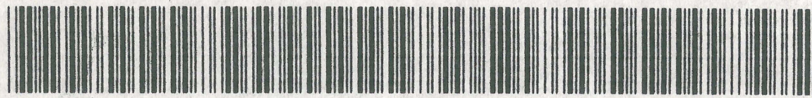
part. B

Begins: 8/5/81
Ends: 12/5/81



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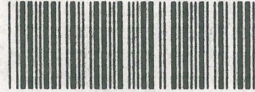


PART B

Chex (Howe)

MAIS LECTURE

PO -CH /GH/0058
PART B

Disposal Directions: 25 Years

D Anderson
25/7/95

8/5/81

1

PRINCIPAL PRIVATE SECRETARY

cc Financial Secretary
Sir Douglas Wass
Mr Burns
Sir Kenneth Couzens
Mr Ryrie
Mr Middleton
Mr Britton
Mr Burgner
Mr P V Dixon
Mr Lavelle
Mr Monck
Mr Unwin
Mr Turnbull
Mr Aaronson
Mr Cropper

Mr Ford - Bank of England

MAIS LECTURE: 12 MAY 1981

The Chief Secretary has seen Mr Aaronson's further draft of the Mais Lecture attached to his minute of 7 May. The Chief Secretary finds the draft generally admirable but has the following comments on the text:

1. Paragraph 3: Penultimate sentence beginning " My views have developed......". This is confusing phraseology for oral presentation.

2. Paragraph 8: The Chief Secretary does not find the Lord Robbins quotation very persuasive. While what he says may be right, it does not make a new point or prove the point.

3. Paragraph 10: Final sentence noting "the problems may have become more difficult in the modern world..." the Chief Secretary thinks this point is dealt with too casually. On the face of it it does seem to suggest that nil inflation is no longer possible. A word of explanation is called for.

4. Paragraph 13: The Chief Secretary would drop the

quotation. It reads like a "backing out" exercise at the time - and it still talks of a system of price surveillance. Surely we do not want to echo that now?

5. Paragraph 24: On the quote from the Governor's 1978 lecture, the Chief Secretary sees the strategic importance of tying the Governor to this, but feels one quote should be omitted, otherwise it reads as if the Chancellor is, in a way, shadowing him.

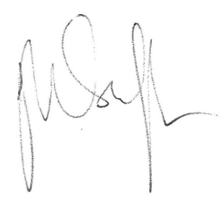
6. Paragraph 28: The Chief Secretary feels that we surely don't want to pray the Governor's evidence to the Treasury Select Committee in aid here as he is suspected of being obscurantist on this.

7. Paragraph 30: Insert a new sentence "There are other requirements as well." after the third sentence.

8. Paragraph 31: The Chief Secretary thinks the sentence beginning "Once the Government provides a stable financial framework......" needs to be spelled out slightly more fully.

9. Paragraph 41: Amend third sentence to read "Indeed they would have a particularly instructive and beneficial part to play if they sought to make......".

2. Generally, the Chief Secretary thinks the Chancellor's speech should say more about the MTFS as an innovation; its' role in expectations; and people's surprise that the Government is sticking to it etc...



MISS J M SWIFT
8 May 1981

32

11/5.

Chief Secretary

cc Financial Sec.
Sir D Wass
Sir K Couzens
* Mr Burns
Mr Byatt
* Mr Middleton
* Mr Britton
Mr Burgner
Mr Pv Dixon
Mr Lavelle
Mr Monck
Mr Kemp
Mr Turnbull
* Mr Cropper
* Mrs Gilmore
* Mr Aaronson

MAIS LECTURE

I attach a copy of Mr Aaronson's redraft of 8 May, as amended by the Chancellor over the week end. He would like to discuss these, and any comments recipients may have on the 8 May draft, at No 11 at 12-00 noon today, Monday, 11 May. Those asterisked

4

and any others having
specific comments are invited
to the meeting.

Would Mr Britton and Mrs Gilmore
please consider what might go
into a 2-3 page press release?

C Tolkien
11/v/81

5

Reference

CHANCELLOR

cc Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr Burns
Sir Kenneth Couzens
Mr Ryrie
Mr Middleton
Mr Britton
Mr Burgner
Mr P V Dixon
Mr Lavelle
Mr Monck
Mr Kemp
Mr Turnbull
Mr Cropper

You may also like to look at some suggestions of mine on the earlier draft, which are in some places complementary to the later Britton / Aaronson text.

JW
8/5

MAIS LECTURE

I attach a redraft, taking account of your comments and the Chief Secretary's. This has been prepared in consultation with Mr. Burns. Mr Britton has also been through the lecture and tried to make the language more precise.

2. It is the feeling of everyone with whom I have discussed the draft that the numerous quotations are not consistent with the aim of a sophisticated, quasi-academic tone. I have therefore followed specific suggestions (such as the Chief Secretary's) for deletion.

R. H. Aaronson
8 May 1981

CODE 18-78

DRAFT MAIS LECTURE

Introduction

1. I am honoured to be invited to give the third Mais Lecture. It is hard for anyone to measure up to the standard set by my two predecessors. But I recognise a certain logic in the choice. Those who instituted the lecture envisaged that it should be given either by a theoretician or a practitioner. It therefore seems ~~right~~ natural that ~~a~~ an economic Minister should follow the central banker and the economist.

2. I have ~~endured the heat of the kitchen now~~ now been a participant in the evolution of economic policy for almost 10 years. My first experience as a Cabinet Minister was in the engine room of prices and incomes policy in Mr Heath's government. During four years in Opposition I continued to play a part in reformulating the counter inflation strategy ~~in opposition~~. And for the last two years ~~now~~, of course, I ~~am~~ have been responsible for its implementation.

3. I hope then that ~~if I~~ I may offer you today some thoughts distilled from that experience. ~~they will not be without interest.~~ My approach will not be theological. I do not believe that rigid adherence

/to one

to one or other "school" of economics is the best way to respond to our economic problems. Economics is an empirical subject, so all our judgements must be based on an assessment of the evidence available to us at a particular point in time. My views have developed, I hope, in response to my experience; and I acknowledge ~~I admit that~~ on some subjects [acknowledge] they have changed ~~very~~ significantly. I am perhaps not alone in this. But, as I hope to illustrate in the course of this lecture, the broad outline of This Government's economic ~~the~~ strategy for which I am now responsible has developed in a reasonably steady ~~and consistent~~ fashion over the years.

Inflation

4. I have chosen as my title "The Fight against Inflation". This is not because ~~[I think]~~ inflation is the only aspect of the economy on which ~~the~~ Government should have a policy, or indeed that the conquest of inflation is our only goal. The ~~Our~~ ultimate goal must be ~~is~~ to restore the British economy to growth and prosperity: defeating inflation is one condition for that. The other is ~~but there are others, such as~~ improving the performance of the ~~supply side of the~~ economy by making it more flexible and adaptable in its response to technological change and developments in market conditions. ~~the removal of unnecessary distortions of the market~~. Both tasks are vital. Whilst the

/conquest of

8

conquest of inflation may not be a sufficient condition for sustainable economic growth, it is, we believe, a necessary condition. ~~It is thus the first problem to be tackled.~~

5. Some people no doubt ~~would not accept that statement. They~~ would argue that our first priority now should be to reduce unemployment. I am equally concerned about unemployment, but I do not believe that the way to reduce it is to relax in the struggle against inflation. In the 50's and 60's - especially after the publication of Phillips' famous article in 1958 - many people believed that there was a policy trade-off: that if you tolerated so many extra points on ~~off~~ the inflation rate you could get so many extra points off the unemployment rate. But however strong a negative correlation Phillips found for the 100 years up to 1958, more recent experience does not support the argument. In each cycle since then inflation has accelerated and unemployment has risen. The average rate of inflation under successive governments (in the years up to 1979) has marched remorselessly upwards: 3½%, 4½%, 9%, 15%. Meanwhile unemployment ~~has~~ also rose ~~risen~~: 300,000, half a million, three-quarters of a million, one and a quarter million.

(Spell out "per cent")

/All this has

6. All this has ~~led me to~~ strengthened the conviction that it is no longer possible - if indeed it ever was - to reverse that trend in unemployment by stimulating demand and permitting higher inflation. ~~Successive governments have tried this and failed.~~ The notion of a trade-off in this form no longer commands wide acceptance. [~~Now~~] If we look instead at the simultaneous upward trends in inflation and unemployment it is possible to draw a very different conclusion. Now that it has been shown what ~~It seems likely, especially in view of the~~ damage high rates of inflation can do to an economy, it has been widely accepted that the defeat of inflation is ~~now~~ a precondition for a reduction in unemployment. Inflation is the enemy of ~~inimical to~~ confidence and stability. The uncertainty it creates - over future <u>relative</u> prices as well as the general price level - discourages new investment, and so ~~thus~~ undermines the vitality and competitiveness of the economy. Inflation distorts the choices of savers as to where to direct their savings, encouraging ~~making~~ them to prefer ~~seek~~ inflation "hedges" such as antiques or housing to investment in productive sectors of the economy.

7. Moreover ~~But~~ the defeat of inflation is ~~also~~ a worthwhile goal in its own right. For inflation ~~It~~ is socially divisive. ~~It bears unequally on different people.~~ It ~~is unpredictable and therefore~~ redistributes wealth in an arbitrary ~~and unplanned~~ way [~~from lenders to borrowers and vice versa.~~] It exacerbates tension over pay bargaining, as employees

~~seek to~~

seek to correct the erosion of their real incomes.
that has taken place since their last settlement.

Living with inflation

8. In his lecture last year, Lord Robbins argued persuasively against those who claim that a society can tolerate persistently high levels of inflation. His words are worth repeating: "In Latin America", he observed,

> "It is true that the economic system has not come to an end in Latin America, despite [inflation] rates which, if not rivalling the hyperinflation of Germany and elsewhere after the First World War, have still been very high. But "democratic government there has more or less perished and some things even more important than democracy as well" and I doubt ... whether societies more complicated than those of Latin America can stand without catastrophic divisiveness degrees of inflation even considerably less".

TYPE OUT TO MARGIN – WITHOUT UNDERLINING

9. Others have argued that a little inflation is a tolerable, even a good, thing. They claim it has virtues in reconciling the excessive claims made on total national product to the resources actually available. The trouble with this argument is that it requires people to be fooled. It is unlikely to hold in today's circumstances when

/inflation is

Claims on total output, the argument ran, would almost inevitably exceed what was actually being produced. The general price level should be allowed to rise to reconcile the irreconcilable.

On to J.W's pencil text

Living with inflation

8. In his lecture last year, Lord Robbins argued persuasively against those who claim that a society can tolerate persistent high levels of inflation. His words are worth repeating:

> "It is true that the economic system has not come to an end in Latin America, despite [inflation] rates which, if not rivalling the hyperinflation of Germany and elsewhere after the First World War, have still been very high. But democratic government there has more or less perished and some things even more important than democracy as well; and I doubt ... whether societies more complicated than those of Latin America can stand without catastrophic divisiveness degrees of inflation even considerably less".

9. Others have argued that a little inflation is a good thing. They claim it has virtues in reconciling the excessive claims made on total national product to the resources actually available. The trouble with this argument is that it requires people to be fooled. It ~~is unlikely to hold in today's circumstances~~ when

6. In practice I do not believe that we can learn to live with inflation in any sort of satisfactory way. That would imply that a purely 5 technical solution was available to a problem which I am convinced is much more complex and deep rooted ~~[illegible]~~. There are two aspects to inflation: one monetary, and one non-monetary, and neither can be ignored. Inevitably in an open society there is competition for real income; and in an economy where the springs of growth and enterprise have become rather sluggish, that competition becomes sharper. Inflation is [commended in these circumstances as] the device which reconciles these conflicting claims; but as people see that nominal money amounts no longer buy what they expected, the competition becomes still greater, and inflation accelerates. That, as I see it, is the non-monetary aspect.

9A. For the inflation to come about, however, Governments have to permit an increase in the stock of money sufficient to support a given level of real activity in the economy at the higher price level induced by that competition for real income. Hence the monetary aspect. Governments have a choice: whether to go on with the palliative of accommodating inflation without worrying too much about trying to improve the underlying workings of the economy, or whether instead to refuse to allow monetary expansion to continue in that way — so producing a situation in which society is brought face to face with the need to adjust and to correct underlying weaknesses.

inflation is so familiar to us. As the Chairman of the US Federal Reserve put it recently:

> "The game was up when the public would no longer accept nominal gains as a substitute for the real thing."

So I do not believe that there are virtues in inflation, however low the rate. Even at 5% prices double every 14 years. And there is always the danger that if some inflation is tolerated, a slight acceleration will also be tolerated, and so on until the rate is back at a high level.

10. ~~We cannot~~ I do not believe that we can afford to go on compromising with inflation. Price stability - zero inflation - <u>is</u> possible. It is not all that long since we had it in Britain, at least for a short time. Prices in the early part of 1960 were no higher than in the spring of 1958. ~~We have certainly not experienced inflation from the~~ dawn of time. According to Deane and Cole (British Economic Growth 1688-1939) the price level at the outbreak of the First World War was about in line with what it was in 1660, so far as it is possible to make a comparison. The price level did rise on occasion in between, usually because of wars, but

9B The alternative approach was recently condemned by ~~inflation is so familiar to us. As~~ the Chairman of the US Federal Reserve, ~~put it recently:~~
"The game was up," he said, "when the public would no longer accept nominal gains as a substitute for the real thing."

"Inflation, instead of being a relatively benign source solvent, is a degenerative disease"

So I do not believe that there are virtues in inflation, however low the rate. Even at 5 per cent prices double every fourteen ~~14~~ years. And there is ~~always~~ the ever present danger that if some inflation is tolerated, a slight acceleration will also be tolerated, and so on until the thing is once again out of control ~~rate is back at a high level~~. Give inflation an inch and it will take an ell.

10. I do not believe we can go on compromising ~~We cannot afford to compromise~~ with inflation. Price stability - zero inflation - is possible. It is not all that long since we had it in Britain, at least for a short time. Prices in the early part of 1960 were no higher than in the spring of 1958. ~~We have~~ Inflation has certainly not ~~experienced inflation from~~ gone on continuously since the beginning ~~dawn~~ of time. According to Deane and Cole (British Economic Growth, 1688-1939) the price level at the outbreak of the First World War was about in line with what it was in 1660, so far as it is possible to make a comparison. The price level did rise from time to time during that period ~~occasion in between~~, usually because of wars, but

Infl has certainly not gone on continuously since the beginning of time

/prices then

prices then fell back so that the trend was roughly steady. The problems ~~may~~ have certainly become more difficult in ~~the modern world~~ recent years - [even Germany and Switzerland do not enjoy price stability at the moment] - but ~~I do not believe they are so incapable of solution that we can never get back to price stability.~~ [CST says this is too bland. Can someone add "the word of explanation" for which he asks]

We should not conclude that we shall never again be able to do better than we have in the 1970s.

11. It follows from ~~all~~ this that ~~all~~ alternative policies which compromise with inflation must be rejected. This is true of policies of import control and devaluation - which would undoubtedly set prices accelerating - as much as of policies of so-called "reflation". They would not solve any of our long-run problems.

Short- and long-run causes

12. What then are the right weapons for the fight against inflation? This question cannot be answered until we are clear about the causes of inflation. Here I would distinguish between non-monetary shocks to the price level, such as changes in commodity prices, [real exchange rate movements] and indirect tax

~~Is this para. consistent?~~ ~~And~~ Is an exchange rate change non-monetary?

/changes,

changes, and the slower-acting influence of the rate of monetary growth. All kinds of shocks can upset the relation between money and prices in the short run; in some cases the relationship may change permanently, but the evidence suggests that over the medium term velocity of circulation is relatively stable and predictable.

13. From this it follows that to control inflation on a permanent basis it is necessary to control the rate of monetary growth. One can, of course, hold down individual prices for a short time by a variety of direct controls and subsidies. ~~I spent some time trying to do so~~ From 1972 to 1974 ~~. But I recognised even then that they were not capable~~ I was the Minister responsible for the design and implementation of price controls. My Treasury colleague, Lord Cockfield, was Chairman of the Price Commission, which we established. And we learned, as did others, from that experience that price controls are neither an acceptable nor an effective way of achieving a permanent reduction in the rate of inflation. Price controls create their own tensions, by ~~cannot be maintained for ever. They~~ preventing the adjustment of relative prices, which is essential to the proper functioning of the economy. Where prices are held down ~~constant~~ by subsidy, as has ~~[illegible]~~ repeatedly been attempted, particularly ~~been done in the past~~ in the case of ~~some~~ nationalised industry prices, the burden of the subsidy rises over

/time and

time and ultimately must place an excessive strain on public finance. In short, if the underlying causes of inflation are not tackled a policy of price control can only check price rises for a short time.

