

PO-CH/NL/0091 PT A

Part A.

SECRET

(Circulate under cover and
notify **REGISTRY** of movement)

Begins: 13/12/85

Ends: 8/1/86



PO -CH /NL/0091



PART A

Chancellor's (Lawson) Papers:

**MONETARY POLICY IN THE
1986 MEDIUM TERM
FINANCIAL STRATEGY**

1600 /NL/0091

PO -CH

PART A

Disposal Directions: 25 Years

D. Anderson

1/8/95



Express
Parochial

Ch.

The latest paper is pretty

how all countries - US, Germany - do it

deadful (I don't think I'm

alone in that view). If you

would do some thinking about

brave money, I suggest you dip

(below)

into the reference work/prepared

before your Mansion House

speech. This is a pretty horrible

read too, but it contains an

exhaustive list of everything

(attached)

we have been said/above for 3,

and some useful tables & charts.

For the meeting after Xmas,

Peter will be submitting an

annotated agenda, as well as

the narrow money paper you asked for.

The MHS were done surprisingly well, but we left a major question about one the baptism phrase of M_3 as a target aggregate. We'll need to discuss the following

possibilities:-

- (i) set new targets for M_3 for the whole MTFs period.
- (ii) set ~~target~~ a M_3 target - but only for the year ahead.
- (iii) Drop M_3 altogether, & don't replace it
- (iv) Replace M_3 by some other measure of broad money / liquidity

You'll also notice that the idea of dropping all monetary targets is hailed in Terry's Cheverton paper.



My present view is that (ii) is the right approach (The idea, incidentally came from this office, but I can't now remember whether it was your idea or mine).

My comments on the final suggestion are on the Chevening paper. As long as they are predictable:
RH
23/12

From: SIR PETER MIDDLETON

Date: 13 December 1985

SIR P
MIDDLETON
→ CH/EX
13/12

CHANCELLOR

[How good have these work assumptions be in practice?]

- cc Economic Secretary
- Sir G Littler
- Sir T Burns
- Mr F E R Butler
- Mr Cassell
- Mr Fitchew
- Mr Peretz
- Mr Odling-Smee
- Mr Scholar
- Mr Sedgwick

[Broad money]
[as in balance of payments]

[as a problem]

MONETARY POLICY IN THE 1986 MTFS

We have to clarify our monetary policy in the 1986 MTFS. To start the ball rolling Mr Sedgwick and a group of officials from the Treasury and the Bank have prepared the paper below (copies attached for those who do not already have it). It is the outcome of a good deal of work during the autumn - following up the analytical paper which Mr Sedgwick sent you before the Mansion House speech.

2. We have to decide three issues:

- (a) What target, if any, to have for broad money in 1986-87.
- (b) What ranges do we set for narrow money over the MTFS period, and what, if any, ranges should be set for broad money.
- (c) How do we explain and operate our monetary policy.

3. I know how heavy your diary is at present. So I suggest that you read this note with the Chevening papers over Christmas. We might then aim for an internal discussion early in the New Year before opening up with the Bank.

P E MIDDLETON

fixed for 9/1

MONETARY POLICY IN THE MTFS

INTRODUCTION

This paper considers the presentation of monetary policy in the 1986 MTFS. It takes as given the commitment to reduce inflation and the growth of money GDP further over the medium term. It therefore considers what public presentation of monetary policy would both reinforce and make absolutely clear this overriding medium term commitment and provide the necessary information for financial markets on the operation of monetary policy in the short term.

2. The announcement in the Mansion House speech that the Government would no longer overfund together with its decision to allow £M3 to grow significantly above its target range in 1985-86 has focussed attention on the role of broad money in the MTFS. The 1986 MTFS will need to spell out its role in counter-inflationary policy.

3. The main issues for decision, in the run up to the 1986 MTFS, that the paper discusses are as follows:

1: Establishing the public commitment to reduce inflation further

- Should the monetary targets (and in particular the target range for broad money growth if they are high) have an important role in establishing the government's counter-inflation intentions over the medium term, or can the illustrative path for money GDP growth perform this role on its own? If the path for money GDP growth can fulfil this role on its own, is there any need for ranges for monetary growth after 1986-87?

2: The number of target aggregates

- Should there continue to be "targets" for both broad and narrow money with equivalent status (along with the same official role as in the 1985 MTFs for the exchange rate)?

3: The nature of "targets"

- Should the ranges be presented more as guidelines, to be taken account of in assessing interest rate policy, but not necessarily adhered to in all circumstances?

4: The measure of broad money and its name

- Should the MTFs continue with £M3 as currently defined, switch to an institutional aggregate including building societies' deposits, or switch to an existing aggregate such as PSL2A? What should be the label used in the MTFs for a measure of broad money wider than £M3?

5: The ranges for monetary growth

- Should the range for broad money reflect recent velocity trends and therefore be significantly higher than envisaged in the 1985 MTFs? Is there a case for reducing the MO range?

6: Operational guidance

- Is any additional guidance (compared with earlier MTFs) needed on how interest rate decisions will be taken within a target period to avoid charges that the government is abandoning the MTFs? Will clarifying the role of targets be sufficient?

4. The material in the paper is arranged as follows:

Section A considers the nature of the commitment to monetary growth;

Section B considers the choice of aggregates to be targeted (concentrating on broad money) and the appropriate ranges for them, together with the role of the exchange rate.

The paper draws on extensive work carried out in the Treasury and Bank since the summer on the behaviour and significance of broad money*.

A TARGETS AND THEIR ROLES

5. The principal aim of the MTF5 is to establish a financial framework that gives credibility to the Government's counter-inflation objectives. (All) Governments have aimed to achieve low inflation. The role of intermediate targets has been to convince markets and wage earners that this overall objective will actually be achieved by setting public commitments for nominal variables that the Government can supposedly influence directly. The intention in the 1986 MTF5 should be to ensure that the intermediate targets fulfil this basic role more effectively than in the recent past. To achieve this aim the language and commitments in the 1986 MTF5 will need to be consistent with the evolving practice of recent years. The Mansion House Speeches were a significant step in this direction, though they deliberately did not discuss the details of monetary targeting in the 1986 MTF5.

6. This paper assumes that there will continue to be roles in the MTF5 for broad money, narrow money and the exchange rate, and that these will continue to be monitored, along with a considerable amount of other information, in assessing monetary

*A copy of the Treasury/Bank paper was sent to the Chancellor by Mr Sedgwick in the run up to the Mansion House speech.

conditions and making interest rate decisions*. In order to operate policy in a more flexible way without appearing to violate the fundamental aims of the strategy, the 1986 MTFSS will need

(a) to make absolutely clear, in a way that does not rely too much on medium term paths for monetary growth, its commitment to declining inflation,

and (b) to establish that the modified target ranges are more "conditional" than has been understood in the past.

The next two paragraphs deal with these points in turn.

7. As Section B will make clear, a realistic target range for any measure of broad money in 1986-87 and subsequent years will be centred around a high level. (This will not of course be the case for MO.) If the commitment in the MTFSS to target growth rates for broad money is more 'conditional' than in previous years, it is questionable how far even a path for growth over the medium term will be helpful in establishing the commitment to reduce inflation. The text in the MTFSS dealing with the Government's aspirations for inflation and the numbers for money GDP growth will inevitably be more important in fulfilling this role, and will therefore assume greater importance within the MTFSS as a whole. It will, however, be vital to ensure that this enhanced medium term role for money GDP is not misinterpreted as implying an operational role during 1986-87.

8. The potential types of commitment to monetary growth include (in increasing order of conditionality):

(i) specific target ranges - with the presumption that actual or prospective deviations from the range will lead to corrective action;

*Section B does discuss, only to reject, the possibility of discarding broad money altogether.

(ii) guideline ranges* - to be taken account of in assessing monetary conditions when determining interest rate policy, but without the presumption that corrective action will necessarily be appropriate if monetary growth is outside the range;

(iii) monitoring or "taking account of" a particular monetary aggregate, but without a published range.

9. Option (ii) now seems more suitable than (i) in the absence of suitable instruments to achieve unconditional targets - for broad money at least. It is, of course, what we have actually been doing in recent years. What is clear, however, is that as the nature of the commitment to particular growth rates for the targetted monetary aggregates becomes more conditionial, their status in the MTFs will become closer to that of the exchange rate (which currently has the status of option (iii)). For this reason the relative importance of the exchange rate in the MTFs is bound to appear greater than in the past. This will bring public presentation and the actual operation of policy closer. (The nature of the commitment to each monetary variable in the MTFs is discussed again at the end of Part B.)

B THE ROLES OF MONETARY AGGREGATES AND THE EXCHANGE RATE

10. Most of the discussion in this section concerns the status of broad money in the MTFs. This is addressed first. Narrow money and the exchange rate are dealt with briefly in the course of the discussion.

11. The issues addressed for broad money are:

- (a) the coverage of the targeted aggregate;
- (b) the name it should be given;

*or even "target zones with soft edges": John Williamson's phrase to describe the status of his target zones for the exchange rates of the main reserve currencies.

- (c) the target range;
- (d) the precise nature of the public commitment.

These are discussed in turn below. There is, however, the prior issue of whether there should be a target for broad money in the 1986 MTFs. There are two principal arguments that can be used to justify dropping broad money.

