principle it should prove less subject to some of the distortions that can make the control of £M3 difficult; it encompasses building society deposits which are fairly clearly a substitute for current account and time deposits together with liquid assets such as Treasury bills and local authority deposits which are likely to be close substitutes for certificates of deposit. However, an M5 target could mean

that interest rate adjustments in response to changes in the money stock would have to cover explicitly sensitive areas of policy such as housing and LA finance.

Conclusion

69. This paper has looked at monetary targets from the standpoint of arriving at an aggregate which offers the government the best prospect of achieving its objectives. There can be no universal objective, but the main choice of emphasis lies between domestic credit and money measures. As far as the various M's are concerned, £M3 seems to be the most satisfactory aggregate for target purposes currently at our disposal:

a. It conveys a comprehensive simple message about the broad thrust of policy.

b. It facilitates the development of co-ordinated policies within the UK policy making framework in which the Chancellor is ultimately responsible for all aspects of economic policy.

c. It allows the use of a range of policy instruments where there are serious deviations from the target which it is necessary to correct.

d. It is difficult to control at times, but no country has managed to find a completely controllable target which also carries conviction as an economic regulator. Other aggregates may appear easier to control either because we have not yet attempted to control them or because they have little impact on the economy.

e. It fulfills the essential condition that it is a monetary aggregate whose supply we are able to influence.

f. Though its relationship to money incomes is not particula stable, we cannot say with confidence that others are so much more stable that the difference constitutes a reason for change.

70. A new M5 series seems potentially to be a very useful aggregat for target purposes, and might be an improvement on £M3. But we do not know yet. It is inconceivable that we could move to an M5 until we have explored the properties of the series at present under consideration.

71. M1 might have greater advantages in terms of controllability, but it is unlikely to carry conviction with the markets if this is all it achieves; other means would be needed to demonstrate our ability to direct those policies which affect the supply of money in a desired direction. The gains made in recent years in co-ordinated policy formation would be lost.

72. It may be thought that inflation is now sufficiently under control that we should seek to release other policies from the shackles of an all-embracing monetary target. On this view anything which limited the impact of the target to a separate role guiding changes in a relatively unimportant instrument (interest rates) would be desirable. We could expand the economy more rapidly while keeping the markets happy with the M target. For those who share this view, many of what I see as advantages of financial targets and the criteria to be taken account in selecting them become disadvantages and things to avoid.

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