14. What is needed is a framework which permits relative prices to adjust to their market-clearing levels against the background of an overall ~~check on rises in~~ restraint of the general price level. Such a system promotes economic efficiency and freedom.

The need for monetary policy

15. The framework ~~which has been evolved~~ which has been judged desirable, for restraining the general price level is, here and in many other countries, is control of the supply of money. ~~This is of course not a recent idea. It is at least as old as [Fisher]. For me, there has been no blinding flash on the road to Chicago.~~

In a general way this was well understood by David Hume, even before Adam Smith. There has been no sudden blinding flash on the road to Chicago. If there is too much money in circulation, prices will rise. If we don't want that to happen - And I have already explained why I am sure we should resist it - then we have to keep monetary growth under control.//

16. ~~Nor is the importance of monetary control recognised only in this country. In the European Community, the IMF, the OECD, it is simply taken for~~

Some people in Britain still imagine that this Government is in some way eccentric in re-emphasizing this truth. But, as Alexandre Lamfalussy of the Bank of International Settlements observed the other day, ~~[illegible]~~ western industrial countries have been demonstrating ~~the~~ an "increasing, and in some cases dominant, reliance on monetary policy in fighting inflation".

/granted that

~~granted that a key element in economic policy must be a firm limitation of the extent of monetary expansion. I find the attitude of~~ The continental Europeans, ~~especially refreshing since~~ *recognise the point very readily!* they do not seem to suffer the same intensity of theological debate ~~over simple propositions~~ about monetary policy as we do in this country, or as to a lesser extent do the North Americans. ~~A good~~ *Consider, for* example, ~~of the common sense to be found in Europe is~~ the evidence submitted by the Bundesbank in response to the enquiry conducted by our own Parliamentary Select Committee. They rightly insist that a sound monetary policy promotes growth. "The Federal Government and the Bundesbank are both firmly convinced that in the long run a consistent policy of tight and stable money creates the best conditions for satisfactory economic growth". In the face of *such widespread* ~~this~~ international agreement, ~~I found the statement~~ *a layman was perhaps entitled to feel at least mildly puzzled by the ~~[illegible]~~ bald assertion* of ~~the~~ 364 economists that there was no theoretical basis for policies of monetary control. ~~extremely puzzling~~ *A clock which strikes thirteen times thereby casts doubt upon the reliability of ~~[illegible]~~ all ~~the rest of~~ its testimony.*

17. What perhaps is more recent is the setting of explicit monetary targets. But the evolution of such

/targets has

targets ~~has~~ [appear to have] been ~~a~~ quite natural development. When currencies were tied to the gold standard monetary restraint was more or less automatic. If prices rose too rapidly in one country a balance of payments deficit would ensue. The country would lose gold across the exchanges with a consequent reduction in money supply ~~and thus~~ [and so in ability to finance the going level of activity. The result was a strong downward pressure ~~on inflation~~] inflation. The fixed exchange rate system effectively produced the same result[: countries which inflated too fast had to cut demand in order to maintain the external value of their currencies and prevent the total loss of their reserves.] Thus for most of the nineteenth and twentieth centuries monetary discipline was imposed from without via the linking of the currency to an external standard.

18. By the early 1970s, however, the strains of the fixed exchange rate system imposed by inflation and the weakness of the dollar forced ~~its~~ [the] abandonment. ~~It must be doubtful whether the fixed exchange rate system could have coped with the shocks the world economy has experienced in the last decade.~~ A floating rate system became necessary. ~~But it was then also~~ [And thus it also became] necessary to make explicit the implicit monetary control that had been exercised by the old system. ~~Most large Western countries were quick to do this.~~ [Hence the significance of monetary targets, or – for those smaller countries which prefer this approach – the objective of keeping the domestic currency in a fixed relationship with the currency of a major economy.]

/In Britain

19. In Britain the lesson was learnt rather painfully. Monetary growth was allowed to accelerate rapidly in 1972 and 1973 and by 1975 inflation, helped by the rise in the price of oil, had risen above 25 per cent. A sterling crisis ensued in 1976. ~~And the then Chancellor, prompted by~~ So my predecessor, with the encouragement of the IMF, realised the need for monetary targets and restraint of public borrowing. By 1977 Mr. Healey was prepared to say that "we cannot master inflation unless we have control of the money supply". ~~In 1978~~ And in the following year Mr. Callaghan ~~described evolution of monetary targets as follows~~ explained that: "It was against this background" - that is to say the earlier rapid monetary growth and inflation - "that the Government took the decision to put the money supply under proper control and then to publish quantified monetary targets".

20. Thus monetary targets were already an established part of British economic policy when this Government took office. The important innovation that we have made is to set out these targets for a longer period ahead. If monetary policy is to provide a framework of stability for the operation of the economy, it must clearly be sustained

/and permanent.

and permanent. That is the reason for the medium-term financial strategy. And once ~~one has~~ such a strategy, one has to take action from time to time to ensure that its direction is maintained. This is what I did in the last Budget.

21. ~~Another lesson learnt by~~ the last Government ~~is~~ that, having moved to a system of monetary targets, you cannot have it both ways and also hold the exchange rate at a particular level. the monetary targets ~~must~~ come first. The Governor described ~~this~~ in 1978

> "A time came when we felt unable any longer to maintain full control over the growth of the money stock without setting the exchange rate free to float - concern about exports nothwithstanding. The decision made in those circumstances emphasises our commitment, in conditions of conflict, to controlling the monetary aggregates."

/In any case,

22. ~~In any case, the~~ The similar experience of ~~many~~ other countries suggests that market forces are ~~often~~ almost always too strong to resist for very long. Not only has it proved impossible to operate an exchange rate policy, but domestic monetary control has been compromised by the attempt. In the end there is little alternative but to leave exchange rates to be determined by the balance of forces in the market. So despite the importance of the exchange rate - both in its influence on the rate of inflation and its effect on industry's competitiveness - there are no magical means open to the Government to manipulate it. ~~I have~~ No doubt ~~that~~ we could reduce the current nominal exchange rate by pursuing more inflationary policies. But that would not help competitiveness. The only solution to our competitiveness problem is to adjust our costs to the exchange rate, not the other way round. Our wages and prices must be directed towards those which rule internationally. I shall say more on this in a moment.

/The conduct of monetary polic

The conduct of monetary policy

23 Given then that monetary control has the central place in our anti-inflation strategy what has been our experience with the policy over the last two years? The first point to make is that this has been a time of upheaval in the world economy. The 1979 increase in the world price of oil - as serious as that of 1973-74 - has created worldwide recession and increased inflationary pressures. The oil price increase has almost certainly ~~contributed to~~ magnified the strength of sterling. All this has made economic management over the last two years more difficult.

24 Inflation has, however, been coming down. It was on an upward trend when we came to office and reached a peak of nearly 22 per cent a year ago. But since then it has declined steadily. The annual increase in the RPI is down to 12½ per cent and we forecast single figures next year. [This

/deceleration of

deceleration of prices has come in response to tight financial conditions. Nonetheless the recorded rate of growth of £M3 - our target aggregate - was well above the target range last year. This was partly due to the removal of the corset, but by no means entirely. This has led some - including this University - to criticise us for maintaining an insufficiently tight monetary policy. But other indicators suggest that this criticism is not justified: the behaviour of the narrower monetary aggregages, the strength of the £, the level of real interest rates and the fall in inflation itself. So most commentators, and indeed the Treasury and Civil Service Select Committee, agree with our view that "monetary conditions have been tight."

25 There were many special factors at work last year, not only the unwinding of corset distortions but also the nature of the recession, with its severe pressure on company finances. That is why it was right to take account of all the various monetary aggregates, and of the level of real interest rates,

/in reaching

in reaching day-to-day decisions about monetary policy. We have always ~~said that we would do so~~ for example, in the Green Paper on monetary control published a little over a year ago.

26 Nonetheless, over the medium-term there are great advantages in using for target purposes a broad aggregate like £M3, with its clear link with fiscal policy. The Governor ~~concluded~~ in his 1978 lecture ~~that~~ "We have chosen best in selecting £M3." And I note that the City University study to which I referred also endorsed the use of this aggregate.

Techniques of monetary control

27 Our approach to monetary control has been guided by three ~~principles~~. First, we have learnt that control ~~must be achieved without recourse to~~ quantitative restrictions ~~on~~ institutions. ~~Indeed,~~ with a financial system as well developed ~~as ours,~~ as closely integrated with world financial markets, control so achieved may well be control in name only. We have ~~therefore~~ dispensed with the corset.

/Secondly, in

28 Secondly, in place of such controls we prefer to rely on instruments which have real effects on underlying monetary conditions - fiscal policy, funding and interest rates. I shall say a little about fiscal policy in a moment. As for funding, we have already made two major improvements - the National Savings initiative and the introduction of an indexed gilt. We met our target for National Savings last year and are making a good start to this year's objective of £3 billion. The indexed gilt is, in my view, a major advance which will greatly increase the flexibility of the Government in conducting debt sales. It will help us to secure a reduction of long-term interest rates by demonstrating our confidence that inflation will be reduced and by diminishing uncertainty about future real interest rates.

29 The third principle has been that of an evolutionary approach. The extensive and interesting public debate which followed the Green Paper on Monetary Control confirmed that there were attractions in monetary base control but that we needed more

/information before

information before we could take a decision. We needed to be able to assess more clearly how such a system might operate in practice. For example, the ~~banks'~~ behaviour of the banks in the past has reflected the fact that they have been able to acquire cash with a high degree of certainty as its terms. It is difficult to assess how they would modify their operations if this presumption were changed.

Our approach has therefore been to proceed step by step, making changes which are desirable in themselves and which will enable us to learn more about the way in which alternative methods of monetary ~~base~~ control might operate. [QUAGRO TAKE IN - REST OF OLD PARAS 28] AND 29]

Supporting policies

30. I have never believed that the setting of monetary targets is enough by itself. First of all, we have to have a fiscal policy compatible with our monetary policy. Experience shows that it is virtually impossible to finance an excessive public sector deficit without adding to the money supply. Even were it possible it could jeopardise success against inflation by adding to nominal increases or precipitating a fall in the exchange rate. Alternatively, excessive borrowing could in some circumstances increase the transitional costs of reducing inflation. High interest rates which might be necessary to finance excessive PSBR would bear most heavily on companies, leading to reductions in investment, and stockbuilding. If this more than offset the direct effect of the PSBR itself on aggregate demand, there would be higher unemployment in the short run as well as a weakening of growth prospects in the longer run. It is a measure of our determination to achieve a PSBR consistent with the monetary targets that we were prepared to increase taxes to the extent we

/did

30a Monetary discipline then must be supported by fiscal discipline. That is a proposition that would be endorsed by virtually everyone who has experience of operating policy in finance ministries and central banks throughout the world. We indicated that we accept this constraint when we published in the Medium Term Financial Strategy an illustrative path for the public sector borrowing requirement, which we believe is consistent with the achievement of our targets for £M3. The path for the PSBR is not of course the only possible one which would be consistent with those targets; still less is it intended as a target in its own right. I repeat this because at times our approach to the PSBR has been characterised as much more rigid than in fact it is.

30b This leads me to the important and topical question of the treatment of investment by the nationalised industries. It has been suggested that, by merely waving a statistical wand, and decreeing that borrowing to finance such investment should be excluded from the PSBR, all need for restraint could be abandoned. The truth is quite different. We

/have

have set targets for the money supply, and we intend to achieve them, not by some financial sleight of hand which distorts financial markets and raises the velocity of circulation. This means, in effect, that there is something rather like a cash limit applicable to the whole economy, not just the public sector. The monetary targets have implications for total nominal income and expenditure in nominal terms. These constraints are essential to the fight against inflation and that, rather than any target path for the PSBR, is the ultimate constraint on policy.

30c This does not mean that increased investment by nationalised industry can never be appropriate. What it does mean is that new projects must have demonstrably a better claim for a share in total spending than some other spending they will replace. Normally we would expect to find the offset elsewhere in the public sector. If not, it has to come from the private sector whether in private investment or in consumer spending. There is, alas, nothing to be had without cost.

did in the last Budget. This was a case where our anti-inflation objective conflicted with our desire to reduce the disincentive effects of taxation. Defeating inflation had to come first.

INSERT 30A-C

31. But it is not only Government decisions which determine the extent of the adjustment costs. There is certainly room within the monetary targets for real growth in the economy. During this financial year we expect inflation to drop to 8 per cent, compared with a monetary target of 6-10 per cent and an upward trend in velocity of 1-2 per cent a year. But whether growth materialises depends largely on the decisions of individuals. The money supply targets act as a medium-term constraint on the growth of nominal spending - a sort of national cash limit. But it is the response of individuals which determines how that growth is divided between price inflation and a rise in real output. It is crucial that pay, prices and other variables should all adjust together, within the national cash limit to achieve a reduction in both

/unemployment

31A. Wages and salaries account for about [two thirds] of the national income; they are the dominant share of business costs. If pay increases are too large, there is an inevitable risk that real activity, as well as prices, will be squeezed by financial restraint: ~~unemployment and inflation. If pay is out of line~~ the result ~~will be unemployment~~ [is high unemployment and low, or even negative, growth]. We have in any case been taking too much out of the economy in pay in recent years and leaving far too little for profits and investment. [The real rate of return on capital employed in Britain in 1980 - excluding North Sea companies was less than 3 per cent. The corresponding figure in Japan was 13 per cent.] Moreover, since our pay rises have been much faster than those of our overseas competitors further job losses have come through loss of competitiveness. Wage costs per unit of output almost quadrupled between 1970 and 1980 in the UK. In Japan and Germany they rose by only 70%. Even recently, domestic labour costs have been a larger factor in our reduced competitiveness than the strength of sterling. [That case has been accepted by each of the last three governments.]

32. ~~This leads some to call~~ for an incomes policy. ~~When I w~~as a member of the Heath Government I ~~saw~~ was closely involved in the administration of the policy. And ~~the attractions myself.~~ ~~However~~, as with prices ~~policy~~ controls, I came to doubt whether incomes policy was a sustainable answer to the problem we are discussing. ~~could be sustained for any length of time~~. In a speech in ~~which is now five years~~ ~~1976~~ 1976 I set out a list of objections to any kind of rigid incomes policy.

/I think

[There is then no shortage of reasons for ~~[illegible]~~ sustained moderation in pay bargaining. A reduction in the rate of monetary growth does need to be accompanied by a more-or-less corresponding reduction in the rate of growth of average money incomes, including pay. It is this insight which ~~[illegible]~~, perhaps understandably, prompts people to call for a policy for incomes —]

[If increases in unemployment are to be avoided, then a progressive]

(or "wooden norms", as Lionel Robbins describes them)

I think these still hold good today. The first objection to the setting of wage targets ~~or norms~~ is that they ~~substantially~~ seriously distort and could, over time, destroy the functioning of the labour market. Changes in relative wage rates are, as I said then, the lights that wink at each other ~~over a~~ across a market place ~~where~~ in which ~~so many~~ hundreds of thousands of people change their jobs each month. The second major objection is a political one. If the state itself ~~should~~ attempts to simulate the market place and to plan relativities throughout the economy, ~~then~~ important freedoms ~~itself will be endangered~~ are diminished. The third objection is a very practical one. It has not proved ~~easy~~ possible, despite a series of ingenious attempts, to evolve a practical and durable method of making and enforcing these non-market judgements. The fourth objection to the establishment of an institutional incomes policy is the greatly increased leverage the trade unions (or their leaders) acquire over many matters that are properly the responsibility of the elected Government. Under a variety of administrations the unions have exacted their own price for formal "acceptance" of an incomes policy. They have secured major changes in policy, in the fields of ~~policies for~~ taxation, prices, ~~industry and other~~ industrial relations law and other matters ~~have all been changed,~~ often ~~in a~~ with harmful ~~way, to persuade trade unions to accept incomes policy. And at the same time~~ consequences. In the event the risk of conflict

/between

between Government and trade unions is greatly increased.