- (i) A measure of broad money is supposed to include (most of) the liquid assets that could relatively easily be spent. Monitoring such an aggregate should make it possible to take corrective action if the economy becomes "over liquid". There has been a fairly constant velocity trend since 1980-81 for broad aggregates wider than £M3 (see Table 2). On the other hand the velocity of £M3 has been more volatile. Target growth rates for aggregates broader than £M3 (which to be realistic would need to be high) can fulfill the role of indicating whether the economy is over liquid provided velocity trends remain stable.
- (ii) The Government lacks adequate instruments to control broad money. Because broad money includes interest bearing assets, the authorities cannot be certain that short term interest rates will have the intended effect. (This is not the case with measures of non-interest bearing money, such as M0, or even with money GDP.) With discretionary use of funding now ruled out there is no way in which above or below target growth of broad money during a target period can be corrected.

(except this deliberate instruction)

Whatever the merits of these two lines of argument it is doubtful whether the Government could afford, or indeed would want, to appear indifferent to the growth of broad money to the extent that would be implied by dropping a target for it altogether. This would be particularly the case if other measures - such as dropping the mortgage lending guidance - suggested indifference

to the growth of broad money and credit. Furthermore it is not necessary to run the risk of the charge of indifference. If it were clear that the commitment to a particular growth rate for broad money were as in option (ii) in paragraph 8, many of the difficulties discussed in this paragraph could be avoided. The rest of this paper assumes that broad money will retain a place in the MTFS.

(a) The choice of the broad money aggregate for the MTFS

12. The choice would seem to be between the following:

- EM3;
- an institutional aggregate, including all residents' sterling deposits with banks and building societies;
- an existing aggregate, such as PSL2A*, including most liquid assets; this would include, in addition to those in the 'institutional' aggregate such assets as liquid National Savings instruments, CTDs, and bank bills.

The recent behaviour of these aggregates is shown in Table 1. Table 2 shows recent velocity trends. Annex I gives the precise definition of various aggregates.**

*The figures for PSL2A appear in the monthly press release, though the label 'PSL2A' is not used.

**Another option would be a composite aggregate constructed from the components of PSL2A. The methodology underlying the construction of composite monetary indicators - indices that weight monetary components according to their "moneyness" in order to indicate the transactions services they provide - is not generally understood or accepted either here or in the US. More work on this approach to the measurement of money is underway in the Treasury, but there are important aspects of the methodology that are highly controversial. It will not be possible to make explicit use of an index of this sort until all the problems in the construction and justification of such indices have been dealt with, and, perhaps more important, until there is some understanding of such aggregates among market operators. This is not an option for the 1986 MTFS.

A further possibility would be to add non-residents' deposits to any of these aggregates. One reason for doing this would be that these are similar to OFI's deposits in that they can be switched in and out of foreign currency and so have implications for the exchange rate. On the other hand the exchange rate is taken account of in its own right.

TABLE 1 - GROWTH RATES OF BROAD MONEY AGGREGATES

	£M3	The Institutional measure ¹	PSL2A
(a) Financial Years (Annual changes to Q1, %)			
1980-81	17.9	16.5	14.5
1981-82	14.2	13.4	13.1
1982-83	11.2	13.8	13.9
1983-84	8.0	11.7	11.0
1984-85	11.8	14.0	13.9
(b) Changes in 12 months to (%)			
1984 September	8.8	12.7	12.4
October	8.1	12.5	12.4
November	10.5	14.0	13.6
December	9.3	13.0	12.7
1985 January	9.4	13.1	12.9
February	9.8	13.2	13.1
March	9.2	12.6	12.5
April	12.0	13.7	13.6
May	11.6	13.2	13.1
June	12.2	13.3	12.9
July	12.0	13.0	12.8
August	13.5	13.8	13.4
September	14.1	14.1	13.4
(c) Changes (at an annual rate) in 6 months to (%)			
1984 September	8.6	12.3	12.0
October	8.8	12.5	12.6
November	11.7	14.2	14.3
December	7.8	11.0	10.5
1985 January	11.3	13.4	13.3
February	10.5	13.1	13.2
March	9.8	13.0	13.1
April	15.4	14.9	14.6
May	11.5	12.2	11.8
June	16.7	15.6	15.3
July	12.7	12.5	12.3
August	16.4	14.4	13.5
September	18.5	15.2	13.7
(d) Changes (at an annual rate) in 3 months to (%)			
1985 March	9.1	13.1	13.5
April	17.7	14.9	15.1
May	18.4	15.0	14.3
June	24.7	18.1	17.0
July	8.0	10.2	9.5
August	14.4	13.9	12.8
September	12.6	12.3	10.6
(e) Changes in month to (%)			
1985 June	2.2	1.7	1.6
July	-0.7	0.0	0.1
August	1.9	1.5	1.3
September	1.8	1.3	1.1
(f) Stocks, £bn			
1985 March	111.0	202.4	216.1

¹Residents deposits with banks and building societies

TABLE
1
GROWTH
RATES
OF
BROAD
MONEY
AGGREGATES

TABLE 2 - VELOCITY TRENDS
Annual percentage change to
last quarter of financial year

	<u>MO</u>	<u>£M3</u>	<u>Institutional Aggregate</u>	<u>PSL2A</u>
1980-81	4½	-6½	-5½	-4
1981-82	6½	-3	-3½	-3
1982-83	6	-2	-4	-4
1983-84	1	-1	-4	-3½
1984-85	1½	-4	-6	-5½

13. The main disadvantage of sticking with £M3 is that it has become even more volatile and difficult to interpret in the recent past. This is illustrated in Table 3.

Major disadvantage is that it is probably related to subsequent movements in money and inflation. Volatility is a second order problem; means the information content is limited. But there might still be information in a longer term trend.

TABLE 3 - COEFFICIENTS OF VARIATION FOR QUARTER TO QUARTER CHANGES IN BROAD MONEY*

	<u>£M3</u>	<u>Institutional aggregate</u>	<u>PSL2A</u>
1965 Q1-1969 Q4	0.86	0.40	0.46
1970 Q1-1974 Q4	0.63	0.43	0.45
1975 Q1-1979 Q4	0.56	0.35	0.40
1980 Q1-1984 Q4	0.31	0.22	0.26
1982 January to 1984 December (using banking month data)	0.80	0.40	0.43

*The coefficient of variation is the standard deviation divided by the mean. It is thus a scale-free measure of variation.

Why this increase in volatility: it is - as implied here - due to increasing substitutability between base & b.s. deposits?

say what will happen when B.S. legislation

14. £M3's volatility could well increase further when the building societies' legislation is enacted and its short run movements could be even less well correlated with monetary conditions. Furthermore some building societies will probably choose to become part of the monetary sector. This would lead to frequent, possibly substantial, breaks in £M3.

15. The main difficulty with abandoning £M3 is that of making yet another change in the MTFS. Changes to the target aggregates in the MTFS have been made in ^{two} three out of the last four years

in 1982 PSL2 and M1 were introduced as targets;

in 1984 M1 was dropped, M0 was introduced as a target, PSL2 and M2 were accepted as checks on £M3 and M0;

and in 1985 PSL2 and M2 were dropped as checks.

with a change in target aggregates

? The last two changes have involved moves away from the inclusion of target aggregates incorporating building society liabilities. On the other hand to use a measure which is wider than £M3 as currently defined could be seen as a sensible - even as an essential - change in the face of financial innovation. It is, to say the least, far from obvious that such a change would damage the credibility of policy. and how would you counter it?

16. The case for extending the institutional base of the broad money aggregate to include building societies rests on the ever increasing extent to which they are offering banking facilities in retail markets. Any remaining dissimilarities between banks and building societies are likely to be further reduced after the forthcoming building society legislation. Even now quite small fluctuations in relative interest rates can cause substantial flows of deposits between the two sectors. Whereas the total demand for deposits in the two sectors may remain relatively stable, deposits with either are likely to be more volatile (as Table 3 shows).

US
IT?

17. An institutionally defined aggregate will exclude a number of instruments that have broadly the same liquidity characteristics

as those included. Extending the coverage of broad money merely to include building societies will still exclude a number of instruments (eg. National Savings deposits, Treasury bills, etc.) at present included in PSL2 (which is published) and PSL2A (which is shown in the monthly press release, though not called PSL2A). It would also (presumably) omit commercial paper when there is a market in the UK.

*no longer
this
within
ISS
again?*

18. The share of such instruments in any broad aggregate with both bank and building society liquid liabilities is small. The figures in Table 1 and Annex I show that - except for short periods, eg when the corset-induced 'bill leak' was occurring and being unwound - inclusion or exclusion of such instruments would have made little difference to the path of broad money during recent years. From the viewpoint of monetary targeting and monitoring these are not important components of broad money. It would therefore be possible to justify, at least for the time being, excluding such instruments from the chosen measure of broad money, particularly if the MTFs made absolutely clear that the authorities would continue to monitor excluded assets carefully.

*do we
know?*

ch?

19. There could, nevertheless, be presentational problems in omitting such assets. To avoid these a measure such as PSL2A might be adopted. The following points are worth noting:

such as

(i) If the principal rationale for targeting/monitoring a measure of broad money is that it includes those liquid balances/instruments that could be spent, then there is a presumption that all the relevant assets should be included.