33. ~~What is needed instead is~~ to improve the functioning of the labour market so that pay rates ~~are not agreed that~~ price people out of jobs. The monopoly power of large trade unions is a major impediment. The closed shop, the law relating to picketing and other trade union privileges are all factors unbalancing the labour market and contributing to higher unemployment. ~~We tried to~~ tackle these problems ~~with the Industrial Relations Act. [But legislation in this field needs to be built on consensus.] The vital first step is to~~ spread ~~greater~~ understanding of the link between labour market rigidity and unemployment. There are other distortions ~~too~~ that have contributed to the rise in unemployment: the ~~relation~~ between rates of pay for ~~the~~ skilled and unskilled workers, and ~~for~~ young people and adults. [It is estimated that a young worker in Britain receives on average % of the adult wage rate, compared to % in Germany.] The relation between benefit levels and rates of pay is

/another

another factor. And ~~there are~~ various obstacles to ~~the~~ mobility of labour in the housing market, for example.

34. Besides reducing labour market rigidities, we also have a responsibility to spread greater understanding of the implications of ~~our~~ monetary and fiscal policies, and to influence inflation expectations. ~~This is why we made the MTFS public.~~ I was interested to see a recent study by the Hamburg Institute, which attributed Germany's success in containing inflation after the second oil shock to widespread belief in the determination of the authorities to stick to their monetary targets.

35. We have also attempted to spell out the consequences for employment of pay settlements not consistent with the monetary targets. There is now clear evidence of this realisation, particularly in the level of private sector pay settlements. People are learning - as they have

/in

in other countries - that the real value of their incomes cannot always be guaranteed. Past rises in the retail prices index are having less influence than the realities of the current situation. The task now is to ~~continue~~ the process of education ~~into~~ the public sector.

36. ~~We badly need a better~~ system of wage determination in the public sector. ~~I am not ashamed to admit that~~ my own ideas on this subject have changed ~~radically~~. The problem is an intractable one. In 1974 I thought ~~in terms of~~ an independent agency to determine relativities in the public sector. ~~In~~ 1975 I was ~~prepared~~ to argue for indexation of public sector wages, to avoid friction at a time of high inflation.

37. But what I have said all along is that the Government must ~~inevitably~~ have a policy for the pay of its own employees. ~~It must~~ determine the resources that can be ~~made available~~. We ~~have~~ now ~~set forth~~ on the task of creating a ~~new~~ pay system for the civil service. We do not rule out the possibility

possibility of outside comparisons as one factor to be taken into account; but any new system must ensure that pay rises take account of what the taxpayer can afford. The old comparability system failed to do this. Creating a new scheme will take some time. But the public sector must continue, along with the private sector, to play its full part in the attempt to gear down pay and prices and therefore improve the prospects for unemployment.

38. This need applies to the nationalised industries as well. In those industries we are increasing external disciplines on wages and other costs: through opening some industries to a measure of competition, returning all or part of others to the private sector, referring individual industries to the Monopolies and Mergers Commission, and setting firm limits on external financing. But I do not believe that we have yet got the complete answer.

/39.

39. Similarly, in the directly employed public sector we need more coherent bargaining arrangements than either the series of ad hoc solutions from Willberforce to Clegg or the rigid roundabout process of pay comparability. The Government is now set forth on the task of attempting to create an alternative system, which will take some time. But the public sector must continue, along with the private sector, to play its full part in the attempt to gear down pay and prices and therefore improve the prospects for unemployment.

40. I believe that wage bargainers will show greater responsibility the more open is the Government's approach to economic management. The undue influence of particular interest groups needs to be challenged in a much wider and more open consultation. It is

/only

only by making clear the nature of the national cash limit and the demands applied to it that we can ~~begin to~~ discuss [with sufficient effect] the influence and role that each of the major participants can play. [This is why we] ~~We~~ have tried within the framework of NEDC to promote ~~the widest~~ [wider] discussion on these matters. ~~It is not a matter of~~ [We do this not with a view to] striking a~~n~~ ~~old style~~ deal [of any kind] ~~designed only to appease the prejudice of individuals,~~ but [gradually] to promote a wide[r]-ranging discussion where each party is ~~forced~~ [helped] to realise the claims that others have upon the economy. [There is still a very long way to go.] It may be that ~~we have~~ [Government itself has] not yet been open enough. ~~We have further steps in mind. But~~ Trade unions ~~too~~ [too] must [continue to develop their willingness to join others in recognising] ~~recognise~~ the need for a~~n~~ open and informed discussion of pay [and competitiveness].

/41.

41. The NEDC has a developing role to play. So too do bodies such as the Treasury Committee, which provides a non-partisan commentary on Government policy. Indeed they would have a particularly instructive and beneficial part to play if they sought to make the case for pay moderation, or suggested reforms to the determination of public sector pay, or stressed the importance of restoring competitiveness and improving mobility in the labour market.

Removing other rigidities

42. But it is not only pay which needs to adjust more quickly if we are to minimise the costs of reducing inflation. The same need applies to prices. Thus the progress we have

/made on

made on the supply side of the economy, which will have beneficial long-term effects, will also ease the process of transition. We have removed Government controls - on prices as well as wages, dividends and the movement of currency across the exchanges - and we are strengthening the forces of competition by such means as widening the scope of the Monopolies and Mergers Commission. The combination of monetary deceleration and monopoly pricing would spell loss of output and loss of employment. But if prices can adjust freely to the new market conditions the difficulty is greatly reduced.

Conclusion

43 Squeezing inflation out from an economy which has become accustomed to high rates over a period of years cannot be an easy task. I have no doubt that the road ahead will continue to be a long and hard one. It is not sufficient to apply anti-inflationary policies for a brief period. That would not permanently conquer

/inflation

inflation and it would condemn us to a continuation of our long economic decline. It will be particularly tempting to relax our vigilance as the economy begins to grow again, to fall back into bad old habits and throw away the hard-won gains. All my experience leads me to the conviction that we must resist this temptation. We must eradicate the inflationary mentality - in Government, and among individuals. When we have done that we will find that low inflation or even price stability need not be painful. Indeed in the long run it will usher in a whole variety of other benefits.

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H. M. TREASURY

Parliament Street, London SW1P 3AG, Press Office: 01-233-3415
Telex 262405

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THE MAIS LECTURE

Text of the Third Mais Lecture given by the Chancellor of the Exchequer, the Rt Hon Sir Geoffrey Howe, QC, MP, at the City University, London, today, Tuesday 12 May 1981, on the subject "The Fight Against Inflation". A short summary precedes the text.

PRESS OFFICE
H M TREASURY
PARLIAMENT STREET
LONDON SW1P 3AG
01-233 3415

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SUMMARY

The Chancellor argues that the fight against inflation is a task of the highest priority. This is not because other economic problems, such as unemployment, are unimportant, but because it is now recognised that reducing the inflation rate "is a pre-condition for the restoration of growth and a reduction in unemployment". He describes the damage that inflation can do to industrial confidence and social stability. There is no question of compromising with inflation.

A permanent reduction in the rate of inflation requires sustained control of the money supply. There is nothing new about the idea that if there is too much money in circulation, prices will rise. What is rather more recent is the setting of explicit monetary targets, but this is because previously monetary control had been imposed from without via the fixed exchange rate regime, and before that the gold standard. When floating exchange rates became necessary most large Western countries realised the need for explicit monetary targets to replace the earlier external constraint. We have had monetary targets now since 1976. The important innovation under this Government has been to put the targets on a more permanent basis by means of the medium term financial strategy.

The Chancellor recalls the success already achieved against inflation and argues that monetary conditions were tight in 1980-81, despite the rapid growth in £M3. Over the medium term, however, £M3 remains the most suitable target aggregate.

But "I have never believed", the Chancellor states, "that the setting of monetary targets can be enough by itself". Firstly, fiscal policy has to be consistent to avoid excessively high interest rates. Secondly, the average growth of money incomes has to be in line with the monetary target, which imposes a "national cash limit". This limit allows room for real growth in 1981/82, but the decisions of individuals will determine how much of the increase in money incomes will go into price increases and how much into growth in real output.

But the Chancellor explains how a rigid incomes policy can distort the labour market, curtail freedom and give undue influence to trade unions. Nor have the practical problems of deciding relativities ever been overcome. Instead, the Government's responsibility is to improve the functioning of the labour market and spread wider understanding of "the consequences for employment of pay settlements not consistent with the monetary targets". The Chancellor sees the possibility of a greater role for the NEDC in discussing such matters. The Government may not yet have been open enough, but trade unions too should recognise the need for an informed discussion on pay and competitiveness. He would like to see the Treasury and Civil Service Select Committee studying these issues as well.

The Chancellor ends by emphasizing that monetary control and the fight against inflation must be sustained. This is ultimately the key to the regeneration of our economy.

THE full text of the lecture follows

MAIS LECTURE

THE FIGHT AGAINST INFLATION

Introduction

I am honoured to be invited to give the third Mais Lecture. It is hard for anyone to measure up to the standard set by my two predecessors. But I recognise a certain logic in the choice. Those who instituted the lecture envisaged that it should be given either by a theoretician or a practitioner. It therefore seems natural that an economic Minister should follow the central banker and the economist.

I have now been a participant in the evolution of economic policy for almost 10 years. My first experience as a Cabinet Minister was in the engine room of prices and incomes policy in Mr. Heath's government. During 5 years in Opposition I continued to play a part in reformulating the strategy against inflation. And for the last two years, of course, I have been responsible for its implementation.

I hope then that I may offer you today some thoughts distilled from that experience. My approach will not be theological. I do not believe that rigid adherence to one or other "school" of economics is the best way to respond

to our economic problems. All our economic judgements must be based on an assessment of the evidence available to us at a particular point in time. My views have developed, I hope, in response to my experience; and on some subjects I acknowledge they have changed very significantly. I am perhaps not alone in this. But, as I hope to illustrate in the course of this lecture, the evolution of this Government's economic strategy for which I am now responsible has been a logical development given the experience of recent years.

Inflation

I have chosen as my title "The Fight Against Inflation". This is not because inflation is the only aspect of the economy on which Government should have a policy, or indeed because the conquest of inflation is our only goal. The ultimate goal must be to restore the British economy to growth and prosperity: defeating inflation is one crucial condition for that. The other is improving the performance of the economy by making it more flexible and adaptable in its response to technological change and developments in market conditions. Both tasks are vital. But whilst the conquest of inflation may not be a sufficient condition for sustainable economic growth, it is, we believe, a necessary condition.

Some people no doubt would argue that our first priority now should be to reduce unemployment. I am equally concerned about unemployment, but I do not believe that the way

to reduce it is to relax in the struggle against inflation. In the 50s and 60s - especially after the publication of Professor Phillips' famous article in 1958 - many people believed that there was a policy trade-off: that if you tolerated so many extra points on the inflation rate you could get so many extra points off the unemployment rate. But however strong a negative correlation Phillips found for the 100 years up to 1957, more recent experience does not support the argument. In each cycle since then inflation has accelerated and unemployment has risen. The average rate of inflation under successive governments in the years to 1979 has marched remorselessly upwards: 3½ per cent, 4½ per cent, 9 per cent, 15 per cent. Meanwhile unemployment also rose: 300,000, half a million, three-quarters of a million, one and a quarter million.

All this has strengthened the conviction that it is not possible to reverse that trend in unemployment by stimulating demand and permitting higher inflation. The notion of a trade-off in that form no longer commands wide acceptance. If we look instead at the simultaneous upward trends in inflation and unemployment a very different conclusion suggests itself. Now that it has been shown what damage high rates of inflation can do to an economy, it has been widely accepted that the defeat of inflation is a pre-condition for the resumption of steady growth and a reduction in unemployment. Inflation is

the enemy of confidence and stability. The uncertainty it creates - over future relative prices as well as the general price level - discourages new investment, and so undermines the vitality and competitiveness of the economy. Inflation distorts the choices of savers as to where to direct their savings, encouraging them to prefer inflation "hedges" such as housing or antiques to investment in productive sectors of the economy.

Moreover the defeat of inflation is a worthwhile goal in its own right. For inflation is socially divisive. It redistributes wealth in an arbitrary way. It exacerbates tension over pay bargaining, as employees struggle to maintain their real incomes.

Living with inflation

In his lecture last year, Lord Robbins argued persuasively against those who claim that a society can tolerate persistently high levels of inflation. "In Latin America", he observed, "democratic government .... has more or less perished and some things even more important than democracy as well". I share his doubts "whether societies more complicated than those of Latin America can stand without catastrophic divisiveness degrees of inflation even considerably less".

Others have argued that a little inflation is a tolerable, even a good, thing. In practice I do not believe that we can learn to live with

inflation in any sort of satisfactory way. That would imply that a purely technical solution was available to a problem which I am convinced is much more complex and deep-rooted. Inevitably in an open society there is competition for real income; and in an economy where the springs of enterprise have become rather sluggish, that competition becomes sharper. Some people commend inflation in these circumstances as the device which reconciles these conflicting claims. But as people see that nominal sums of money no longer buy what they expected, the competition becomes still greater and inflationary pressure grows. Governments then have a choice between accommodating the inflationary pressure and improving the underlying workings of the economy to make more real resources available. There is no doubt in my mind that while the former may be a short-term palliative, the latter is something which eventually has to be faced.

The alternative approach was recently condemned by the Chairman of the US Federal Reserve. "The game was up," he said, "when the public would no longer accept nominal gains as a substitute for the real thing. Inflation, instead of being a relatively benign social solvent, is a degenerative disease." So I do not believe that there are virtues in inflation, however low the rate. Even at 5 per cent prices double every fourteen years. And there is the ever present danger that if some inflation is tolerated, a slight acceleration will also be tolerated, and so on until the thing is once again out of control. Give inflation an inch

and it will take an ell.

I do not believe we can go on compromising with inflation. Price stability - zero inflation - is possible. It is not all that long since we had it in Britain, at least for a short time. Between October 1958 and May 1960 the Retail Price Index did not move by more than one point in either direction. Inflation has certainly not gone on continuously since the beginning of time. According to Deane and Cole (British Economic Growth, 1688-1939) the price level at the outbreak of the First World War was about in line with what it was in 1660, so far as it is possible to make a comparison. The price level did rise from time to time during that period, usually because of wars, but prices then fell back so that the trend was roughly steady. The problems have certainly become more difficult as a result of the upward trend in prices since the last war. But we should not conclude that we shall never again be able to do better than we have in the 1970s.

It follows from the damage done by inflation that alternative policies which compromise with it must be rejected. They might seem to provide short-term relief but they would not solve any of our long-run problems.

Short - and long-run casues

What then are the right weapons for the fight against inflation? This question cannot be answered until we are clear about the causes of inflation. Here I would distinguish between non-monetary influences on the price level, such as changes in commodity prices and indirect tax changes, and the slower-acting influence of the rate of monetary growth. All kinds of shocks can affect prices in the short run; in some cases they may change the relationship between money and prices permanently, but the evidence suggests that over the medium term the velocity of circulation is relatively stable and predictable.

From this it follows that to control inflation on a permanent basis it is necessary to control the rate of monetary growth. One can, of course, hold down individual prices for a short time by a variety of direct controls and subsidies. From 1972 to 1974 I was the Minister responsible for the design and implementation of price control. My Treasury colleague, Lord Cockfield, was Chairman of the Price Commission, which we established. And we learned,as did others, from that experience that price controls are neither an acceptable nor an effective way of achieving a permanent reduction in the rate of inflation. Price controls create their own tensions, by preventing the adjustment of relative prices, which is essential to the proper functioning of the economy. Where prices are held down by subsidy, as has repeatedly been attempted, particularly in the case of nationalised

industry prices, the burden of the subsidy rises over time and ultimately must place an excessive strain on public finance. In short, if the underlying causes of inflation are not tackled a policy of price control can only check prices rises for a short time.

What is needed is a framework which permits relative prices to adjust to their market-clearing levels against the background of an overall restraint of the general price level. Such a system promotes economic efficiency and freedom.

The need for monetary policy

The framework for restraining the general price level which has been judged desirable, here and in many other countries, is control of the supply of money. In a general way this was well understood by David Hume, even before Adam Smith. There has been no sudden blinding flash on the road to Chicago. If there is too much money in circulation, prices will rise. If we don't want that to happen - and I have already explained why I am sure we should resist it - then we have to keep monetary growth under control.

Some people in Britain still imagine that this Government is in some way eccentric in re-emphasizing this truth. But, as Alexander Lamfalussy of the Bank of International Settlements observed the other day, Western industrial countries have been demonstrating an "increasing, and in

some cases dominant, reliance on monetary policy in fighting inflation." The continental Europeans recognise the point very readily: they do not seem to suffer the same intensity of theological debate about monetary policy as we do in this country, or as to a lesser extent do the North Americans. Consider, for example, the evidence submitted by the Bundesbank in response to the enquiry conducted by our own Parliamentary Select Committee. They rightly insist that a sound monetary policy promotes growth. "The Federal Government and the Bundesbank are both firmly convinced that in the long run a consistent policy of tight and stable money creates the best conditions for satisfactory economic growth".