*eg. gilts close
guaranteed
(come on!)
but see below!*

(ii) The choice of precisely which instruments to include in a measure of broad money is not at all clear. The principal problems concern whether to include those national savings instruments which have broadly similar liquidity characteristics to building society instruments, and short term marketed instruments, such as bills and possibly short gilts.

!!

*What
was! (SSM
done)*

*This is a
fundamental issue,
funded on you in
Annex 2, but
has not
been
discussed*

*Why our
funding rule
is based on
broad money*

(iii) Inclusion of certain types of public sector debt in a measure of broad money has implications for what constitutes funding. All of the changes to the definition of broad money considered in this paper involve redefining funding. Over-funding would be £1½ bn less in 1984-85 if we were looking at PSL2A instead of £M3. (Annex II shows the 'counterparts' of £M3, the 'institutional' aggregate, and PSL2A, and shows the extent of over and under funding in recent years on the relevant definitions of 'funding' corresponding to these.) This raises the question of what funding rule to adopt if a broader aggregate is targetted.

(b) What to call a broader aggregate

*I have
already
mentioned
our views
on this
issue
(ie 21(i)
below)
The
point
is at
the end of
para 25.*

20. If a wider measure of broad money is adopted the question arises of what to call it. Previous practice with new aggregates suggests that the most obvious course would be to present any new aggregate - such as an institutional aggregate or PSL2A - as a new measure, and to continue to publish figures for £M3 as currently defined. This was the course followed when M2 was introduced; the new measure of transaction balances was not presented as a redefinition of M1 (or £M3), but as a new aggregate. The new institutional aggregate would be close in magnitude to the already published PSL2, while it is getting on for double the size of £M3. (See Annex I.)

21. In the light of the numerous changes to the aggregates targeted in the MTFs (summarised in paragraph 15 above) the introduction of another "new" aggregate could cause problems. It is worth considering all the options. These include

- (i) "redefining" £M3 to cover the building societies as well as the monetary sector;
- (ii) labelling a new aggregate (in the MTFs at least) simply "broad money", augmented by a verbal definition;

(iii) redefining PSL2;

oh God. (iv) labelling the new aggregate £M3A (maybe allowing the A to slip off in due course) or £M4.

These are considered in turn.

22. If it were possible to carry it off, a change in the institutional coverage of £M3, while ostensibly maintaining it as the target aggregate for broad money, would have major presentational attractions. There have of course been important changes in the coverage of £M3 in the past. For instance the deposits included in £M3 were increased in a natural and fairly non-controversial way in 1972 (with the introduction of finance houses) and again in 1981 when the old banking sector was replaced by the new monetary sector, increasing the coverage of £M3 by nearly 10 per cent. (The TSB was responsible for 8 points of the 10 per cent increase in coverage in 1981). In 1984 £M3 was redefined to exclude public sector deposits. All these changes, however, were on a minor scale in comparison with the inclusion of building societies which would increase £M3 by just under 80 per cent. (See Annex I)

(1976 - £M3 invented by IMF/PCG)

23. It is worth considering the criteria that were used to justify the 1981 redefinition of £M3. This led to the inclusion in the monetary sector of institutions covered by the latest banking legislation and by the current practices on supervision. However, coverage by the banking legislation was not a necessary condition for inclusion in £M3. The TSB and Girobanks were included in the new monetary sector because this was deemed "appropriate" (to quote the BEQB) given their roles. The criteria for inclusion in the monetary sector are therefore fairly loose. It would for instance be possible to argue that most building societies have evolved in much the same way that the TSB had done by 1981. Whatever the merits of such arguments, however, the scale of the addition to £M3 that inclusion of building societies would involve is so great that it would be difficult to argue convincingly in public that application of the same loose criteria as were used in 1981 would justify such a redefinition of £M3.

This is a problem, it goes for with new nomenclature

slightly different

24. There is a further complication. On previous occasions there was no revision of past growth rates of £M3; the necessary data simply did not exist. This would not be the case with a redefinition in 1986 to include building societies. If the revised aggregate were to be used in public for monitoring or targeting purposes it would be essential to give the available information on its past behaviour. This could be seen as a fairly drastic rewriting of history if this past series were called £M3. Furthermore figures for £M3 on the old definition would still be available for the past, and presumably - for some time at least - for the future. One or other (and maybe both) of the series for £M3 would gain a suffix or a prefix. Redefinition might simply not work.

25. Looking at the advantages and disadvantages of the '£M3 redefinition' option there is clearly a real risk that it would be misinterpreted as a sleight of hand. It could well involve all the presentational disadvantages associated with a new aggregate together with the added disadvantage of seeming dishonest. Our view is that a monetary aggregate that includes the vast stock of building society deposits is a different animal from one that excludes them and that it would be dangerous to pretend otherwise.

26. Turning now to the other labelling options in paragraph 21 it might be difficult to get away simply with the name "Broad Money". All aggregates have a habit of acquiring summary labels. If we do not provide one the market commentators would do so! That said there are attractions in the label 'broad money'. This was used in the 1984 MTFs and the 1985 budget speech. More importantly the use of so general a label could make clear that the precise definition of this aggregate would be changed from time to time in the light of developments. In short, use of such a label would help to soften the commitment to a particular definition of broad money.

27. Redefining PSL2 on an institutional basis (option (iii) in paragraph 21) is a less attractive, though possible option. On its current definition PSL2 is no longer of interest because

*Sed since has been a pump two years; is this any use the
how true it was in (say 1983/84) i.e. term shows getting
more important (don't know)*

*In what way?
discuss*

of the exclusion of building society term shares which is no longer appropriate or defensible given the recent innovations among building society deposits. There would, however, be problems with the 'redefinition' option even with PSL2, because to bring it into line with the institutional definition it would be necessary to exclude the National Savings and other money market instruments at present included in the published data as well as including both the building society term shares and SAYE accounts and the sterling bank deposits (original maturity over two years) at present excluded.

28. Option (iv) in paragraph 21 - to label the new aggregate £M3A or £M4 - has the advantage of using labels similar to that of the principal aggregate in previous MTFSSs, while at the same time there is no attempt to conceal the scale or nature of the change in definition or coverage. Hopefully the introduction of a new aggregate with such a label would not be a source of hilarity, but this would be a risk.

ugh!

a procedure with your certainty

you can say not again!
and what are the £M3?

(c) The appropriate target range

29. A credible target or guideline range for broad money ought to take account of the recent behaviour of velocity (see Table 2), even though this would imply significantly higher ranges than envisaged in recent MTFSSs. In 1984-85 and so far during 1985-86, the fall in £M3 velocity has been above its average fall in the years since (and including) 1981-82 (ie. the years after the post-corset explosion). For 1984-85 and so far in 1985-86 the falls in the velocity of both the 'institutional' aggregate and PSL2A have been very close to the average for the years since 1981-82.

a point you might have made a lot earlier

30. In the light of this recent behaviour the most realistic basis on which to choose target ranges for the three measures of broad money considered in this paper would be: for wider measures than £M3 to use the trend change in velocity since 1981-82, which has been relatively stable; for £M3 to base the range on the more recent behaviour of velocity which shows no sign of being reversed. Because they would be based only on recent behaviour the £M3 ranges

yes

indeed

would be less well established and therefore more likely to be suspended than those for the wider aggregates with more stable behaviour.

31. Assuming nominal GDP growth in 1986-87 of 6½ per cent, as envisaged in the 1985 MTFs (just over 7 per cent in the 1985 Autumn Statement), the following ranges for 1986-87 are implied:

£M3	9-13
'Institutional' aggregate	9-13
PSL2A	9-13.

(assumption for) given new target GDP growth for 1986-87, this becomes 10-14

a what are the implications of this?

For £M3 this would involve a rise of five points in the range for 1986-87 in the 1985 MTFs. It would be essential to make clear in the 1986 MTFs both the extent to which recent velocity trends had determined the choice of target ranges, and that unexpected developments in velocity in the future would lead to the ranges being changed again. The ranges for the years after 1986-87 would therefore be presented as very provisional.

32. With an assured ^{m?} downward path for money GDP growth in the MTFs the assumption of a constant velocity trend in the future would produce an identical fall for the monetary ranges. But, as argued above, it would be essential for the MTFs to establish the government's counter-inflationary resolve (by primarily means other than a declining path for monetary growth that was liable to revision. The money GDP growth path would inevitably assume more importance. Given the uncertainty about the broad money velocity trends it is not at all clear what purpose monetary ranges for years after 1986-87 would serve*

for broad money

This is enough to make anyone plan for money etc!!

(d) The nature of the commitment

33. Section A described the various types of commitment (targets, guidelines, monitoring) that might be given to the chosen broad

*Sam Brittan has referred to target ranges for money GDP - which he favours - as "velocity adjusted monetary targets". With the target ranges for monetary growth chosen on the assumption of constant velocity they become "velocity adjusted money GDP growth".

or narrow money aggregates. In the light of the difficulties with the control of broad money there is a case for the broad money range being regarded, publicly, as "softer" than for narrow money. This does not entirely preclude the continuing use of the term "target" with a clearly indicated shift in meaning, so that the range is interpreted more along the lines of a "guideline". On balance we favour making clear that the nature of the commitment implied by target ranges for both broad and narrow money is less binding and precise than has previously been assumed by markets. It would be difficult presentationally to introduce and justify a subtle distinction between the commitments of broad and narrow money targets.

at first
 there do they assume?

why?
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to be reasonable.

34. There seems to be no reason to change MO as the targetted measure of narrow money. * Consideration will need to be given, however, to its published target range. Last March the range for 1986/87 given in the FSBR was 2-6 per cent. Recent developments suggest, however, that the speed of financial innovation relevant to MO has not slowed (as once appeared possible). If there is to be a substantial rise in the broad money range there might be some advantage in having a slightly lower range for MO than envisaged in the 1985 MTFs, such as 1-5 per cent. Such a lower range might be appropriate if short term interest rates were for a variety of reasons likely to be higher than envisaged in earlier MTFs. This might emphasise the government's continuing resolve to reduce inflation further. But too great a presentational benefit should not be expected from such a move.

which are?
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 this quite
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 last year

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looks pretty marketization

35. There does not seem, at present, any reason to change the current practice of "taking account" of the exchange rate or to make any significant change in its treatment in the MTFs. Apart from joining the ERM, none of the options for a more formal or precise role for the exchange rate are feasible. However, whatever decisions are taken on broad money - the definition and the degree of commitment to it - it seems inevitable that the role of the exchange rate in the MTFs will appear to be much enhanced.

* All alternatives as MTFs.
 Wh. present will be
 discussed in separate
 paper on ~~the~~
 MTFs ~~issue~~

ANNEX I

This Annex indicates the relative magnitudes of £M3, the institutional aggregate and PSL2A, noting also the magnitudes of the components that are included or excluded between the various definitions.

TABLE A: COMPONENTS OF WIDER MONETARY AGGREGATES

	Level at end 1985Q2 in £ billion	
	Institutional aggregate	PSL2A
£M3	119.0	119.0
Building Society shares and deposits in PSL2 (s.a)	79.0	79.0
Building Society term shares (excl from PSL2)	19.4	19.4
Building Society £ bank deposits and CDs	-4.4	-4.4
National Savings instruments in PSL2, net of NS £ bank deposits		8.7
Other money market instruments in PSL2 (net of BS and DNS holdings)		5.1
<u>Totals:</u> Institutional aggregate	<u>212.9</u>	
PSL2A		<u>226.7</u>

ANNEX
I

TABLE B: WIDER AGGREGATES AS PERCENTAGE OF £M3 IN 1985Q2

	PER CENT OF £M3
1. <u>The institutional aggregate is larger than £M3 by</u>	<u>79 per cent</u>
The building society shares and deposits added to £M3 in forming the institutional aggregate are worth	83 per cent
The building society bank deposits omitted are worth	-4 per cent
2. <u>PSL2A is larger than £M3 by</u>	<u>91 per cent</u>
The building society shares and deposits included are worth	83 per cent
The other money market instruments included (NS instruments, CTDs and others) are worth	12 per cent
The BS bank deposits omitted are worth	-4 per cent
<u>PSL2A is the same as the institutional aggregate except:</u>	
it includes the other money market instruments and NS securities which are in PLS2 and are worth	12 per cent

TABLE
B
WIDER
AGGREGATES
AS %
OF £M3
IN 1985
Q2

SECRET

ANNEX 2 COUNTERPARTS TO BROAD MONETARY AGGREGATES

This Annex defines the counterparts of alternative measures of broad money such as the "institutional" aggregate and PSL2A and compares them with those of £M3. Data are presented on the extent of over- and underfunding, together with private sector credit growth, on the various definitions. Problems with the collection of counterparts statistics on a wider basis are also briefly discussed.

Broad money counterparts

2. In the case of £M3 the main counterparts are:

Funding: the PSBR less debt sales to the non-bank private sector and the external finance of the public sector (debt sales overseas and intervention).

Private sector credit: sterling bank lending to the non-bank private sector (including Issue Department holdings of commercial bills).

Other counterparts: external and foreign currency transactions of UK banks plus their net non-deposit sterling liabilities.

3. Table 1 below summarises and compares the definitions of the main counterparts of interest - namely funding and private sector credit - on the various definitions of broad money.

4. With the "institutional" definition of broad money, sales of government debt to building societies would not count towards funding and private sector credit would include societies' mortgage lending (with bank lending to the building societies netted out).

5. With PSL2A, funding would exclude, as well as societies' purchases

ANNEX
2
COUNTER
PARTS
TO BROAD
MONETARY
AGGREGATES

Issues implications

TABLE 1 - DEFINITIONS OF BROAD MONEY COUNTERPARTS

	£M3	'Institutional' Broad money	PSL2A
Funding	PSBR <u>less</u> sales of government debt to the non-bank private sector, and <u>less</u> external finance of the public sector	As with £M3 but <u>excluding</u> building society purchases of government debt.	As with 'institutional' definition but <u>excluding</u> all other non-bank private sector purchases of 'liquid' national savings, CTDs, local authority temporary debt, and Treasury Bills
Private sector credit	£ bank loans and advances to the non-bank private sector, including Issue Department holdings of commercial bills	As with £M3 but <u>including</u> building society mortgage lending and <u>excluding</u> bank lending to building societies	As with 'institutional' definition but <u>including</u> private sector holdings of commercial bills

TABLE
1
DEFINITION
OF BROAD
MONEY
COUNTER
PARTS

of government debt, all other non-bank private sector purchases of "liquid" national savings, CTDs, local authority temporary debt and Treasury bills (which are included as components as PSL2A). Again lending would include mortgage advances, but in addition private sector holdings of bank bills would be incorporated (these are also a component of PSL2A).

6. Table 2 below shows estimates of overfunding and the growth of private sector credit on the various broad money definitions.

7. The degree of overfunding in recent years is reduced as the broad money definition gets wider. The large difference between the £M3 and "institutional" figures in 1983-4 reflects particularly heavy purchases of gilts by building societies in that year. In 1984-5 the societies purchased far fewer gilts and have become net sellers during this financial year.

8. In absolute terms the stock of private sector credit is increased by around 70% once mortgage lending is included (private sector holdings of bank bills have been relatively small in recent years). However the growth rates of the various definitions of private sector credit show a broadly similar pattern.

Data problems

9. The linchpin to conducting counterparts analysis for the wider aggregates is timely and accurate balance sheet data for building societies.

10. Banking month figures for building societies are not available and, for purposes of present monetary data, the Bank interpolate and seasonally adjust calendar month figures supplied to them by the Building Societies Association. These figures comprise only a portion of the societies' balance sheet. Furthermore the data provided by the societies is typically several weeks out of date (requiring some extrapolation in order to bring them into line with monetary sector figures).

SECRET

TABLE 2 - FUNDING AND PRIVATE SECTOR CREDIT GROWTH, 1980/1 - 1985/6

Funding, £ billion (overfunding (-)/underfunding (+))

	1980/1	1981/2	1982/3	1983/4	1984/5	1985/6 (1st half)
£M3	+1.7	-3.7	-1.9	-4.1	-4.5	+0.8
'Institutional' broad money	+3.0	-2.7	-1.4	-2.1	-4.1	+0.1
PSL2A	+3.5	-1.5	-	-1.6	-2.7	+0.2

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(n.s.a, banking
months)

Private Sector Credit (% growth in year to end-period)

	(£bn at end) (1985 Q3)	1980/1	1981/2	1982/3	1983/4	1984/5	1985 Q2 Q3	
£M3	(133.4)	17.8	24.4	19.9	17.0	17.6	18.7	18.6
'Institutional' broad money	(224.8)	16.9	19.5	18.7	17.6	18.7	18.7	18.0*
PSL2A	(225.3)	15.1	19.2	18.8	17.4	18.8	18.4	17.9*

*partly estimated

TABLE
2
FUNDING
AND
PRIVATE
SECTOR
CREDIT
GROWTH
1980/1
1985/6

11. This situation is likely to persist beyond the switch to calendar month reporting next October. The building societies are unlikely to be able to provide more timely and accurate data on all components of their balance sheet until early 1987. Only at that stage will full analyses of the counterparts - unadjusted and seasonally adjusted - be able to be provided. Until early 1987, therefore, counterparts data for the wider aggregates will be subject to greater revision than is currently the case for the equivalent £M3 figures.

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6/11 - 14/12 will
EST's response

RIDLINGTON
EST
13/12

- 1. MR HALL ^{MH} 13/12
- 2. ECONOMIC SECRETARY

I think this is an excellent paper, which provides a corrective to our institution-led work on the bill.

FROM: S RIDLINGTON
DATE: 13 December 1985

- cc: Chancellor
- Sir P Middleton
- Sir T Burns
- Mr Cassell
- Mr Evans
- Mr Odling-Smee
- Mr Sedgwick
- Mr Peretz
- Mr Mowl
- Miss O'Mara
- Mr Riley
- Mr Walsh
- Mr Hannah
- Mr Hood
- Dr Rowlatt
- Mr Saunders
- Mr Wood
- Mr Walton
- File L2

C/ See only pages 2 to 4 which summarize it and contain or two notable points.