What is perhaps more recent is the setting of explicit monetary targets. But the evolution of such targets has been quite a natural development. When currencies were tied to the gold standard monetary restraint was more or less automatic. If prices rose too rapidly in one country a balance of payments deficit would ensue. The country would lose gold across the exchanges with a consequent reduction in money supply and so in ability to finance the going level of activity. The result was a strong downward pressure on inflation. The fixed exchange rate system effectively produced the same result: countries which inflated too fast had to cut demand in order to maintain the external value of their currencies and prevent the total loss of their reserves. Thus for most of the nineteenth and twentieth centuries monetary

discipline was imposed from without via the linking of the currency to an external standard.

By the early 1970s, however, the strains imposed by inflation, disparities in economic performance and the weakness of the dollar forced the abandonment of the fixed exchange rate system. A floating rate system became necessary. And thus it also became necessary for individual countries to make explicit the implicit monetary control that had been exercised by the old system. Hence the significance of monetary targets, or - for those smaller countries which prefer this approach - the objective of keeping the domestic currency in a fixed relationship with the currency of a major economy.

In Britain the lesson was learnt rather painfully. Monetary growth was allowed to accelerate rapidly in 1972 and 1973 under the impression that, now the restrictions of the fixed exchange rate discipline were gone, this was the way to increase output. By 1975 inflation, helped by the rise in the price of oil, had risen above 25 per cent. A sterling crisis ensued in 1976. And so my predecessor, following discussions with the IMF, realised the need for monetary targets and restraint of public borrowing. By 1977 Mr Healey was prepared to say that "we cannot master inflation unless we have control of the money supply". And in the following year Mr Callaghan explained that: "It was against this background" - that is to say the earlier rapid monetary growth and inflation - "that the Government took the decision to put the money supply under proper control and then to publish quantified monetary targets".

Thus monetary targets were already an established part of British economic policy when this Government took office. The important innovation that we have made is to set out these targets for a longer period ahead. If monetary policy is to provide a framework of stability for the operation of the economy, it must clearly be sustained and permanent. That is the reason for the medium-term financial strategy, which is now in its second year of operation.

The last Government also taught us the lesson that, having moved to a system of monetary targets, you cannot have it both ways and also hold the exchange rate at a particular level. If any inconsistency emerges, the monetary targets have to come first. The Governor described in 1978 how this had happened in the previous year:

> "A time came when we felt unable any longer to maintain full control over the growth of the money stock without setting the exchange rate free to float - concern about exports notwithstanding. The decision made in those circumstances emphasises our commitment, in conditions of conflict, to controlling the monetary aggregates."

The similar experience of other countries suggests that international capital flows are almost always too strong to resist for very long. Not only has it proved impossible to meet a particular exchange rate objective, but domestic monetary control has been compromised by the attempt. In the end there is little alternative but to leave exchange

rates to be determined by the balance of forces in the market. So despite the importance of the exchange rate - both in its influence on the rate of inflation and its effect on industry's competitiveness - there are no magical means open to the Government to manipulate it. No doubt we could reduce the current nominal exchange rate by pursuing more inflationary policies. But that would not help competitiveness. The only solution to our competitiveness problem is to adjust our costs to the exchange rate, not the other way round. Our wages and prices must be directed towards those which rule internationally. I shall say more on this in a moment.

The conduct of monetary policy

Given then that the supply of money has the central place in our anti-inflation strategy what has been our experience with the policy over the last two years? The first point to make is that this has been a time of upheaval in the world economy. The 1979 increase in the world price of oil - as serious as that of 1973-74 - has created worldwide recession and increased inflationary pressures. The oil price increase has almost certainly magnified the strength of sterling. All this has made economic management over the last two years more difficult.

Inflation has, however, been coming down. It was on an upward trend when we came to office and reached a peak of nearly 22 per cent a year ago. But since then it has declined steadily. The annual increase in the RPI is down to 12½ per cent and we forecast single figures next year. This deceleration of prices appears very clearly to have come as a

response to tight financial conditions. Yet the recorded rate of growth of £M3 - our target aggregate was well above the target range last year. This has led some - including distinguished members of this University - to criticise the authorities for maintaining an insufficiently tight monetary policy. But other indicators do not support this criticism: the behaviour of the narrower monetary aggregates, the strength of the £, the level of real interest rates and the fall in inflation itself. So most commentators, and indeed the Treasury and Civil Service Select Committee, rather prefer our view that "monetary conditions have been tight."

There were many special factors at work last year, over and above the unwinding of years of distortion when the Supplementary Special Deposit Scheme was ended. In particular, the nature of the recession itself involved severe pressure on company finances. That is why it was particularly important to take account of all the various monetary aggregates and of the level of real interest rates, in reaching decisions about Minimum Lending Rate. We have always recognised the need for wider judgement of this kind as, for example, in the Green Paper on monetary control published a little over a year ago.

The use of other indicators in the determination of short-term interest rates does not affect the fact that over the medium-term there are great advantages in using for target purposes a broad aggregate like £M3, with its clear link with most aspects of macro-economic policy, especially public

expenditure and taxation. The Governor in his 1978 lecture expressed the view that "in the present state of the art we have chosen best in selecting £M3."

Techniques of monetary control

Our approach to monetary control has been guided by three propositions. First, we have learnt that control cannot safely depend upon direct restrictions applied to institutions. For with a financial system as well developed, and as closely integrated with world financial markets, as our own, control so achieved may well be control in name only. This is why we have dispensed with the corset.

Secondly, rather than depend upon controls of that kind we prefer to rely on instruments which have their effect on underlying monetary conditions - fiscal policy, funding and short-term interest rates. I shall say a little about fiscal policy in a moment. As for funding, we have already made two major improvements - the National Savings initiative and the introduction of an indexed gilt. We met our target for National Savings last year and are making a good start towards this year's objective of £3 billion. The indexed gilt can be seen as a major advance, which will significantly increase the range of options available for the conduct of debt sales. It emphasises our confidence that inflation will be reduced and will, when more indexed stock is issued, diminish uncertainty about future real interest rates.

The third proposition has been that we should follow an evolutionary approach. The extensive and interesting public debate which followed the Green Paper on Monetary Control confirmed that there were improvements to be made to the monetary system, and that control of the monetary base had some attractions. But to make such a step would be a major change with widespread implications for many parts of the financial system. Rather than move precipitately our approach has been to proceed step by step, making changes which are desirable in themselves and which will enable us to learn more about the way in which alternative methods of monetary control might operate.

Supporting policies

I have never believed that the setting of monetary targets can be enough by itself. There are other requirements. First of all, fiscal policy must be compatible with our monetary policy. Experience shows that it is virtually impossible to finance an excessive public sector deficit without adding to the money supply. Even were it possible it could jeopardise success against inflation by adding to nominal incomesor precipitating a fall in the exchange rate. Excessive public borrowing could also in some circumstances increase the transitional costs of reducing inflation. The high interest rates which might be necessary to finance an excessive PSBR would bear most heavily on companies, leading to reductions in investment, and

stockbuilding. If this more than offset the direct effect on aggregate demand of the PSBR itself, there would be higher unemployment in the short run as well as a weakening of growth prospects in the longer run. It is a measure of our determination to achieve a PSBR consistent with a lower monetary target that we were prepared to increase taxes to the extent that we did in the last Budget. The case for keeping taxes down in order to maintain incentives was in conflict with the Government's anti-inflation objective. It was the fight against inflation that had to come first.

Monetary discipline must then be supported by fiscal discipline. That is a proposition that would be endorsed by virtually everyone who has experience of operating policy in finance ministries and central banks throughout the world. We indicated that we accept this constraint when we published in the Medium Term Financial Strategy an illustrative path for the public sector borrowing requirement, which we believe is consistent with the achievement of our targets for £M3. The path for the PSBR is not intended as a target in its own right. I repeat this because at times our approach to the PSBR has been characterised as much more rigid than in fact it is.

This leads me to digress briefly on the important and topical question of the treatment of investment by the nationalised industries. It has been suggested that, merely by waving a statistical wand, and decreeing that borrowing to finance investment for those industries should

be excluded from the PSBR, then the existing restraints could be relaxed, if not abandoned. The truth is quite different. We have set targets for the money supply, and we do not intend to achieve them by some financial sleight of hand which distorts financial markets and raises the velocity of circulation. This means, in effect, that there is something rather like a cash limit applicable to the whole economy, not just the public sector. The monetary targets have implications for total nominal income and expenditure. These constraints are essential to the fight against inflation and that, rather than any target path for the PSBR, is the ultimate constraint on policy.

This does not mean that increased investment by nationalised industry can never be appropriate. What it does mean is that new projects must have demonstrably a better claim for a share in total spending than some other spending they will replace. Normally we would expect to find the offset elsewhere in the public sector. If not, it has to come from the private sector, whether in private investment or in consumer spending. There is, alas, nothing to be had without cost.

Pay

But it is not only Government decisions which determine the side-effects of the anti-inflation policy - and the nature and extent of the adjustment costs. There is certainly room within the monetary targets for real growth in the economy. During this financial year we expect inflation to drop to 8 per cent, compared with a monetary target of 6-10 per cent and an upward

trend in velocity of 1-2 per cent a year. But it is the response of individuals which will determine how this growth in money supply and the growth in money income which it permits will be divided between price inflation and a rise in real output. It is crucial that pay, prices and other variables should all adjust together, so as to achieve a satisfactory balance, within this "national cash limit", between lower inflation on the one hand and more output and employment on the other.

Wages and salaries account for about two thirds of the national income; they are the dominant share of business costs. If pay increases are too large, there is an inevitable risk that real activity will be squeezed by financial restraint: the result would be high unemployment and low, or even negative, growth. We have in any case been taking too much out of the economy in pay in recent years and leaving far too little for profits and investment. The real rate of return on capital employed in Britain in 1980 - excluding North Sea companies was less than 3 per cent - a pitiful figure compared to the rate of return in countries like Japan. Moreover, since our pay rises have been much faster than those of our overseas competitors further job losses have come through loss of competitiveness. Wage costs per unit of output almost quadrupled between 1970 and 1980 in the UK. In Japan and Germany they rose by only 70 per cent. Even recently, domestic labour costs have been a larger factor in our reduced competitiveness than the strength of sterling.

There is then no shortage of reasons for sustained moderation in pay bargaining. If increases in unemployment are to be avoided, then a progressive reduction in the rate of monetary growth does need to be accompanied by a more-or-less corresponding reduction in the rate of growth of average money incomes, including pay. It is this insight which, perhaps understandably, prompts people to call for an "incomes policy". That case has been accepted by each of the last three governments. As a member of the Heath Government, I was closely involved in the administration of the policy. And, as with price controls, I came to learn that that kind of policy for incomes was not a sustainable answer to the problem. In a speech in 1976 I set out a list of objections to any kind of rigid incomes policy. I think they still hold good today. The first objection to the setting of wage targets (or "wooden norms", as Lord Robbins described them) is that they seriously distort and could, over time, destroy the functioning of the labour market. Changes in relative wage rates are, as I said then, the lights that wink at each other across a market place in which hundreds of thousands of people change their jobs each month. The second major objection is a political one. If the state itself attempts to simulate the market place and to plan relativities throughout the economy, then important freedoms are diminished. The third objection is very practical. It has not proved possible, despite a series of ingenious attempts, to evolve a practical and durable method of

making and enforcing these non-market judgements. The fourth objection to the establishment of an institutional incomes policy is the greatly increased leverage the trade unions (or their leaders) acquire over many matters that are properly the responsibility of the elected Government. Under a variety of administrations the unions have exacted their own price for formal "acceptance" of an incomes policy. They have secured major changes in policy, in the fields of taxation, prices, industrial relations law and other matters, often with harmful consequences. In the event the risk of conflict between Government and trade unions has if anything been increased.

None of this is to deny that Government does have an important role in improving the processes of price and pay adjustment. It is certainly necessary to improve the functioning of the labour market so that the pay rates that emerge are not such as to price people out of jobs. The monopoly power of large trade unions is a major impediment. The closed shop, the law relating to picketing and other trade union privileges are all factors unbalancing the labour market and contributing to higher unemployment.

Since 1969, successive Governments have sought by legislation and other means to tackle these problems. Last year's Employment Act was the latest move. It will be easier to make the further progress that is necessary if we can secure more widespread understanding of the crucial link between labour market rigidity -

and indeed market rigidities of other kinds - and unemployment. For there are other distortions that have contributed to the rise in unemployment: the differential between rates of pay for skilled and unskilled workers, and between young people and adults. For example, in Germany apprentice wages by and large progress from about 30 per cent of adult rates to about 50 per cent during the apprenticeship. Here the range is usually much higher: in 1979 the figures for engineering were 42½ per cent to 80 per cent and for the building industry 50 per cent to 90 per cent. The relation between benefit levels and rates of pay is another factor: this is why we are making a number of changes in relative benefit levels and in their tax treatment. And why we are seeking to reduce various other obstacles to labour mobility, in the housing market, for example.

Besides reducing labour market rigidities, we also have a responsibility to spread greater understanding of the implications of monetary and fiscal policies, and to influence inflation expectations. As I explained in a speech in 1975, Government's intention to reduce the rate of monetary growth "needs to be spelt out in a coherent stabilisation policy, intended to spread over three or four years". This was the thinking that lay behind our publication of the Medium Term Financial Strategy. I was interested to see a recent study by the Hamburg Institute, which attributed Germany's success in containing inflation after the second oil shock to widespread belief in the determination of the

authorities to stick to their monetary targets.

We have also attempted to spell out the consequences for employment of pay settlements not consistent with the monetary targets. There is now clear evidence of this realisation, particularly in the level of private sector pay settlements. People are learning - as they have in other countries - that the real value of their incomes cannot always be guaranteed. Past rises in the retail prices index are having less influence than the realities of the current situation. The task now is to maintain that process of education and perhaps above all to extend its impact within the public sector.

No-one can be satisfied with the present system of wage determination in the public sector. The problem is an intractable one. My own ideas on this subject have changed more than once over the years. In 1974 many of us thought that we might be able to rely exclusively upon an independent agency to determine relativities in the public sector. By 1975 I was disposed to argue for indexation of public sector wages, to avoid friction at a time of high inflation. Six years on we can all see difficulties with each of those ideas.

But what I have said all along is that the Government must have a policy for the pay of its own employees. In the last resort it is only Government that can and must determine the resources that can be set aside for pay in the public service. We are now ready to embark once again upon the

task of creating a workable and acceptable pay system for the civil service. We do not rule out the possibility of outside comparisons as one factor to be taken into account; but any system must ensure that pay rises take proper account of what the taxpayer can afford. The old comparability system failed to do this. Creating a new scheme will take some time. But the public sector must continue, along with the private sector, to play its full part in the necessary task of gearing down pay and prices and so improving the prospects for unemployment.

The same general need applies to the nationalised industries as well. The most obvious way of improving the level of nationalised industry investment, for example, is to change the balance between current and capital spending in the industries themselves. Part of the answer lies in seeking to strengthen the external disciplines on wages and other costs: by opening some industries to a measure of competition, by returning all or part of others to the private sector, by referring individual industries to the Monopolies and Mergers Commission, and by setting firm limits on external financing. The problem is magnified by the tendency of wages in this sector to move very closely together. Obviously we have not yet got the complete answer.

I have long believed that the chances of securing greater responsibility on the part of wage bargainers will be enhanced by as much openness as possible in the Government's approach to economic management. The

undue influence and disproportionate power of particular interest groups needs to be exposed by wider and more open consultation. It is only by making clear the nature of the national cash limit and the demands applied to it that we can discuss with sufficient effect the influence and role that each of the major participants can play. This is why we have tried within the framework of NEDC to promote wider discussion on these matters. We do this not with a view to striking a deal of any kind, but gradually to promote a wider-ranging discussion where each party is helped to realise the claims that others have upon the economy. There is still a very long way to go. It may be that Government itself has not yet been open enough. Trade unions too must continue to develop their willingness to join others in recognising the need for open and informed discussion of pay and competitiveness.