R 18/12

Ch/ Peter apparently regards this paper as copy - I'm not quite sure why. It doesn't say that B's lending will increase by £10 billion; there is

(will be included in index of Mtg on bank & names memos for (1986 notes))

ECONOMIC EFFECTS OF BUILDING SOCIETY LEGISLATION

I attach a paper written jointly by Mr Walton and me which addresses the possible economic effects of the proposed legislation. You may find this useful as general background to the Building Societies' Bill.

2. The paper is fairly long, but Section A gives a comprehensive summary of the paper's main conclusions.

whether
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sufficiently
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lending
secured on
property etc.
I have not been through every page of this, but the conclusions don't seem excessive; & Steve Redington - who used to work for me - is probably pretty good.

S J Ridly

Rh.
23/12.

S J RIDLINGTON
HF3

ECONOMIC EFFECTS OF BUILDING SOCIETY LEGISLATION

CONTENTS

<u>Section</u>	<u>Paras</u>	
A	Introduction and Summary of Main Conclusions	
B	The Legislative Changes	
	Interest Rate Setting Arrangements	B2
	Balance Sheet	B3-B7
	Financial and Other Services	B8-B9
	Constitutional/Prudential Changes	B10-B11
C	Changes to Interest Rate Setting Arrangements	
D	Implications for Building Societies Balance Sheet	
	Commercial Assets	D2-D3
	Liquidity Ratio	D4-D7
	Wholesale Liabilities	D8-D11
	Reserves and Reserve Ratio	D12-D15
	Retail Deposits	D16-D20
E	Wider Implications of the New Lending Powers	
	£M3 and Broader Monetary Aggregates (PSLs)	E16-E18
	Effect on the RPI	E19
F	Expansion of Financial and Other Services	
G	Constitutional Changes	

2602/003

ECONOMIC EFFECTS OF BUILDING SOCIETY LEGISLATION

Section A Introduction and summary of main conclusions

A1. The purpose of this paper is to assess as far as possible the main implications of the forthcoming building society legislation. Section B of the paper outlines the main legislative changes, and sections C to G assess the economic implications.

A2. The main conclusions appear to be:

- (i) As there has already been a substantial erosion of the interest rate cartel, and as advised rates are sensitive to market pressures, the withdrawal of exemption from the Restrictive Trade Practices Act is unlikely to have a major impact on societies' interest rates. The main impact could be on the speed of adjustment of rates to changing market conditions. Individual societies may react quickly to increase rates when short of funds, but more slowly to reduce rates for fear of a sharp loss of market share. Interest rates could on average be slightly higher than when rates were set in collusion (section C).
- (ii) The potential scope for class 2 and 3 lending will be about £10 billion (section D); much the same as the potential expansion of wholesale funds (see (iv) below).
- (iii) Prospects for the liquidity ratio are unclear, though on balance societies may need to operate with a slightly higher liquidity ratio than the current sector aggregate of 16½ to 17 per cent. One factor supporting this conclusion is that societies will want to protect themselves against sharp short term fluctuations in inflows that may arise if individual societies interest rates move out of line in the short term (Section D).
- (iv) The scope for expansion of wholesale funding will be enormous - of the order of £10-15 billion. A continued rapid build up of wholesale deposits seems inevitable given that wholesale funds are significantly cheaper than premium retail deposits and are relatively easy to manage. However, a too rapid expansion of

SECTION
A
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wholesale deposits will not be possible without adversely affecting the cost of such funds. This will tend to mitigate the speed of the build up (section D).

(v) Prospects for the reserve ratio are important for the societies as its level will influence the extent to which societies will be able to utilise their new lending powers. Societies will be required to maintain higher reserve ratios on riskier business. Margins have improved substantially in 1985 and this will lead to a rise in the general reserve ratio from 4 to around 4¼ per cent this year. Further small increases seem attainable but these may be insufficient for societies initially to exploit the full potential of the wider lending powers (Section D).

(vi) Banks have made considerable progress in the last 5 years in whittling away the competitive advantage of the building societies. These cost improvements suggest that banks may be in a better position to compete with building societies for retail deposits on interest rate spreads without damaging overall profitability. As a result it seems unlikely that societies will be able to finance additional lending by significantly increasing their share of the retail savings market. Additional lending arising from the legislative changes is most likely to be financed by greater wholesale funding (Section D).

(vii) Whilst class 2 and 3 lending may be quite attractive, there are many factors that suggest that societies will use their new lending powers with caution. The expansion of such lending will, at least initially, be much less than the potential £10 billion. It is difficult to quantify, but class 2 and 3 lending may rise to around £2 billion in the first year or so (Section E).

(viii) Reflecting the likely interest rates and terms, class 2 loans may be more attractive than class 3 for societies and borrowers alike (Section E).

(ix) Total lending will not increase to the same extent as the increase in societies class 2 and 3 lending. There will be some switching away from bank lending to persons and from personal sector borrowing from finance houses and other consumer credit companies.

Whilst finance houses' business looks most threatened, the riskiness of their business may not appeal to most societies. They will still have a role to play, though their lending rates may have to rise relative to other sectors as their risk exposure on a smaller volume of lending increases (Section E).

(x) Increased competition for all types of personal lending is likely to lead to some equalising of interest rates. Non-home loan rates may in general fall slightly, while there may be upward pressure on the mortgage rate (Section E).

(xi) If total lending increases, it is most likely that PSLs will rise. The implication for £M3 is less clear. It may rise or fall, depending on how the societies finance additional lending (Section E).

(xii) At present the weight on housing costs in the RPI is derived from expenditure on interest payments on building society loans. As a consequence, the weight of this component in the RPI will increase as societies make a greater number of loans for purposes other than house purchase.

(xiii) The expansion of money transmission services is likely to increase the velocity of M0, implying slower growth of the aggregate for given money GDP (section F).

(xiv) If societies undertake incorporation, they will become part of the monetary sector, and £M3 will be subject to breaks in the series. The new legislation will lead to a further significant blurring of the distinction between banks and building societies as financial intermediaries (Section G).

A3. Much depends of course on how the building societies choose to exploit the wider powers. The Abbey National, and to a lesser extent the Nationwide, may move quite vigorously into the new powers, while the Halifax and many of the smaller societies may move more cautiously. The medium sized societies will most likely follow the style of their individual managements. Some could therefore be quite rash, while others will be more conservative. As competitive pressures become more intense the commercial prospects cannot be too good for the latter category. Apart from providing money transmission services and chequing accounts, it is doubtful whether small societies will change greatly from their traditional type of business.

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relative to present trends?

even harder to interpret!

SECTION B THE LEGISLATIVE CHANGES

B1 The legislative changes can be classified into four groups; interest rate setting arrangements, the balance sheet, the provision of financial and other services and changes to the constitutional/prudential framework. This section outlines briefly the proposed legislative changes.

Interest Rate Setting Arrangements

B2 The exemption from the Restrictive Trade Practices Act of agreements between building societies' on interest rates will be withdrawn at the same time as the Bill. Societies will have to set rates independently or face possible referral to the Restrictive Practices Court.

Balance Sheet

B3 On the liabilities side, excluding reserves, at least 80 per cent of liabilities have to be raised from retail sources.

B4 On the assets side, not more than one-third of the total stock may be held in liquid form. Commercial assets - broadly total assets less liquidity and fixed assets - are distinguished between three groups, described as Class 1, 2 and 3 respectively, depending on the nature of the business involved. Quantitative limits apply to each group although these can be changed within limits without primary legislation.

B5 Class 1 assets consist essentially of loans secured on first mortgage for residential property. At least 90 per cent of commercial assets will have to be Class 1 loans. A further secured advance on a Class 1 loan is also Class 1. Thus, for example, the existing terms of the Bristol and West Personal Loans Scheme will be Class 1 loans.

B6 Class 2 assets cover all other forms of wholly secured lending, some of which are already within existing building society powers. These, which can extend to 10 per cent of commercial assets, include all other loans for residential property on second mortgage and some loans on first mortgage on, for example, some types of business premises.

Section
B
THE
LEGISLATIVE
CHANGES

B7 Class 3 assets include all other forms of lending, investment in land and property, and equity investment in subsidiaries and associates. Unsecured loans will initially be limited to £5,000 per person. Class 3 lending is restricted to societies with at least £100 million in commercial assets and no more than 5 per cent of commercial assets may be Class 3 loans. The sum of Class 2 and 3 lending must not exceed 10 per cent of commercial assets.

Financial and Other Services

B8 Building societies will be able to offer a fuller range of personal banking and money transmission services. These include cheque books and cards, teller machines, point of sale services and foreign currency services. To some extent societies already provide these services, but they have inevitably faced restrictions because of their inability to lend unsecured; for example, they have been unable to issue credit cards.

B9 Building societies may provide mortgage management, estate agency services and structural surveys. Societies may also act as insurance intermediaries. Other financial services to be allowed include access to services of Stock Exchange members, and the ability to invest in, or set up, housing finance in the European Community. Shares in these companies will be Class 3 assets.

Constitutional/Prudential Changes

B10 Mergers will continue to require the support of 75 per cent of shareholders voting but will also need the support of 50 per cent of borrowers voting. At present borrowing members do not have a vote in most societies.