The NEDC then has opportunities of this kind to develop its role. So too do bodies such as the Treasury and Civil Service Select Committee, whose role is to provide a non-partisan commentary on Government policy. Indeed it could be particularly instructive if the Committee now felt disposed to study the case for constructive reforms of the labour market and the case for pay moderation in the context of the need for improving competitiveness and controlling the costs of the public sector.

Removing other rigidities

But it is not only pay which needs to adjust more quickly if we are to minimise the costs of reducing inflation. The same need applies to

prices. Thus the progress we have made on the supply side of the economy, which will have beneficial long-term effects, will also ease the process of transition. We have removed Government controls - on prices as well as wages, dividends and the movement of currency across the exchanges - and we are taking other steps to strengthen the forces of competition, for example, by widening the scope of the Monopolies and Mergers Commission. The combination of monetary deceleration and monopoly pricing could spell only loss of output and loss of employment. But if prices can adjust more freely to changed market conditions, this difficulty is greatly reduced.

Conclusion

Squeezing inflation out from an economy which has become accustomed to high rates over a period of years cannot be an easy or painless task. We have made a good start, but we still have a long way to go. It is not sufficient to apply anti-inflationary policies for a brief period. That would not permanently conquer inflation and it would condemn us to a continuation of our long economic decline. It will be particularly tempting to relax our vigilance as the economy begins to grow again, to fall back into bad old habits and throw away the hard-won gains. All my experience leads me to the conviction that we must resist this temptation. Proper monetary control must be maintained and the inflationary mentality must be eradicated - in Government, and among individuals. When we have done that we will find that low inflation or even price stability need not be painful. Indeed I am convinced that the defeat of inflation will prove the key to the regeneration of our economy.

THE SECOND MAIS LECTURE

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Objectives of Monetary Policy: Past and Present

Lord Robbins, CH, CB, CBE

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THE MAIS LECTURE is an annual lecture given at The City University, London, by a distinguished practitioner or theoretician in the field of money, banking and finance in honour of Lord Mais, who, as Lord Mayor of London in 1973, launched the appeal for funds to establish the Centre for Banking and International Finance at the University.

Lord Robbins, CH, CB, FBA, CBE, was educated at Southall County School and the University of London. After serving in the First World War he taught at the London School of Economics and the University of Oxford. He was Professor of Economics at the London School of Economics from 1929–61 and from 1941–45 was seconded to the Economic Section of the Offices of the War Cabinet as Director. After retiring he continued to play an active role at the London School of Economics as a member of the Court of Governors and from 1968–74 as its Chairman. From 1961–70 he was Chairman of The Financial Times. He has been a Trustee of the National Gallery and a Director of the Royal Opera House, Covent Garden. From 1961–64 he was Chairman of the Committee on Higher Education.

He has published a large number of articles, essays and books including 'An Essay on the Nature and Significance of Economic Science', 'The Theory of Economic Policy in English Classical Political Economy', and 'Political Economy Past and Present'. He has been awarded honorary degrees from a large number of universities both British and foreign.

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Objectives of Monetary Policy: Past and Present

I

May I begin by saying how honoured I feel at being asked to deliver this lecture. I listened with rapt admiration to its inauguration last year by the Governor of the Bank of England to whose calm head and sober perspective we owe so much of what stability there has been in our distraught and deranged economy in recent years; and I know that I cannot maintain that standard. But it is a stimulus to do what is possible.

Let me first explain my intentions. It would be idle in my present position for me to discuss the technicalities of current financial problems. But it has occurred to me that some survey of the general aims and objectives of the ideas which have dominated monetary policy in this country during the last half century and some glance at present conceptions may not be outside the spirit of Lord Mais's foundation; and this I propose to attempt. My lecture will thus fall into four parts. In the first I shall consider changes of thought regarding internal financial policy since 1925. In the second I shall turn to external financial relations in the same period. Thirdly and fourthly I shall consider present problems in both these aspects. As you will realise from the nature of this programme, the treatment must be highly impressionistic. But I hope I shall avoid superficial detail.

II

I begin with the period 1925–31 when the main internal and external objectives were the same, namely to maintain the parity of the pound sterling. As I think it would now be commonly agreed that the parity chosen in 1925 was an inappropriate overvaluation, this decision involved all sorts of troubles: a disastrous coal strike, continuing unemployment, and trouble with the balance of payments. If one contemplates the vicissitudes during this period of the recommendations for policy of John Maynard Keynes, his advocacy of tariffs and his growing economic nationalism, it is easy to see in these reactions desperate attempts to escape the results of the folly of the decision of 1925. It is also easy to imagine that, if the policy had been adopted at an earlier date after the war of a return to gold at a devalued parity the history, not only of this country but of the entire western world might have been different.

Then came the Great Depression of the thirties; and in spite of the fact that in 1931 the attempt was abandoned to maintain sterling at the 1925 parity, unemployment developed on a scale which, as a percentage of the working population, has not been seen since that day. It was in those times that the idea of government spending to offset the decline of private investment, either by way of long-term loans or an unbalanced budget, began to influence

public opinion on a large scale, backed, as it was, by the sensational break with much traditional opinion regarding the capital market, in the shape of Keynes's *General Theory*. Later on these views were immensely strengthened by the palpable effect on employment of increased government spending on re-armament which, by the spring of 1939, when unemployment was still about 1,300,000 – a much larger percentage of the working force than the same figure would be now – had led Keynes to warn that movements already taking place were beginning to make the assumption of underemployment invalid.

It is against this background of inter-war experience that the celebrated *White Paper on Employment Policy,* issued under the auspices of the wartime Coalition, must be interpreted. This was a very moderate document, denounced as such by Beveridge in his *Full Employment in a Free Society* where he took as his leading principle the maxim that in the labour market demand should always be in excess of supply – a principle which, although I do not think he realised it, was clearly absolutely a recipe for non-stop inflation. But in order to understand the commitment to 'high levels of employment' which the Coalition document certainly gave, it must be realised that the opinion at that time prevalent among most economists of the English speaking world was that, after a brief restocking boom at the end of the war, the main problem would be *deflation* rather than *inflation,* and therefore that the business of government in this respect would be to sustain aggregate demand rather than to restrain it. I am quite sure that among those who were responsible for the drafting of the White Paper there was no intention of commitment to a policy of letting the value of money be determined by the demand for wages and salaries, however unrelated that might be to the value of the product.

As we know, the history of the years after the war was the reverse of the expectation on which the White Paper was based. Indeed for a very long time the percentage of unemployment was far less than even Beveridge, who had promised an average of three per cent if his ideas were accepted, had expected. This indeed had, in my opinion, very adverse results on conceptions of appropriate policy. An unemployment percentage often below two per cent had only to rise a decimal point or two, when politicians of all parties – and even the quality newspapers – would express grave apprehensions and hasten to adjust policy accordingly. At an early stage the decline in the purchasing power of money in this country brought with it all sorts of inimical tendencies as regards production and distribution, not to mention trouble with the balance of payments, all of which might have been avoided if this internal overheating of the economy had not taken place. And it is surely clear that the main *raison d'être* of the disastrous policies of the early seventies – the Heath inflation – sprang from fears aroused by the rise in unemployment more or less inevitably caused by the stabilisation of a devalued pound which had begun under Mr Jenkins's Chancellorship. It cannot be said that the government responsible was not warned of the probable consequences of what they were doing: a group of some of the best of the younger

economists led by the late Harry Johnson – and including Professor Griffiths – wrote a prophetic protest to the Prime Minister of the day predicting the dangers to which he was exposing the economy. But I doubt whether their very moderate and correct analysis received any consideration whatever.

It is sometimes said that the conceptions of policy which were dominant during the period I have been discussing were appropriately to be described as Keynesian. Whether this is correct or not is not, I think, a matter which is fruitful to discuss, for there are almost as many varieties of points of view of those who are designated as Keynesians as there are persons concerned. But I think it is important to distinguish such points of view from those of Keynes himself; for to attribute to him approval of most of the errors of judgement which have led us into the pickle in which we find ourselves is to commit a grave injustice. It is true that his important and influential work, the *General Theory of Employment, Interest and Money,* has been described as essentially the economics of depression; and in my opinion there is something in this description. But to judge Keynes's outlook in the last years of his life by his prescriptions for dealing with acute deflation and not to take account of his *How to Pay for the War* which is a prescription for dealing with incipient inflation, is radically to distort the perspective. It is probably wasted effort to spend much time speculating on what a great man might have said in circumstances which had not arisen when he died. But it is my profound impression that Keynes would not have viewed with complacency the inflationary tendencies of the last quarter of a century and that, had he lived, his protests against them would have been as pronounced as his protests against the deflation tendencies of the inter-war period.

III

I now turn to considerations of external policy.

As is well known, in the days of the Gold Standard the division between internal and external objectives of policy was of relatively minor significance. Apart from a few currency cranks whose views carried little or no weight, the idea of a common basis for money in the western world was more or less taken for granted; and though there were numerous problems concerned with the stability of local banking systems and the size of reserves, the idea of national independence in this respect was not at all prominent. What discussion there was related to the international system as a whole. The bi-metallic controversy of the last half of the nineteenth century, in so far as it was not stoked up by the interests of the silver producers, was essentially of this nature and not so uninteresting as Oscar Wilde thought it was; and the beginnings of discussion among professional economists regarding the regulation of the future value of money was likewise principally concerned with international action. At the end of his life, Alfred Marshall wrote to Keynes that he was convinced that monetary reform, if it came, had to be international in character.

But the First World War with its recourse to unequal issues of paper money

by the respective combatants and therefore with the mechanisms governing national balances of payments unrelated to a common standard, changed all that: and the attempt in 1925 to restore a sterling–dollar relationship was frightfully botched that in some ways it made things worse. Thus concern with national policy was, so to speak, forced upon public opinion by the break-up in 1914 of the international standard and the lamentable failure to restore its effectiveness when the war was over. In the years immediately following the war Keynes saw no alternative but a return to gold. But even before 1925, in his *Tract on Monetary Reform,* he was considering independent national action to set a good example to others.

In the end the collapse of the pound sterling in 1931 and the uncertainties regarding the dollar after 1933, not to mention the troubles of these countries – the so called Gold Block – which attempted to maintain a stable relationship with gold, completed the process. It may be that such developments were inevitable; but certainly, even when the disorganisation created by uncertainties of exchange rates were generally realised and attempts were beginning to be made, via the tripartite agreement between the US, UK and France, to introduce some order into the situation, it was the co-ordination of national policies rather than the acceptance of a common standard which was the order of the day.

It is against this background of inter-war confusion and the change in outlook which accompanied it that the attempt to create a new international monetary system must be considered. Both Keynes and White, the initiators of thought in their respective centres, were intent on eliminating the disorderly relationships between different currency centres which had prevailed. In its origin the Keynes plan was the more ambitious. He actually produced a scheme for an international money which would automatically reduce the deflationary pressures attributed to the gold standard. But this ran against the alleged unwillingness of the US Congress to bear the unlimited liabilities of a creditor position which was then assumed to be likely to last forever. It also contained fewer safeguards against inflation than might have been regarded as desirable. Eventually, as we all know, there emerged the establishment of a fund of different currencies, available to its various members on rules which permitted changes of exchange outside very narrow limits only by common consent.

Now I may have a lingering personal interest in events in which as an official I played a humble role. But I confess that I still think that the agreement which brought the International Monetary Fund into being was a notable achievement – one of the few attempts at international co-operation which have had any meaning; and certainly it has built up a secretariat which, in various ways, has contributed greatly to expert discussion and advice.

Unfortunately, as regards its operations, it had various inbuilt defects which, as time has gone on, have gradually shown themselves.

First, as regards constitution, its makers did indeed avoid the fatal error of the one state one vote system which makes such utter nonsense of the Assembly of the United Nations: votes weighted according to a complicated formula

were adopted. But the size and composition of the executive council were inappropriate for discussion of the degree of secrecy necessarily involved in changing the par values of important currencies. The result has been that all such changes have been decided by other methods. The reference to the council was just ritual rubber stamping.

Secondly the rules permitting changes of rates in conditions of a fundamental disequilibrium which was inadequately defined, tended to give rise to the build-up of speculative positions long after change had become desirable, by reason either of unequal rates of inflation or changes in the terms of trade. In consequence, there developed a reaction favouring completely free floating – of which more later.

Finally the drafting of the agreement and its interpretation by the US Congress resulted in effect that the ultimate basis of the system involved a dollar which in fact was far less susceptible of change than other currencies. The result was that, when the US position came under strain, for a long time nothing could be done about it and then eventually there was a breakdown into a system of floating rates for the main currencies – which was just what the founders of the Fund had intended to avoid.

I still think the IMF has its uses and potentialities, especially when a government which has been pursuing radically destabilising policies wishes to change course but desires to have some other institution on which to put the blame. But it would be idle to argue that there is at present any consensus whatever regarding desirable international monetary policy, such as seemed to prevail at its inception.

IV

So much for a most superficial view of the vicissitudes of opinion in regard to monetary objectives in the past half century. I now come to present conceptions of policy and, as I indicated at the beginning, I propose to treat it under the same two headings, first internal policy, neglecting external effects, and then the complications of external policy.

To begin then with internal policy. I take it that most of us are against inflation, particularly when it is so well anticipated that it no longer seems to have any favourable effects on unemployment. I know that some highly sophisticated people, especially in the United States of all places, have tried to show that it does not matter all that. But I am quite out of sympathy with this attitude. It is true that the economic system has not come to an end in Latin America, despite rates which, if not rivalling the hyper-inflation of Germany and elsewhere after the First World War, have still been very high. But democratic government there has more or less perished and some things even more important than democracy as well; and I doubt very much whether societies more complicated than those of Latin America can stand without catastrophic divisiveness degrees of inflation even considerably less. We only have to look around in our own unhappy country at the deterioration of industrial relations, the 'real' profitability of enterprise, so concealed by his-

toric cost accounting, and the general erosion of standards of public and private honesty, to see what can be done to a hitherto stable society by rates of inflation of the kind we have experienced in the last few years.

So what? There are still some who, looking at the historic record, point out that metallic standards have never deteriorated in this way unless the subject of wilful debasement by governments. They may still be right in urging that, given the pressures on most kinds of governments, we cannot do better than this. But I am sure that, among expert opinion at least, they are a minority whatever may be the desires of a substantial proportion of the rest of humanity. Most expert opinion has, so to speak, eaten of the tree of the knowledge of good and evil as regards gold. It knows that its relative stability is largely a matter of geological and technological accident; and it thinks we ought to be able to do better. A stable money which does not depend on digging metal from one place and depositing it in another is still a common aspiration among men of good will not infected by cynicism.

What then are the causes of inflation under paper moneys? Over the course of history, even modern history, probably the principal causes have been, quite simply, excessive spending on the part of governments. Either because of the pressures of war or because of the subtler pressures of desire for growth or welfare, governments, unrestrained by the obligations of convertibility have indulged in demand inflation. Excessive creation of money and credit – these are simple matters to understand, although the necessary political mechanism for restraining them is not perhaps so simple.

In recent years, however, there have been influences which are more complex. If the terms of trade turn against an economy, say because of a cartel controlling important raw materials, then, in the absence of an increase of the supply of money and credit from some quarter or other, people have less to spend on other things and demand in such quarters falls off. But if, in compensation for this deprivation, new money and credit is created, then, failing some extraordinary increase in productivity, inflation will take place. The same sort of reasoning applies to the prices of services. If rates rise appreciably above the value of the production in respect of which they are paid, then either with constant aggregate expenditure, there is unemployment or, if new money and credit are created, you have inflation. It is, of course, true that, in either of these cases, increased expenditure may be financed by a more intensive use of money and credit. But clearly there is a limit. It is safe to say that continuing inflation arising from increasing costs can only be mainly financed from increases in the supply of money and credit – until all confidence in the future value of the currency concerned has vanished.

This brings me to the question of monetarism. Monetarism has become a dirty word nowadays among those who positively prefer policies which ignore the effects of variations in the supply of money. It is therefore probably incumbent on anyone who insists on the importance of this factor to spell out exactly where he stands. In my judgment the essential truth of the so-called monetarist attitude – the truth to which I should be willing to subscribe – is the contention that continuing marked disparities, either way, between the

rate of change of output and the rate of change in the money supply lead to damaging changes in the value of money.

Such is the extent of my agreement with the so-called monetarist point of view. Now for qualifications positive and negative – remember always that I am still dealing with internal problems ignoring international complications.

First, I repudiate the suggestion that any sane monetarist regards the influence of the supply of money as uniquely and at all times correlated with the volume of production. This accusation is frankly tilting at windmills. It is abundantly clear that, in the short period, there may be, and indeed are, fluctuations in velocity (or the demand for money) which also influence the volume of output. This has been again and again emphasised by the monetarists themselves, especially Friedman. All that is claimed is that sharp falls in the value of money are not likely to go far if the rate of increase of the money supply is held to a constant target.

So much by way of vindication of a position which is often misrepresented. There are however two respects in which I must part company with this outlook. The first relates to causation. Your true blue monetarist denies the significance of cost inflation. A rise in costs is a once for all business, he contends: and, while it may cause unemployment, it is not cumulative in its effect on the value of money. It is always the government which is to blame rather than those who demand disproportionate rates of pay and prices. Perhaps controversy in this respect is a matter of semantics. But I personally am not prepared to concede that oligopolistic demands for prices and rates of pay far exceeding the value of the product are not to be called, in common language, inflationary. I agree that, if there is no response *via* increasing the supply of money, the results are more likely to be unemployment then continuing decline in its value. But I am not prepared to exempt such claims from any part in the causation of inflation. That seems to me to put too severe a limitation on the notion of a cause: and to provide excuses for conduct which does not deserve them.

My second reserve concerns policy. A rigid monetarist denies all place in his strategy for overall stabilisation to variations of fiscal policy. I am not inclined to go as far as this. I agree that, if monetary policy conforms to the monetarist criterion, then recourse to tinkering about with the budget may be eventually unnecessary; and I am sceptical of the so-called 'fine tuning' of years past, here and in the United States. But I am certainly not prepared to pass a self-denying ordinance in this respect and to forswear in all circumstances recourse to any fiscal instruments – for instance the regulator. It is not difficult for me to conceive of practical situations in which a combination of monetary and fiscal policy is sensible.

I now turn to an entirely different conception of policy – the conception which, conceiving most of the inflations of recent years to have been started on the cost side, urges that the most effective way of dealing with this is the policy of an overall control of incomes. This is usually combined with a recommendation of overall control of prices. But since this is so obviously a political cosmetic and since, the control of public service prices apart, it so

clearly complicates unnecessarily the administrative problem, difficult enough in all conscience, I leave it undiscussed.

Now let me make it clear that, so far as the sections in which the government is directly involved there must be an incomes policy. The government is the ultimate employer; and any employer who goes into the labour market without clear conceptions of what he is prepared to pay for the various services which he purchases is clearly asking for trouble. Doubtless such plans are much more difficult to elaborate in the public than in the private sector: the myth of the bottomless purse dies hard; there is often no guidance from the market, and political considerations thrust themselves into the picture. I will not go into the question of what such considerations imply for the desirable width of government administration. All that I wish to emphasise here is that nothing that I am going to say exempts government from having a policy for wages and salaries in the sector for which they are directly responsible.

But the conception that I am discussing, the conception of a general policy for contractual incomes throughout the whole economy, nationalised industry and private enterprise, goes much further than this: and here it is necessary to make quite explicit the main points of the relevant considerations.

I will leave undiscussed the administrative difficulties involved, though those members of the audience who have been concerned either in Whitehall or in the different branches of business, will, I imagine, agree that the additional burden of interpreting and arguing about individual problems is very formidable. Indeed, in our own recent history it must have subtracted a substantial amount of time which otherwise might have been devoted to improving our not exactly brilliant record of productivity.

The central idea, as I understand it, of a general wages and salaries policy, is that if such money costs can be kept roughly in line with the value of the Gross National Product, then inflation will not take place; and policy as regards money supply and general expenditure can be devoted to maintain a reasonable level of employment. The problem was discussed at some length by Beveridge, in the book to which I have already referred, whose recommendation of a demand for labour always in excess of supply certainly raised it in a very acute form. But he preferred to rely on a rather nebulous appeal to understanding and good behaviour, leaving it to others to urge the more logical and drastic solution.

Unfortunately things do not work out that way – in theory or in practice. Even in speculation in the study it is difficult to conceive of a centrally managed incomes policy which could take into practical account the multitudinous changes in the demand for and the supply of the various kinds of labour, which is the theoretical desideratum of this conception of policy. Much more probable in practice is the setting of wooden norms, either completely general or, at best, covering widely different fields of activity, which can never be remotely near an approximation to the theoretical ideal. Moreover, hitherto in history, the imposition of wages and incomes policy has been preceded by rates of general public expenditure having markedly inflationary tendencies which set up disturbances which multiply the difficulties of achieving the ideal norm.

On top of this, in real political situations, the measures of this sort adopted have a tendency to upset, or to threaten to upset, relativities between higher and lower paid groups of producers: and this increases the difficulties of controlling the situation. In many communities people tend to attach almost as much importance to relativities as to absolute levels and often fight as hard for them. Policies which ignore such factors tend to lead to situations in which there are scarcities of some types of services coexisting with excesses of others. It is really no accident that, hitherto, attempts to control inflation arising on the cost side by measures of this sort, have sooner or later broken down, leaving behind them wreckage, both industrial and social, which takes some time to clear up.

This is not to say, however, that there is no conceivable use for wages and salaries policies in certain very limited circumstances. Consider a position in which, inflation having become something of a social menace generally recognised as such, steps are being taken, either by action on the money supply or by appropriate fiscal measures, to bring it under control. In such a position there can be little doubt that, if wage and salary demands out of harmony with the proposed reduction in the rate of inflation are achieved and the government stands firm in its anti-inflationary policy, then unemployment will tend to increase. On the contrary, if there is restraint in such quarters, either voluntary or statutory, this need not happen. This then is the genuine use of such policies, voluntary or compulsory, not to curb inflation – that is better done in other ways – but rather to prevent an increase of unemployment. Admittedly they cannot be expected to work for ever; all such policies known to me, at least in democracies, have sooner or later come to grief. Admittedly in practice they are liable to involve all the difficulties already discussed. But it is undeniable that they can have that use for short periods.

But how precarious it all is once inflation has infected the system. If, without political bias, I may allude to the episodes of last winter, I would say that the former Prime Minister, Mr Callaghan, was quite right in his suggested guideline of an average increase of earnings of five per cent. Given a rate of growth of GNP of two per cent that would have left us perhaps another year to achieve the eventual goal of the elimination of inflation. But, alas, how vain it was to expect it to happen. Two years of income restraint, imperfect as that was, was too much for the powerful producers' associations with the special legal privileges which successive governments have conferred upon them: and in fact they achieved an increase in earnings considerably more than twice that figure.

On the whole then, I am clear that the method of controlling inflation by general control of wages and salaries is one which has only limited justification in very exceptional circumstances; and even then it gives rise to false expectations. Speaking generally I am convinced that the control of aggregate expenditure in one way or another is still the main hope of restraining the alarming decline in the value of money which has been the outstanding internal menace to free societies in the years since the Second World War.

V

I now come, finally, to the problem of relations between national currencies. Here I have to be more tentative than ever, since the situation and its associated problems are changing from year to year.

Let me begin, however, with what I believe to be an incontestable proposition, namely that so long as different rates of inflation in relation to the value of output, prevail in different areas, so long fixed rates of exchange between the different currencies concerned will not be permanently viable. Small areas may link up with large areas and may avoid exchange depreciation for a time by borrowing. But, in the end, if they wish to maintain a fixed rate relationship, they have to harmonise their monetary policy with that of the parent area. As for large areas, changes may for a time be averted by concerted action by benevolent central bankers. But if unequal rates of inflation persist, eventually the rates of exchange will be affected. I do not need to quote contemporary examples.

Now advocacy of generally floating rates as an ideal rather than a remedy for a situation that has got thoroughly out of hand, has been very popular in the last quarter of a century. But I personally do not think that, even on the purely speculative plane, on which some of its advocates elect to move, this claim is generally tenable. This for two reasons: one analytical; one ideological.

The analytical reason is pretty obvious, though it is odd that it should have received so little attention. The fundamental argument for floating rates, whether correct or not, is that they provide an easier way of adjusting to changes in international demand and supply than adjustments of money incomes. How much easier to let the rate of exchange go down than to risk the impairment of industrial relations. But in the end this rests upon the assumption that the recipients of money incomes are relatively indifferent to what happens to exchange rates, which may be true – or may have been true – in very large currency areas, but is palpably not the case in small ones. This is indeed one of the chief justifications for small areas linking their currencies to the currencies of larger ones. But I doubt whether, save in the very large areas, the assumption holds that the markets for services nowadays are usually focused exclusively on money rewards and not on the real goods and services which they purchase – and these real rewards in part depend upon costs and prices in international markets. I am therefore reasonably clear that we have outlived the epoch in which governments could get away with the adverse results of internal policies, by simply relying on changes in rates of exchange.

My second reason is severely practical though it involves an element of ideology. In the long run a system of floating rates can only be maintained if it involves exchange control somewhere or other. Otherwise the anticipation of change leads to movements of funds which may be highly disequilibrating and may eventually lead to the disuse of those currencies which are expected to deteriorate fastest. Who of us would not have liked to have had our investments and pension arrangements in Swiss francs or German marks in the last twenty years or so if we had not been subject to severe penalties for doing so?

Thus, in the end, the so-called 'liberal solution' of the problem of international currency relations proves to depend on the totally illiberal system of exchange control. The freedom that it is supposed to guarantee is only the freedom for the internal government to debauch the currency – or allow it to be debauched – at the expense of the unfreedom of the citizens to preserve the value of their savings.

It is my impression that in the last few years fashionable opinion has begun to perceive that the argument for a general international system of floating rates involves considerably greater inconvenience than was earlier supposed. It will be remembered that a great cry of relief went up as what remained of an international system in the form of the Smithsonian agreements collapsed – as might have been expected. Freedom from Bretton Woods, freedom from any external obligations, what splendid prospects that opened – or seemed to open. Nowadays I suspect that responsible opinion is coming to the view that, whatever might be the case in a world in which each currency area was committed to maintaining stability in the internal value of money, and exchange markets looked after changes in the terms of trade, we are a long, long way from that. The international monetary position is highly unsatisfactory and indeed pregnant with all sorts of considerable trouble.

But where then are we to turn?

I am afraid I do not see much prospect for the re-creation or perhaps better said the creation of an international system devoted to maintaining the purchasing power of money at fixed exchange rates. I still value what remains of the IMF with its dedicated expert staff and their influence. But I do not see the special drawing rights as at present constituted as a suitable basis for such a system. I remember with some sympathy the remark of a high international expert who said that he would believe in SDRs *in that role* when his wife asked him for a necklace composed of such paper. As for possible reinforcements, I have sometimes thought of Irving Fisher's compensated gold unit as a backing, provided that it was somewhat modified in both how it was managed and in its basis. But although the popularity of gold as an investment shows that there is a considerable body of opinion which might be attracted by such a solution, such is the irony of history – it would have to confront the implacable opposition of the massed body of much American expert opinion to anything related to gold! As for an international standard directly related to stocks of commodities, although in some ways not unattractive, I should be doubtful of its successful management; especially given the present frame of mind of the less prosperous 'developing countries' who doubtless would clamour in vast numbers for representation on its management.

In my judgment, a completely international system cannot be created yet awhile, even if that were thought to be more desirable than other imperfect arrangements. But we can possibly hope to eliminate some of the elements of instability in the present international situation by some consolidation of financial arrangements among the countries of Western Europe. I agree with the view that a strong Western European currency, although not ideal, would solve many local problems in this important area; and I think that its relation-

ship with the dollar and other currencies need not give rise to the difficulties which have recently beset the international financial situation.

But having said this about Western Europe, I would wish to add immediately that I am convinced that we need to go much beyond the present arrangements and proposals which are fashionable and thought to be advisable in this respect. I am sure that, with different rates of growth in money supply in the different Western European centres, a system of fixed exchange rates must inevitably break down: and although *ad hoc* adjustments may from time to time be possible, the fact that they may have to take place, necessarily impedes the objective of the whole system.

How can this be avoided? It is of course conceivable that, in the absence of exchange control, the most stable of the various currencies might attract so much use that it became eventually the main money of the entire area. Alternatively, it might be that the central Commission of the Community might embark on the issue of a new money parallel with existing currencies, but guaranteed to be so managed as to maintain a constant value in terms of a representative collection of commodities. This too, if allowed to be freely used for all transactions within the community, might speedily become the predominant Western European medium of exchange: and, although it has not been canvassed widely in this country, it certainly commands the support of some of the best of the younger economists on the continent.

Whatever form such a change might take, the fundamental desideratum is this: that eventually there should be one Western European money so that transactions *between* what are now areas of independent money supply should involve no more complications than at present take place with transactions *within* these areas. Confronted as we now are with states, with different historic origins and different fiscal systems, which insist that whatever happens they must retain sovereignty in every conceivable respect, this is doubtless a tall order and perhaps unlikely to happen. But, in the last analysis, I doubt very much whether eventually the different societies of Western Europe will survive unless they are prepared to readjust to some sort of federal unity – and of such unity a common money must be an important, although by no means the only, essential feature.

VI

In concluding I would like to emphasise what has been the main thought animating my remarks in the second half of this lecture which is simply that, somehow or other, inflation must be stopped, at any rate in the main Western states of the world. I do not think that all problems would be solved by stable monetary conditions in such areas: we should still be confronted with the many real problems of production and distribution. But the instability of units of account creates a multiplicity of complications which ought to be unnecessary; and internal stability and orderly relations between states would be immensely facilitated if they were absent.

Let me end by quoting some words from the last sentences of a public lecture which I delivered some years ago. 'Stop the inflation,' I said, 'that is the paramount need of the moment in the economic sphere: if we meet it . . . we have still a future of high promise. If we do not then I fear that our days are numbered, certainly as a great power, perhaps even as a stable society.' These words were uttered in 1951. They are still applicable. Indeed they are much more urgent: and the problems involved are much more complex.

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THE FIRST MAIS LECTURE

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Reflections on the Conduct of Monetary Policy

The Rt. Hon. Gordon Richardson, PC, MBE
GOVERNOR OF THE BANK OF ENGLAND

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THE CITY UNIVERSITY
Centre for Banking
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THE MAIS LECTURE is an annual lecture given at The City University, London by a distinguished practitioner or theoretician in the field of money, banking and finance in honour of Lord Mais, who, as Lord Mayor of London in 1973 launched the appeal for funds to establish the Centre for Banking and International Finance at the University.

The University was honoured that the Governor of the Bank of England accepted to deliver the inaugural lecture. The Rt. Hon. Gordon Richardson, MBE, who was educated at Nottingham High School and Cambridge University, practised at the bar until 1955. He was appointed Chairman of J. Henry Schroder Wagg & Co., in 1962, has served with distinction on various government committees and has been Governor of the Bank of England since 1973.

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Reflections on the Conduct of Monetary Policy

I must begin by saying what a privilege and pleasure it is for me to have been invited to inaugurate this new series of lectures in the field of banking and finance which are to take place annually at The City University. It is a fitting tribute to the energy and broad interests of Lord Mais, who in 1973 as Chancellor of this University and Lord Mayor launched the appeal for funds to set up this University's Centre for Banking and International Finance, that these lectures should bear his name.

This academic occasion provides me with a welcome opportunity to speak at greater length than is usually possible – or indeed acceptable – at a public function, and I propose to use it by sharing with you some reflections on the conduct of monetary policy, as they have formed in my mind over the past five eventful years. By so doing I shall hope to contribute to the public debate on monetary policy – a debate which I whole-heartedly welcome.

The City University is an especially appropriate place for me to do so. A personal reason is that it gives me the occasion, before the departure of Dr Parkes for the University Grants Committee where his expertise in the elasticity or dynamic plasticity of academic structures will be fully tested, to discharge some part of my debt of gratitude for the Honorary Doctorate of Science conferred on me some two years ago by this University during his Vice-Chancellorship – although the moral of my lecture, that the conduct of monetary policy is an art rather than a science, might be taken to suggest that he gave me the wrong degree.

Another reason is that this University, through its relationship with the City and its institutions, established with them in the ten years of its existence, has been able to combine intellectual rigour and practical relevance in its academic approach to banking and international finance: this is one of the objectives of the Centre and finds its personification in its Director, Professor Brian Griffiths.

We are now at an historical juncture when the conventional methods of economic policy are being tested. The principles on which we have conducted economic policy since the war are having to be reassessed, because, with changing conditions, we are no longer so certain of being able to achieve what once seemed possible. At the same time, the greater emphasis on monetary policy has occasioned new initiatives in ways of conducting it. The present is therefore a suitable time to try to take stock.