B11 A consultative paper has been published with the Bill discussing ways in which societies with the approval of their membership could convert to company status. Finally, building societies will be encouraged to appoint an ombudsman, but the main powers of supervision will remain with the Commission.

SECTION C CHANGES TO INTEREST RATE SETTING ARRANGEMENTS

C1 This section looks in greater detail at the likely implications of the withdrawal of exemption from restrictive trade practices on interest rate setting after the building societies legislation.

C2 There has been a substantial erosion of the cartel over the last few years as a result of greater competition among building societies. For example:

- fewer societies now rigidly follow BSA advised rates for ordinary share accounts and base mortgages;
- many new types of savings accounts have been introduced, the rates on which are determined independently by individual societies;
- from time to time there have been differential mortgage rates for larger loans;
- there have been indications of tighter profitability such as the end of the rapid expansion of branch networks.

C3 Even in the setting of base mortgage rates, where collusion is still widespread, the recommended rate system is sensitive to market pressures. This is a result of the societies' stated objective to meet mortgage demand and because of increased competition from the banks.

C4 As a result of these moves in recent years towards a more competitive interest rate setting environment, the legislative changes are unlikely to have a major impact on societies' interest rates. It seems unlikely that any one building society could keep its rates out of line for long. The main impact could be on the speed of adjustment of rates to changing market conditions. For example, responses to market pressure could be asymmetrical. Individual societies may react quickly to increase rates when short of funds but more slowly to reduce rates for fear of a sharp loss of market share. This suggests that deposit and mortgage rates could on average be slightly higher than when rates were set in collusion.

SECTION
C
CHANGES
TO
INTEREST
RATE
SETTING
ARRANGEMENTS

Liquidity and Reserve Ratios

C5 Changes to interest rate setting arrangements could have implications for the liquidity ratio. These, together with other influences on the liquidity ratio, are discussed in section D. There may also be some pressure on societies to reduce margins as individual societies try to increase their market share. Equally, there will be pressure on societies to maintain or increase reserves to cover higher risk business (see section D).

SECTION D IMPLICATIONS FOR BUILDING SOCIETIES BALANCE SHEET

D1 This section considers the direct or first round effects of the legislation for building societies' assets and liabilities. The objective is to highlight the likely tensions and pressures on the societies' balance sheet in preparation for a discussion of the wider issues in Section E.

Commercial Assets

D2 Table 1 provides an estimate of the consolidated balance sheet for societies with commercial assets (ie "mortgages") of more than £100 million at end 1984, and a forecast for 1987 Q1 based on the growth of the balance sheet projected in the October internal forecast. The scope for unsecured lending would have been about £4 billion on the basis of the end-1984 balance sheet, rising to about £4½ billion by the time the legislative changes are introduced.

Section
D
IMPLICATIONS
FOR
BUILDING
SOCIETIES
BALANCE
SHEET

Table 1 Balance Sheet of Societies with Commercial Assets over £100 million

(£ billion)

	<u>Total Assets</u>	<u>Assets</u>			<u>Liabilities</u>			
		<u>Mortgages</u>	<u>Liquid Assets</u>	<u>Other Assets</u>	<u>Shares</u>	<u>Deposits & Loans</u>	<u>General Reserves</u>	<u>Other</u>
1984 Q4	97.6	77.8	18.6	1.1	83.7	8.0	3.9	2.0
1987 Q1 ²	111.4	88.8	21.2	1.3	95.5	9.1	4.5	2.3

¹ At end 1984 Q4 societies with commercial assets of over £100 million accounted for 95 per cent of the total sector.

² Assumes average annual growth rate of balance sheet of 14 per cent per annum, in line with October internal forecast.

D3 The scope for total class 2 and 3 lending would be slightly more than twice the estimate for class 3 lending since all societies may undertake class 2 lending. The potential scope for total class 2 and class 3 lending after the legislative changes is therefore likely to be of the order of £10 billion.

Liquidity Ratio

D4 Some aspects of the legislation suggest a higher liquidity ratio will be needed by societies while other aspects indicate a lower one. One consequence of increased competitiveness and independence in setting interest rates seems to have been a rise in the volatility of liabilities (see table 2). Withdrawals as a percentage of mean liabilities have increased sharply from 21 per cent in 1970 to 64 per cent in 1984.

Table 2 Volatility of Building Society Funds

	Mean Balance of Liabilities £ million	Withdrawals £ million	Withdrawals as % of mean liabilities
1970	9,505	2,056	21.6
1975	20,959	6,416	30.6
1980	46,995	20,511	43.7
1984	88,656	56,725	64.0

D5 One might expect increased volatility of funds to lead to a higher liquidity ratio, though for a number of reasons - such as the revised tax treatment of societies' gilt holdings and the societies' move towards liability management - this has not been observed to date. Further, to the extent that the legislation leads to more independence in setting rates, the more likely it is that individual societies will want to maintain a higher level of liquidity to protect themselves from sharp short term fluctuations in inflows. In aggregate this suggests a higher liquidity ratio.

D6 The more widespread use of wholesale funds could have mixed implications for the liquidity ratio. Unlike retail funds, because most wholesale funds are not withdrawable on demand they ought to require a lower level of liquidity backing. Furthermore, the recent euro-sterling issues by societies' have a life of 7 to 15 years, a much longer term and therefore more certain source of funds than societies' have been used to. However they will eventually be required to refinance these and other wholesale loans and, unless, careful societies could face acute liquidity problems if they suddenly lost favour with the wholesale markets.

D7 On balance, we think it is unlikely that the liquidity ratio will fall much below the current 16½ to 17 per cent level, and if anything it may rise slightly.

Wholesale Liabilities

D8 At present there is no statutory limit to wholesale funding, though societies are asked to approach the Registry for discussions if they either propose to issue CDs or contemplate raising money from wholesale money markets totalling more than 5 per cent of total liabilities. After the legislation at least 80 per cent of funds will have to be raised from retail sources. As table 3 shows, at present wholesale funds account for 4½ per cent of total liabilities, though the share is rising rapidly. The scope for expansion after legislation is therefore enormous; of the order of £10-15 billion.

Table 3: Building Societies' Wholesale Deposits

	Wholesale Deposits (£billion)	% increase on previous year	Wholesale funds as % of total liabilities
1981	0.1	-	-
1982	0.4	183	0.5
1983	2.0	420	2.3
1984	3.8	88	3.7
1985 ¹	5.2	37	4.4

¹ 1985 figures estimated

D9 It seems likely that wholesale funding will become increasingly important to the building societies as a means of financing their lending. Successive changes to the tax treatment of interest payments on wholesale funds in the 1983, 1984 and 1985 Finance Acts have helped to open up the wholesale markets to the societies. The latest of these, in the 1985 Finance Act, enables societies to pay interest gross from April 1986 on floating rate notes issued in the euro-sterling markets. Several of the larger societies have responded to this by issuing more than £800 million of FRNs since October. Other issues can be expected to follow.

D10 Another factor likely to lead to a continued build up of wholesale funds is the relative cost of such funds. Table 4 shows how relative costs have moved over the last 5 years. With the exception of 1984, wholesale funds (raised at about 1/8 to 1/4 over LIBOR) have been marginally more expensive than the average rate paid on retail funds, but considerably cheaper (by 1-2 per cent at present) than retail accounts that attract premium rates. In addition wholesale funds are relatively cheap to manage.

Table 4: Relative Costs of Wholesale and Retail funding

(per cent per annum, average over year).

	Cost of Retail Funds		Cost of Wholesale Funds
	<u>Average</u> ¹	<u>Marginal</u> ²	<u>3MIB offer rate</u>
1982	12.2	12.9	12.3
1983	9.9	10.7	10.1
1984	10.7	11.5	10.0
1985	11.9	12.9	12.2
1985 Q4	11.2	12.7	11.5

¹ Average interest paid on all retail funds, grossed up at composite rate

² Interest rate paid on premium account, grossed up at composite rate, estimates.

D11 Relative costs will depend on the future movement of building societies' rates relative to other short term interest rates. One factor that will influence the relative cost is of course the degree and rapidity of the build-up of wholesale funding itself. A build up of over £10 billion in wholesale liabilities is fairly large in relation to the size of the euro-sterling market (£4 billion) and of the stock of sterling wholesale bank deposits* (£80 billion). Excessive calls on these markets by the societies would in itself reduce the cost advantage of wholesale funding. Nevertheless, given current interest rate differentials, there may still remain considerable scope for a rapid build up of wholesale (and therefore total) liabilities without significantly affecting the average cost of raising funds.

Reserves and Reserve Ratio

D12 The Chief Registrar in his 1983-84 Annual Report argued that societies need to build up reserves over and above those needed for traditional business, if they are not to find capital adequacy a constraint on the use of wider lending powers after the legislation. Prospects for the reserve ratio are clearly important for the societies, and its level will influence the extent to which building societies can use their new lending powers. The Commission will set reserve ratios relative to the spread of business societies' have. Higher reserve ratios will be required as business becomes riskier.