What I have to say today falls conveniently under three main headings. First, I shall review the change in our ideas about monetary policy since the Radcliffe Committee reported, and will discuss the shift of emphasis towards concern with

the monetary aggregates. Second, I shall attempt to consider more systematically the place of monetary policy in the management of the economy. And third I shall review some of the problems of implementing monetary policy – of management of the growth of the aggregates; of the choice of aggregate for the control variable; and the case for what are sometimes known as 'rolling targets'.

The recent development of monetary thought

It may be helpful to start with an historical perspective. We tend to forget how much our ideas change in only a few years. It makes our present ideas clearer if we see them standing in contrast to what we thought earlier; and it is salutary to have to work out why we think that we now know better than we did five or ten or twenty years ago. A convenient landmark is the Radcliffe Report published in 1959.

The change in ideas since the Radcliffe Report

The doctrine of the Radcliffe Report was always complex and is perhaps difficult to summarise fairly in today's changed climate of ideas. The Radcliffe Committee saw the monetary system more as a set of institutions supporting numerous flows of funds, than as a set of institutions providing a stock of means of payment. Monetary policy was seen as acting on total demand mainly by affecting the ease of access to finance, or what was more vaguely called the 'liquidity of the economy'. Changes in monetary policy took their effect through changes in interest rates: the latter (it was argued) altered the liquidity position of financial institutions, and this in turn affected the availability of funds to borrowers. The difference from present-day thought is illustrated by a quotation from the Report: 'The authorities thus have to regard the structure of interest rates rather than the supply of money as the centre-piece of the monetary mechanism. This does not mean that the supply of money is unimportant, but that its control is incidental to interest rate policy'.

The Committee were mainly looking, as we do not today, for quick tangible effects from monetary measures on the level of demand. The Report left a clear impression that its authors believed that monetary policy had little such effect, and that what effect it did have was not all to the good. They found it difficult to believe that 'any of the changes in interest rates' had much influence – though some effect on demand probably resulted from the 'diffused difficulty of borrowing'. But 'the really quick substantial effects', they concluded, 'were secured by the hire purchase controls' – though these had disruptive effects on particular industries. That, as they said, was 'far removed from the smooth and widespread adjustment sometimes claimed as the virtue of monetary action: this is no gentle hand on the steering wheel that keeps a well-driven car in its right place on the road'.

The Bank did not entirely share this scepticism, as its evidence to the Committee demonstrated. The Radcliffe Report failed to establish a consensus. It did, however, provide a focus for monetary debate, and one strand of the Bank's

thinking – and indeed practice – which found an echo in the Report was the importance attached to operations in the gilt-edged market having a wider objective than merely financing the Government – though the objective suggested was couched in terms of the long-term rate of interest rather than, as today, in terms of the monetary aggregates.

Since those days ideas about monetary policy have undergone further evolution. On the theoretical plane, arguments advanced by Keynes and later by Friedman suggesting that there might well be a stable relationship between the demand for money and the level of income and interest rates found apparent statistical verification in the late 1960s. The identification of this function appeared to provide a sound intellectual basis for monetary policy; but it left a practical choice whether the money supply or the level of interest rates should be taken as the proximate objective of policy.

What swung the argument in favour of choosing a quantity rather than a price as the best indicator of the thrust of monetary policy was the acceleration of inflation. Since 1970 not only have prices risen much faster than in the 1950s and 1960s but the rate of inflation has varied considerably from year to year. With increased inflationary expectations, interest rates also have risen greatly. We can, if we like, think of the nominal interest rate as having an 'expected inflation' component and a 'real' interest element. But we can never observe expectations, which are in any case likely both to differ from person to person, and to be volatile. The real rate of interest is an abstract construct. This has made it very difficult to frame the objectives of policy in terms of nominal interest rates.

For these reasons we were led to pay increasing attention to the monetary aggregates as a better guide – though not of course a perfect guide – to the thrust of monetary policy. In this we were not alone; a move in this direction occurred quite widely in the Western world towards the end of the 1960s. This emphasis was reflected in the new approach to monetary policy put into effect in September 1971, on which I must now say a few words.

Competition and Credit Control

The aims of Competition and Credit Control were twofold. First, it was a move away from reliance on direct restrictive controls in the monetary sphere. They had remained in being far longer than appropriate for the health of the banking system, and such restraining effects as they had were being increasingly eroded. More positively, it was a move towards a system in which market forces could play a predominant role. As I have already indicated, importance was now attached to the monetary aggregates; their rate of growth was to be controlled by the market instrument of interest rates.

A change on these lines was clearly desirable and indeed overdue. Nonetheless the results over the ensuing two years have provoked serious criticism. There was rapid expansion of the monetary aggregates, and the economy did in fact expand rapidly – though in some large part no doubt because the stance of fiscal policy was strongly expansionary. And prices later started to rise rapidly – though here again other factors, including a world-wide commodity boom, have

also to be taken into account. I shall not attempt to disentangle the complex strands of causation, but some points may be remarked.

The removal of earlier restrictions over the growth of bank lending allowed the banks to recapture a share of the business which controls had caused to be undertaken through non-banking channels. Such reintermediation was indeed natural, as the banks benefited from their comparative efficiency in the provision of services. In addition we had hoped that this process would go further: that some of the business undertaken by the fringe institutions which had grown up during the 1960s would be taken over by the longer-established banks. In the event, however, this transfer was to some considerable degree frustrated by the more general expansion in lending which took place.

In the two years to September 1973, M3 grew at an average annual rate of about 26%, compared with about a 10% rise in M1. Part of the increase in broad money was possibly associated with a general preference for increased liquidity at a time of uncertainty surrounding the future course of inflation and interest rates; part undoubtedly reflected the sort of reintermediation I have touched on above; and part reflected the arbitrage which developed when companies found it profitable to borrow on their lines from the banks and on-lend in the wholesale money markets. To the extent that these factors represented shifts in the demand for money function rather than an excess creation of money, their effects on the real economy were likely to have been much less significant.

The process of reintermediation was accompanied by a number of other developments. In the financial sphere the banks – here and in many industrialised countries – were shifting towards 'liability management'. In expanding their loan books they began to pay less attention than before to the resources already available to them, since they could if necessary make up any deficiency by recourse to the wholesale money markets. This was facilitated by the encouragement of competition in the banking system in 1971. With banks increasingly prepared to compete for wholesale deposits in this way, the development of the broader monetary aggregates came increasingly to depend on interest rate relativities – between wholesale money rates, Treasury bill and local authority rates on the one hand and bank lending rates on the other – rather than on the average level of rates. In 1972 and 1973 for example the major banks competed extremely vigorously to expand the size of their books and their individual share of the market; this helped to bring about a pattern of interest rates conducive to very rapid expansion. The Supplementary Special Deposits scheme was precisely tailored to arrest this development: after its introduction at the end of 1973 the differential between rates of interest offered on wholesale deposits and charged on loans widened and the rate of growth of wholesale deposits fell back. However it is hard to know how much this was due directly to the impact of the scheme and how much due to other factors.

The Government over this period was deliberately promoting a faster rate of economic growth. To revive slack domestic activity against a background of mounting concern for unemployment, an expansionary budget in the spring of 1971 was followed by further tax reductions and increases in expenditure in July,

and another reflationary budget in the following Spring. The public sector borrowing requirement began to move upwards.

The monetary expansion which occurred largely resulted from the conjunction of these separate factors – reintermediation, the banks' aggressive search for new business and with it their move to liability management, and fiscal expansion. Monetary expansion must have contributed to the rapid rise in asset prices that occurred, notably in real property. It is more difficult to decide how far it caused the boom in the real economy, and the acceleration in the rate of inflation that began to set in. Some would regard the monetary development as the sole, or at least the dominant, cause; others would see it as a minor contributing factor accompanying, and in part reflecting, other more powerful forces. Despite such uncertainties about the nature and the effects of the monetary expansion, it cannot be judged other than excessive.

It had proved difficult to raise interest rates sufficiently to match the worsening inflationary environment and braking the monetary expansion by this means was in any case proving unacceptably slow to show its results. In these circumstances, after raising Minimum Lending Rate from 7½% to 13% during the second half of 1973, the Bank introduced the new mechanism of Supplementary Special Deposits.

Since then emphasis has continued to be placed on controlling the growth of the monetary aggregates as a specific proximate target for policy. Only since 1976 has this taken the form of publicly declared quantitative targets. Before that it constituted an internal aim: I think it is not therefore entirely accidental that during each of the three years 1974–1976 the growth of £M3 was about 10%, well below the rate of expansion of national income in current prices. This was achieved during a period in which inflation, though latterly declining, was at an explosive rate and in which the financing requirement of the public sector increased notably.

The place of monetary policy in the scheme of things

I now turn to discussing the place of monetary policy in the context of economic policy generally, and what we hope to accomplish by monetary policy.

I am conscious that this aim is ambitious. This is a subject much written about and much disputed by economists and non-economists alike. Moreover a statement of view by an institution is something very different from that of an individual expert. An institution like the Bank differs in being first a collectivity, a team; in having primarily operational responsibilities; and, as such, in operating in a political environment. We hope to be sensitive to new currents of thought; yet at the same time we much exercise our judgment and not be too ready to accept every change of intellectual fashion. Formulating a line of practical policy and trying to stick to it, while yet remaining appropriately flexible amid the uncertainties of day to day affairs, feels very different from devising ideal solutions in the seclusion of a study.

It is, however, reasonable to expect us to seek to abstract ourselves from day-to-day pressures, and to try to systematise the philosophy that underlies our

actions, though of course I have no illusions that I am stating the last word. Indeed, I hope that our critics will say why they disagree, and that thus we together participate in a dialectic which will contribute to the evolution of a new climate of public opinion.

Monetary targets and their part in general economic policy

I will start by trying to say something about the nature of monetary targets; and go on to touch on some current issues about the proper way to conduct economic policy.

The achievement of a monetary target is not an end of policy in itself. The real objectives of policy include economic growth – in the short-term, and also in the long-term: and stemming from this the provision of sufficient investment for the future, and of adequate employment opportunities. They include also price stability, both as a major end in itself, and as a means to much else; and as a means if not an end, they include maintaining an appropriate relation to the rest of the world and a prudent balance of payments stance. It could be argued that monetary policy is but one instrument of policy, along with fiscal policy, exchange rate policy and, to the degree that it is possible, incomes policy; and that all such policies should be jointly set so as to achieve the desired feasible combination of final objectives, and should be adjusted from time to time as circumstances change.

In such a context, is there a place for having a target for the single instrument of monetary policy? Might this not introduce an element of undesirable rigidity – particularly inappropriate, it might be thought, for monetary policy, whose advantage has often been claimed to be that it was flexible?

To this, however, it can be replied that we should beware of over-reacting to changing circumstances, and of being over-active in economic management. Policy changes are unsettling and disturbing in themselves. It is right that people should know what the broad lines of policy are, and that such policy should be kept on its stated course until circumstances clearly call for a reappraisal. There has in any case been a reaction against frequent policy adjustments, or attempts at what has popularly been dubbed 'fine tuning' – a reaction which is part of a wider disillusion with the possibilities of economic policy and the post-war enterprise of trying to manage the economy.

This spirit of disillusion with demand management is justified up to a point, but is capable of being carried too far. To eschew demand management entirely would involve tenacious faith in the self-correcting properties of the private sector of the economy, for which the evidence is not strikingly clear. Moreover the economic functions of government have become so extensive that it is difficult to define what a neutral policy is.

What, however, does seem clear to me is that the conventional methods of demand management can only work well against a background of financial stability. In recent years the economic system has received so many shocks that the stability of the post-war world has been fractured.

Our first order of business must, therefore, be to restore confidence in the

framework of the system. The crucial economic decisions, for example to undertake investment, involve an act of faith in the future. That faith has been undermined by uncertainty – uncertainty in particular about the future value of money, externally and internally. In times past other features of the economic system, such as fixed exchange rates or Gladstonian budgetary principles, were thought to provide some guarantee of stability. These restraints have now gone. The main role therefore that I see for monetary targets is to provide the framework of stability within which other policy objectives can be more easily achieved.

It is essential for this purpose that monetary targets should be publicly announced, and that the authorities' resolve be sufficient to make that announcement credible. Our acts have, I believe, given observers cause to regard our resolve as strong. This in itself has dampened fears of worsening inflation, and provided an appropriate backdrop against which we can continue the struggle to bring inflation steadily down. I would not claim that monetary policy can or should be left to fight inflation singlehandedly – I shall turn to this subject again later. But monetary targets have an important place in the relevant armoury.

Monetary targets represent a self-imposed constraint or discipline, on the authorities. This can at times seem irksome, the more so perhaps because the permissible thresholds cannot be precisely and scientifically set, involving a considerable element of judgment. Yet the layman's apparently intuitive perception of the broad relationship between monetary growth and inflation – clearer perhaps to him than to the professional who knows all the necessary qualifications – may well make it easier to explain and justify measures necessary to achieve the goal of stability but with immediately unpopular effects. We need a basis of public support and understanding of the limits to prudent action. Furthermore, quantitative monetary targets can provide a useful trigger for more expeditious policy decisions.

The main purpose of having publicly announced monetary targets is, therefore, to provide a basis for stability. Stability does not, however, imply rigidity. There can be occasions when policy needs to be adjusted because circumstances have changed. There is a case for adjusting monetary policy, as well as fiscal policy, to offset cyclical swings in the economy. In recent years, however, severe cyclical disturbances have been overlaid and accompanied by an even more menacing inflationary trend. We will not, in my judgment, be able to deal satisfactorily with the present recession until we can conquer our inflation problem, whose implications for monetary policy I now turn to discuss.

Monetary policy and inflation

There is, I think, a two-way connection between inflation and economic expansion. The common wisdom used to be that there was a trade-off: high levels of activity led to high rates of inflation, and lower levels of activity similarly to lower rates of inflation. Nowadays, with the elusiveness of what economists call the Phillips curve, this route to controlling inflation has seemed to become less sure. And yet some important part of that connection must surely remain. The

Governments of almost all industrial countries have acquiesced in low rates of economic expansion in the last three years. Their motives have been manifold but a main one has been a fear of inflation; and inflation rates have fallen. And in this country, I think it is generally accepted that the practicable rate of economic expansion will depend in large part on how successful we are in moderating the pace of inflation. The connection is in part a matter of market forces – strong demand pressure would generate larger wage increases; in part semi-political – unrestrained expansion would erode the braking power of the present policy of pay restraint.

The reverse connection is that – quite apart from this connection via economic policies – inflation impedes economic expansion by inducing caution among consumers, and by making business, and in particular investment, so much less predictable. If we could reduce inflation, this would itself generate a faster expansion in the private economy. The expansion we sacrifice in order to deal with inflation is less than might appear.

One should recognise that the blame for inflation rests not on any simple cause, but rather on a multitude of political and economic pressures. Is it not clear enough that our system has a strong inflationary bias? In recent years annual wage increases have become the accepted norm, though there is no logic in this. The size of wage increases moreover depends on an unco-ordinated and to some degree competitive process in which, to say the least, the collective effect on price stability does not naturally act as a dominant consideration. Governmentally-inspired efforts at pay restraint take their rationale from these circumstances. In our post-war history there has been a succession of attempts at such policies, some more successful than others; and I would guess that we are destined to continue the effort. Such policies have their obvious shortcomings and considerable attendant disadvantages. Nevertheless from the point of view of monetary policy we should welcome whatever success they can achieve, while giving them in turn all the support from monetary policy that we can devise.

I would not want to suggest that there is always a direct, simple chain of causation running from the money supply to the price-level. Indeed, it is generally recognised that inflation can, at least for a time, follow a life of its own quite independent of current or past monetary developments. The peak of recent inflation in the United Kingdom three years ago owed much both to the rise of world commodity prices in 1973 and to the repercussions this had – through the unfortunate accident of the threshold agreements then in force – on domestic wages. Equally, exchange rate movements had important effects – though I know this raises more complicated issues on which I shall comment later.

But though the causation may not be simple, there is an observable statistical relation between monetary growth and the pace of inflation. I am not here thinking of the short-term relationships which underlie the demand for money equations to which I have already referred. There has been a fair measure of success in establishing such relationships, even though the success is far from complete. I think however that what is far more important is the relationship between monetary growth and inflation over the longer term. A great deal of work has been devoted to the study of this relationship over long time periods

and in many countries; and that there is such a relationship cannot, I think, be doubted. To many this provides adequate intellectual justification for establishing medium-term aims for the rate of growth of the money supply.