* broadly defined as the sum of OFIs, ICCs and overseas deposits with UK monetary sector

D13 The desire to build up reserves will also be a key factor influencing the setting of margins in the coming years, but how much the ratio will need to rise is not clear. At the end of 1984 the general reserve ratio for the industry as a whole was 4 per cent, (see Table 5) compared to about 6 to 7 per cent for the banks. Our general conclusion is that societies will be able to achieve small rises in the reserve ratio in 1985 and 1986. This is based on the following:

(i) The differential between lending and borrowing rates (grossed up at the composite rate) has improved substantially from 0.8 per cent in 1984 to 1.3 per cent in 1985. Our estimates suggest that if all other income and expenditure items remain at their 1984 balance sheet shares in 1985 this increase in margins will lead to a rise in the general reserve ratio to $4\frac{1}{4}$ per cent (see table 5). Maintaining 1985 margins (broadly the assumption in the October internal forecast) will lead to a further rise in the reserve ratio in 1986.

(ii) The introduction of class 2 and 3 lending will itself increase margins and add to reserves all other things equal. For example, if class 2 and 3 lending were to attain their maximum share of commercial assets, and attracted interest rates of mortgage rate plus 3 per cent and 7 per cent respectively, the average interest rate on commercial assets would rise from the mortgage rate to the mortgage rate plus $\frac{1}{2}$ per cent.

(iii) In recent years societies have cut back the growth of management expenses (see table 5). If this trend were to continue, reserves would benefit.

(iv) Commission (included in other income in table 5) may rise as societies increase the range of services offered.

Table 5: Factors Influencing Reserve Ratio

A. Income and expenditure

(per cent of total balance sheet unless otherwise stated)

	1975	1980	1982	1983	1984	1985*
Total balance sheet (£bn)	24.2	53.9	73.0	85.9	102.7	118.0
<u>Income:</u> Mortgage interest	8.0	11.0	9.6	8.0	8.6	10.2
Investment & bank interest	1.7	2.0	2.0	1.6	1.6	[1.6]
Other	0.3	0.3	0.7	0.9	0.6	[0.5]
<u>Expenditure</u> Management expenses	0.8	1.1	1.2	1.15	1.1	[1.1]
Interest on liabilities, inc. CRT	8.5	11.5	10.2	8.4	8.9	10.0
Corporation tax	0.2	0.2	0.2	0.1	0.2	[0.4]
Addition to general reserves	0.4	0.5	0.7	0.8	0.6	[$\frac{3}{4}$]
Memo: General Reserve Ratio	3.3	3.5	3.8	4.1	4.0	[$4\frac{1}{4}$]
Free Reserve Ratio**	n.a	2.2	2.6	2.8	2.8	[3]

** General reserves less fixed assets as % of balance sheet

B. Interest Rates

	1975	1980	1982	1983	1984	1985
Mortgage rate less Deposit rate (gross at CRT)	0.86	1.11	0.84	0.76	0.79	1.32
3 month inter-bank	10.7	16.6	12.3	10.1	10.0	12.2

* 1985 estimate

D14 Arguing against these factors are:

(i) Increased competition, both amongst the societies and between the societies and the banks may cause a fall in margins from the current high level.

(ii) The return on liquid assets would fall if the general level of market interest rates fell.

(iii) Corporation tax liabilities would rise as pre-tax profits rise.

(iv) Further reductions in management expenses as a share of the total balance sheet may be difficult to achieve as societies incur additional administrative costs as a result of providing new and more costly services.

(v) Commensurate with the increased risk associated with their lending business, an increase in bad debt provision will be necessary.

D15 It seems likely that the reserve ratio will rise to about 4¼ per cent in 1985. Further small increases seem attainable but these may be insufficient, at least initially, for societies to exploit the full implication of the wider lending powers.

Retail Deposits

D16 The extent to which societies can increase retail deposits would appear to depend on two main factors:

(i) Can societies increase their lending rates (and hence deposit rates) relative to their competitors?

(ii) And/or, can societies increase their deposit rates by cutting their margins to attract a larger share of retail savings?

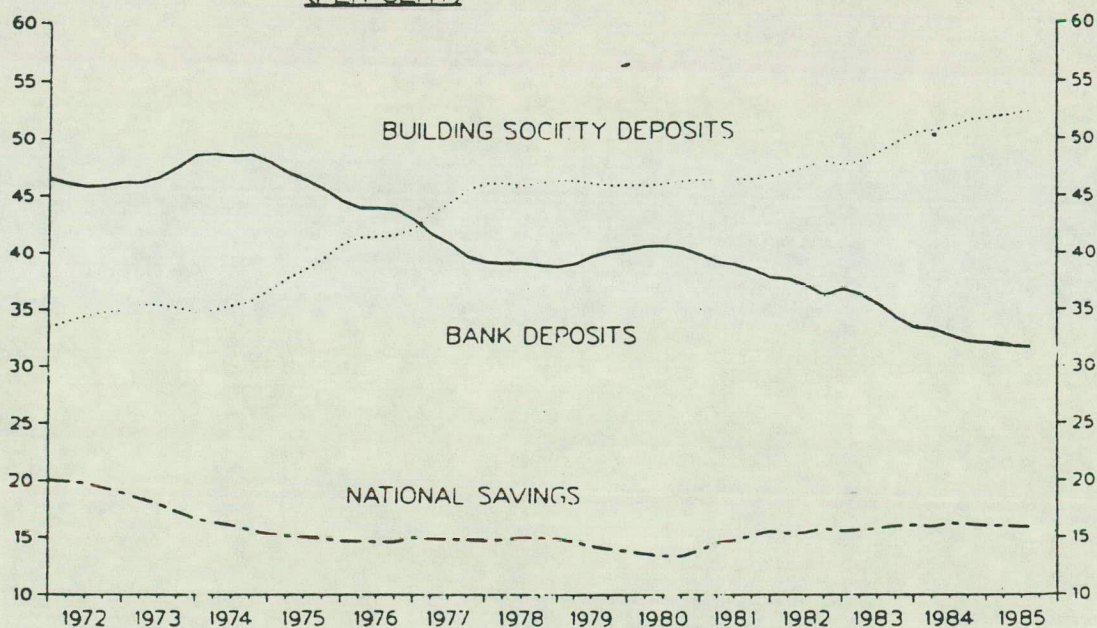
D17 The answer to the first question will probably be no. Increasingly the societies are competing in the same market for

loans as their competitors, so the opportunity to charge differential rates will be small. Of course, to the extent that societies indulge in class 2 and class 3 lending, the average rate of return on their assets will rise, but it has been argued that the societies will not want to pass this on to depositors because of their need to protect the reserve ratio.

D18 In the past their low operating expenses have enabled societies to operate with low margins. This has been one factor that has enabled them to increase their share of the retail savings market - see chart I below.

CHART I.

SHARES OF BANK DEPOSITS, BUILDING SOCIETY DEPOSITS
AND NATIONAL SAVINGS IN PERSONAL SECTOR LIQUID ASSETS:
(PER CENT)



D19 However, table 6 below shows that the societies' average cost advantage relative to the banks has been eroded recently. This is largely because banks have reduced staff costs substantially, whereas societies' costs have changed little.

Table 6: Net Operating Expenses - £ per £100 of mean assets

	1979	1980	1981	1982	1983	1984
Banks	2.21	2.41	2.18	2.03	1.81	1.66
Building Societies	0.83	0.95	1.01	1.05	0.95	0.85

Further, as societies' powers widen their operating costs may increase whilst banks' costs may continue to fall as they react to increasing competition from the societies. These cost improvements suggest that banks may be in a better position to compete with building societies on interest rate spreads without damaging overall profitability. As a result societies will probably not be able to increase significantly their share of the retail savings market. The experience of recent months, when the banks appear to have curtailed the fall in their share of this market by offering higher interest accounts without significantly affecting profitability lends support to this conclusion.

Conclusions

D20 This section has identified the main "first round" tensions and pressures on the building societies balance sheet. The potential scope for increased lending is large - of the order of £10 billion. But the scope for increased wholesale funding (to match higher lending) is even greater. For the reasons described above, we think that increased lending is most likely to be financed largely by wholesale borrowing. The scope for further significant increases in the societies' share of retail savings looks remote. Concern over the reserve and liquidity ratios look to be factors that will mitigate the use of the new lending powers.

SECTION E WIDER IMPLICATIONS OF THE NEW LENDING POWERS

E1 This section investigates the wider implications of the new

lending powers. In particular we consider the likely scale of increased lending in the first year or two after the new powers are in place, the likely response of the banks and other lending institutions, and the implication for interest rates. The section goes on to consider the possible implications for the various monetary aggregates. The analysis is largely qualitative since the effects are difficult to quantify. We concentrate on lending to the household sector other than strictly for house purchase or improvement (hereafter defined as non-home loans) as this seems likely to be the main source of building societies' additional lending.

E2 Section D has shown that the potential increase in class 2 and 3 lending is of the order of £10 billion. Not all of class 2 and class 3 lending will be for non-home loan purposes (see Section B) but a significant proportion will be. Class 1 non-home loans may rise too.

E3 Table 5 below shows that the stock of non-home sterling loans to the household sector was £22 billion at end 1984, with the majority being provided by the monetary sector in the form of overdrafts, credit card lending and personal loans. With a potential lending capacity of about £10 billion, the societies could have a substantial impact on this market.