Some I know may still feel doubts as to how the statistical relationship between money and prices should be interpreted. Governments and Central Banks are often in effect under pressure to validate price increases stemming from non-monetary sources because the alternatives have seemed to be pressures on interest rates or on employment. It might then be questioned whether under such circumstances the causality could not run as much from prices to money as from money to prices.

To those who doubt on some such grounds how far monetary policy can be of help in dealing with inflation, I would venture to address a more general defence of our present line of policy. The latest issue of the National Institute Economic Review suggests for instance that the Institute is of this school. The Institute base their contention on the grounds that labour market pressures in general and unemployment in particular do not serve greatly to moderate the wage spiral, unless extremely severe. With wages in their view thus determined by non-market pressures, they argue that financial targets will either fail to bite, and thus be ineffective; or alternatively that they will have their major impact on real output. But in the same issue I note that the Institute declare that the early re-establishment of reasonably full employment would be foolhardy until a solution is found to the problem of inflation – which, from the viewpoint of the Institute, depends on the adoption of incomes policies on a permanent basis. Until then, it is implied, the pace of expansion will have to be kept down to a strictly modest pace.

I concur with this last judgment – as I have already indicated, I take the view that we cannot allow the economy to expand very vigorously until inflation has been brought down to a lower level and we have some assurance that this achievement will not be threatened by faster expansion.

A monetary target both provides an overt public expression of this need for caution, and embodies some assurance that action will be triggered if the need for it arises. In the short-term if things go wrong adherence to an unchanged monetary target will be the equivalent of early restraining discretionary action. In the longer-term, the commitment to monetary targets will also ensure a general degree of caution. One may therefore say that in a figurative sense to announce such a commitment is to serve notice on all those concerned, including those concerned with wage bargaining, how far the authorities are prepared to finance inflation. It will be said that those involved in wage bargaining pay no heed to the size of the monetary targets. This may be so – though I would think it better if it were not. Yet, over time, perseverance with a policy of the sort I have outlined will, I believe, have an increasingly pervasive effect. As it becomes clear to all that faster growth can only be had with less inflation, will there not be more pressure to see how this can be done?

I think one thing will be evident from what I have said. Monetary policy is often classed as an instrument of demand management: in practice, until we have made more progress with inflation, its services are likely to be pre-empted

by the need to use it as an instrument against inflation. Nevertheless, it is clear also that we need a reasonable rate of expansion; and the prospect I see is not no expansion, but of a reasonably controlled expansion.

I should now refer to the relation between monetary policy and the exchange rate. Many monetarists would I know see the chief influence of monetary policy on prices as coming via this route, and would regard a floating exchange rate as an essential concomitant of a sound monetary policy.

It will be plain that the Bank have not adopted the whole of this intellectual position. The advantages of an appreciating rate for domestic prices are evident enough. But as a recent issue of the Bank's Quarterly Bulletin made plain, we are also concerned with the effect on export prices and on the profitability of exports. Nor did we wholly accept the argument that capital inflows arising at a time when we were intervening on the exchanges to keep the rate lower than it would be on a free float must necessarily undermine the effectiveness of our monetary control. Indeed for ten months of last year – when massive inflows occurred – this was not the case. A time came however when we felt unable any longer to maintain full control over the growth of the money stock without setting the exchange rate free to float – concern about exports notwithstanding. The decision made in those circumstances emphasises our commitment, in conditions of conflict, to controlling the monetary aggregates.

The implementation of monetary policy

I should now like to turn from the broad general principles of policy to the more technical problems of implementing monetary policy in practice.

Management of the monetary aggregates

The difficulties of achieving the desired path for the monetary aggregates can be described in various ways. Let us start by considering what influences the demand for money. Given the level of national income, and neglecting temporary influences, we work on the theory that interest rates are the main determinants of the demand for money. That is the logic of our method of operating, as I have sought to describe it earlier in this lecture – we seek to manage the course of the monetary aggregates by bringing about changes in interest rates. But it is of course difficult to predict the level and structure of interest rates at which the stock of money the public wants to hold will be brought into equality with the stock the authorities would like to see being held. I need not apologise for this: the converse of this ignorance is that how interest rates will be influenced by various factors is highly uncertain, a fact of life known to all market operators.

In practice we often try to get round this difficulty by building up a forecast from, as it were, the 'supply' side. Thus we look separately at the main items which statistically speaking are the components of the money supply on a broad definition – such as the public sector borrowing requirement, sales to the public of government debt, the volume of bank lending to the private sector and external flows to the private sector. What we are in effect doing in such an

exercise is to attempt to predict what the rate of monetary expansion will be if we refrain from trying to change interest rates – as a preliminary to considering the need for intervention. This may disguise, but does not really evade, the central difficulty of prediction which I have just mentioned.

We are of course kept constantly awake to this difficulty by the sheer erratic variability of the counterparts of the money stock with which we are dealing. For example, since 1974 the mean error of forecasts of the public sector borrowing requirement made at the beginning of each financial year has been of the order of £3 billion. Again, the monthly growth of bank lending frequently fluctuates from its trend by over £100 million; extreme fluctuations in recent years have been as much as three times as large as this. Moreover in the last two decades bank lending has been greatly affected by numerous types of official intervention and control; and, partly no doubt in consequence, we do not now know at all exactly how it is likely to respond to changes in economic or financial conditions.

The essence of monetary management, as I see it, is to act to offset divergences from forecast in these sources of monetary expansion – difficult to predict and control – as soon as it becomes reasonably clear that inaction is likely to undermine achievement of the monetary target. Such divergences from forecast are difficult to identify quickly, partly because of inevitable delays in statistical information about the recent past.

A corollary is, I believe, that so long as we can see our way to bring it back within a few months to the charted path, we should not be unduly concerned when monetary growth goes temporarily off course. I do not for example see much case for supposing that the temporary slow-down in monetary growth last winter, or the temporary acceleration last autumn – largely influenced by massive inflows of funds from abroad – had or will have a significant effect on the development of the economy. Nevertheless, the long-run is a summation of short periods; and what is above all important is that we do not allow monetary developments to diverge too long from trend.

I know that there are critics and commentators who believe that the problem of maintaining control over these short-term developments could be more satisfactorily achieved by a change in our form of operations. They argue that control over some form of high-powered or base money would be more effective in controlling monetary growth than are our present methods. This same debate is occurring in several countries between Central Banks and their academic critics. It is the case that most Central Banks, including most of those with publicly quantified monetary targets, seek to affect monetary growth by varying the general level of interest rates. The monetary authorities in the USA, in Canada and in Germany, for example, operate by this method. I would not seek to suggest however that the methods adopted by the major central banks are, ipso facto, right.

This is too large a subject to enter at this stage in my address, and I would hope to return to it on some future occasion. What I want to say now is that I doubt whether a move to base money control would enable control to be achieved with less variation in interest rates than at present. Indeed, the extent of interest rate variation that the system would have to tolerate might be considerably greater,

in the short-run at least, if base money control was to be rigorously imposed.

Choice of monetary aggregate

I turn now to the question of which of the monetary aggregates is the most appropriate series on which to set the target. If you plot the rate of growth of the alternative monetary series in the UK since 1970, particularly the series of M1 and M3, you will see that they have followed markedly differing paths. For the technically minded, the correlation of the quarterly changes in these aggregates over this period has been only +0.1. Which series one chooses to look at can clearly affect one's interpretation of monetary developments.

The broad monetary aggregate, £M3, in terms of which our present target is expressed, has a number of advantages over its rivals. As I have already said, it can be linked to changes in certain key credit counterparts, such as the PSBR, bank lending, government debt sales, DCE and external financial flows, in a way that helps our understanding of the course of monetary developments. It has also some comparative statistical advantages; for example, it is proportionately less disturbed by transit items – somewhat arbitrarily treated as they are – than M1.

Nevertheless there are certain shortcomings in this series which call for caution in its interpretation. The velocity of M3, the ratio of incomes to broad money, has exhibited very sharp fluctuations, with a major fall during the period of adjustment to Competition and Credit Control, and subsequently a return to – or above – its previous average level. The econometric equations, estimated earlier, neither forecast nor have since adequately explained this development. It probably arose because (as I have already noted) the rate of growth of one of the major constituents of M3, wholesale deposits, depends on relative interest rates, rather than their general level.

Increases in Minimum Lending Rate and in the general level of interest rates do not of themselves bring about a shift in the relative pattern of interest rates that would serve to moderate the growth of wholesale deposits within M3. Indeed, if the increase in rates is closely connected, as it often is, with pressure on banks' liquidity, the relative pattern of rates is liable to adjust adversely, leading to even faster growth in wholesale deposits, at least temporarily. On occasions the path of M3 can be significantly influenced by changing competitive conditions within the banking industry – conditions which can change for reasons quite separate from the course of nominal incomes in the economy, or the actions of the monetary authorities.

There is also, I believe, worthwhile information to be obtained from looking at series other than M3. Over the period for which we have complete data since 1963 the relationship between movements of narrow money (M1) on the one hand and of incomes and interest rates on the other has been closer and more stable than has been the case with M3. Though for some economists that alone would be reason for putting chief emphasis on M1, I would not go that far. First, the relatively stable relationship involving M1 has been observed for a comparatively short period, during which the authorities have not given emphasis to controlling M1: this does not guarantee that the relationship would remain as

stable under differing conditions, particularly if the authorities were to seek to control it more closely. Second, I value the broader descriptive analysis that reference to M3 allows, which one cannot obtain with M1.

Reasons could also be advanced for paying attention to wider liquidity series than M3. There is a high degree of substitution between some assets included in M3 and some excluded, Treasury bills and Certificates of Deposit for example. Moreover the growth and evolution of the building societies has blurred the distinction between deposits with banks and shares and deposits with building societies. This development raises a number of issues, among them the scope and coverage of any series intended to measure private sector transaction balances.

One specific proposal put to us is that we should once again provide a refurbished M2 series, which would aim to exclude wholesale deposits (whose course is so hard to predict or control) and to include retail-type time deposits. We welcome and seriously consider suggestions of this kind. However, we have certain doubts about this particular suggestion. We doubt whether the addition to the existing M1 series of seven-day deposits with the clearing banks would provide much additional information. A theoretically better split between retail and wholesale-type deposits might be obtained by grading deposits by size, over and under £50,000 for example. However not only would any such dividing line be arbitrary, but it would impose a new, onerous burden on the banks' statistical systems. Moreover, for the reasons I have already indicated, I am not sure that it would be sensible to restrict a statistic measuring private sector retail-type deposits to the banks alone, excluding similar-type deposits with building societies.

More generally there will be some information to be had from observation of virtually any financial and economic indicator. But we cannot and should not translate all such indicators into targets for policy. That would be a recipe for confusion. We need to have clear and simple targets, and I am satisfied that in the present state of the art we have chosen best in selecting £M3.

Rolling targets

Finally, I might comment on the question of how often targets should be reviewed and revised. The present monetary target was set in last March's Budget to last without review for the whole financial year. But it is open to question whether this is the optimum strategy. New information on the economy is continually becoming available and it is my view that we should reassess developments as often as sufficient information makes this worthwhile.

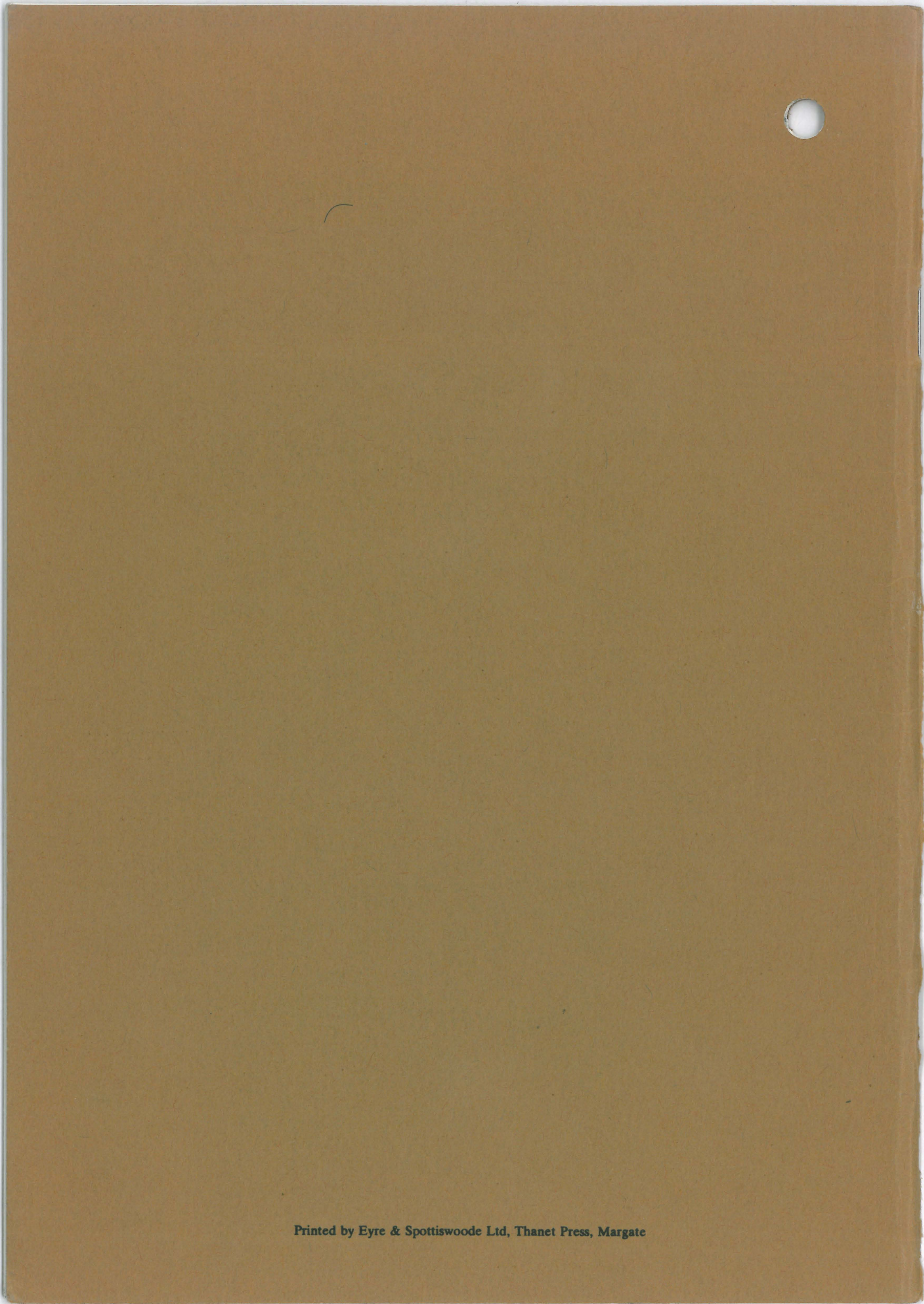
A drawback of the present annual targets has been the implied requirement to hit a particular number on a particular date. The various time-lags in the system make it difficult, and certainly highly undesirable, to try to offset undesired monetary movements very rapidly. Firm deadlines can force one either to try to adjust too fast to an unforeseen trend developing late in the period; or to appear to accept a failure to reach one's target. For such reasons it is for consideration whether it would not be advantageous to rebase the target before the previous target period has been fully completed.

The Federal Reserve undertakes a reassessment each quarter. I believe that for us that would be too frequent. Such a reassessment might however undertaken along with a review of fiscal policy, for instance at the Budget and again in the autumn.

Targets operated in this way have come to be called 'rolling targets' – yet another addition to our growing dictionary of economic jargon, though perhaps a useful and expressive one. I am aware that some people fear that a move to rolling targets would permit much greater elasticity, so that over a period monetary growth could drift further and further away from a desirable medium-term trend. The ability to reassess policy as six-month intervals, however, would not necessarily entail altering course. Indeed I would hope that, more often than not, it would validate staying on the same course for an extended period. I need hardly stress again the value that I place on the importance of maintaining monetary stability.

I would not of course support the adoption of rolling targets if this implied a change of direction in our present strategy. But I could see it as a minor, but useful, technical change to our continuing policy of having publicly-announced monetary targets – a policy which I have sought to defend and explain this afternoon.

In doing so, I have covered a lot of ground and will therefore spare you – and myself – the added burden of summarising what I have had to say. We have not, it is plain, adopted a wholehearted monetarist philosophy. But what we do is likely to give a monetarist a good deal of the prescription he would recommend, which may be what Mr Volcker, President of the Federal Reserve Bank of New York, implied in his phrase 'practical monetarism'. But the essence of what I have been saying is indeed very old fashioned – the predictable caution of a Central Banker.



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