Table 5 Lending to household sector, other than for house purchase and foreign currency loans.

		(£ billion)			
	Total Stock	Advanced by			
		Monetary Sector	Consumer Credit	Insurance Companies	Retailers
1983	18.9	14.8	1.8	0.4	1.9
1984	22.1	17.4	2.2	0.4	2.0

E4 How fast societies' non-home loans increase will depend on a number of supply and demand factors. Taking first the demand factors, it is taken as given that there will be no credit rationing when the societies begin to exploit their new lending opportunities. Another key factor will be the interest rate and terms on such loans. Table 7 shows interest rates on a range of non-home loans currently available, and compares them with our estimates of the rates societies are likely to charge on class 2 and 3 loans.

Table 7 Interest Rates¹ on Non-home Household Loans - October 1985

<u>Building Societies</u>					
Mortgage Rate	Bristol & West Personal Loans (class 1)	Class 2 Loans	Class 3 (unsecured) Loans		
Base +2¼	Base +5¼	Base +5/7	Base +9/11		
<u>Monetary Sector</u>			<u>Other</u>		
Bank Overdraft	Personal Loan	Credit Cards (eg VISA)	M&S Chargecard	Finance House	
Base +5/7	Base +10½	Base +15½	Base +17	Base +[18/20]	

¹ All rates are those on offer in October 1985, expressed as APR's to ensure consistency.

E5 Few of the rates quoted above are or will be specifically related to banks' base rates. In particular, the cost of building society loans will depend on how the mortgage rate moves relative to bank rates. Interest rates on class 2 and 3 loans have not yet been decided by the building societies. The only indication we have is from the Bristol & West Home Equity Scheme which offers personal loans secured on a B & W first mortgage (and thus are class 1) at an interest rate 3 points above the mortgage rate. Class 2 loans are likely to be slightly higher, and class 3 rates higher still, reflecting the additional risk to the lending society.

E6 At the interest rates indicated the availability of class 3 loans may not generate a substantial amount of new credit. Unsecured loans will probably be offered on similar terms to

existing unsecured personal bank loans, though limited to £5000 per person. However, to the extent that building societies will be prepared to supply such loans, some new demand will be created. More importantly, there may be some switching of borrowing from banks, finance houses and credit card business to the local and friendly building society.

E7 On the basis of the indicative rates in table 7, class 2 loans look attractive compared to the cost of alternative sources of funds. More importantly, the terms offered by societies for these loans are likely to be attractive. Being secured, class 2 loans should be available over a long term, even possibly up to the maturity date of the existing first mortgage, which will be considerably longer than most bank and other consumer loans. This will of course reduce monthly repayments and make such loans more manageable. Societies may also find class 2 lending no riskier than marginal class 1 lending.

E8 Those societies which decide to offer class 2 loans are also likely to introduce a B & W type scheme for their existing mortgagors. Such loans will be class 1 and because they are less risky to societies they ought to be cheaper than class 2 loans. This would reduce the attractiveness of class 2 loans except to people with Local Authority mortgages and others who are unable to obtain top-up mortgages from their existing building societies.

E9 The supply factors however largely argue against a rapid expansion of non-home loans:

- Societies will still want to be seen primarily as lenders for house purchase. If traditional mortgage demand remains strong relative to inflows this may limit the amount of non-home lending the societies do. The October internal forecast envisaged demand for loans for house purchase rising fairly rapidly reflecting a decline in the mortgage rate and a rise in house price inflation. If traditional demand does remain strong, and if societies are reluctant to see mortgage rationing re-emerge, funds available for class 2 and 3 lending may be limited.

- Unsecured lending in particular will be more risky, which may make societies tread cautiously. Concern about the reserve ratio (D12 to D15) and the liquidity ratio (D4 to D7) may also mitigate growth in non-home lending.

- But the higher interest rates charged may look attractive to societies and will boost societies' reserve ratios. This will to some extent be mitigated by a higher bad debt provision.

- Societies have been slow to follow Bristol & West's lead in providing secured personal loans to existing mortgagors. This may reflect a lack of management and marketing expertise which takes time to accumulate and may lead societies to be cautious.

- If societies are keen to offer class 2 and 3 loans the potential for raising extra funds in the retail markets may be slim (see D16 to D19), but much better in the wholesale market (D8 to D11).

E10 These factors suggest that societies' non-home loans, whilst being attractive to potential borrowers, will be much smaller in the first year or so than the possible £10 billion or so - perhaps of the order of £2 billion.

E11 Additional non-home loans by building societies will however partly displace other lending. Such substitution will comprise of:

- some possible loss of traditional building society class 1 lending for house purchase (though we would expect this to be small)

- lower bank lending to persons as banks' business is bid away by societies

- lower finance house and other consumer lending for similar reasons.

E12 On interest rate grounds, as table 7 showed, class 2 lending looks favourable compared to banks' personal loans. However, as the banks are liable to compete more aggressively for loan business, they can be expected to have some success in protecting their own personal non-home loan business, and may make further inroads into traditional mortgage lending. Banks' credit card business may be largely unaffected as much may be short term to smooth cash flow problems. Thus such lending may not be a close substitute for building society lending.

E13 On the face of it, the unattractive lending rates charged by finance houses and other consumer credit companies may seriously threaten their lending business. We would expect there to be some increase in building society lending at their expense but this will be mitigated by the following:

(i) Retailers' credit card business may be largely unaffected for the reasons given above.

(ii) Finance house loans are often made to individuals considered too risky by banks. Societies may not be interested in such business.

Finance house business will be cut back somewhat as their less risky clients switch to building society unsecured borrowing.

E14 The total increase in lending seems certain to be less than the increase in building society class 2 and 3 lending. If societies class 2 and 3 lending were to amount to £2 billion in the first year or so, perhaps half may be offset by lower building society class 1 lending and bank lending. Lower bank lending would result from lower lending to the personal sector, lower lending to finance houses and other lenders (as the former finances the latter's lending) and possibly through lower lending to ICCs.

E15 On interest rates, it seems likely that there will be some pressure on traditional mortgage and non-home loan rates to equalise. The degree of convergence may only be slight - banks may need to shave down the rates on non-home loans in the face of competition from societies, and there may be some pressure on societies to increase mortgage rates to protect their reserves.

One further result may be that finance houses will need to increase their lending rates as their risk exposure, on a smaller volume of lending, increases.

£M3 and other broad monetary aggregates (PSLs)

E16 If building society lending were to rise by £2 billion as a result of the legislative changes, and this were to result in a £1 billion reduction in bank lending to the non-building society private sector for the reasons discussed above, considering the counterparts to broad money would suggest that £M3 would fall by about £1 billion and the PSLs would rise by £1 billion with a £2 billion increase in the wedge between the two.

E17 However, the results would depend on how the building society lending was financed. If the change in building society and bank lending above were financed by a commensurate change in NBPS retail deposits with the two, the conclusion in E16 would, broadly, carry through. However, we have argued that increased lending by the societies is more likely to be financed by higher wholesale borrowing. The implications for broader liquidity would depend on the form of wholesale funding used by societies. There are many possibilities with different implications for £M3 and the PSLs. To give the flavour, three cases are shown below.

Case (i) - suppose the extra £2 billion of building society lending is financed solely by increased bank borrowing. Total bank lending would therefore rise, and if matched by larger deposits from the NBPS this would show up as more rapid growth of £M3 as well as PSLs.

Case (ii) - suppose the £2 billion extra building society lending is financed solely by further issues of euro-sterling FRNs. The effect on monetary growth will depend on who holds these issues. Of the FRN issues so far, it seems that the overseas sector have been the major takers. In the monthly money forecast we have assumed that overall societies' FRN issues will lead to a rise in £M3 as some of the sterling required by the overseas sector to purchase FRNs has been acquired overseas and ends up, one way or another, in UK

NBPS bank deposits. In this scenario, higher building society lending financed by overseas purchases of FRNs, increases both £M3 and PSLs by the same quantity. However whilst both £M3 and PSLs would rise by some (small) proportion of the £2 billion FRN issue, this could be more than offset by the fall in £M3 and PSLs brought about by the £1 billion lower bank lending. Overall, both £M3 and PSLs would fall as a result. We had thought that building society FRNs would in part be taken up by overseas banks included in the UK monetary sector. So far, this does not seem to have occurred. If it did in the future, overseas banks' take up would classify as bank lending to building societies, and would lead to an increase in £M3 (as in case (i)).

Case (iii) - suppose societies' £2 billion additional wholesale funding is drawn from the NBPS in the form of, say, other OFIs and ICCs take up of building society CDs or negotiable bonds. If ICCs and OFIs wholesale deposits with building societies input displaced their deposits with banks, extra building society lending would lead to a fall in £M3, but a rise in PSLs.

E18 In practice, extra funding is likely to be drawn from retail and all three wholesale sources mentioned above. The net effect of an increase in building society lending, financed largely by higher wholesale funding on £M3 is therefore unclear, though PSLs are likely to grow more quickly.

Effect on the RPI

E19 At present the weight on the owner-occupiers' housing costs component of the RPI is derived from expenditure on interest payments on building society loans, taken from the FES. As a consequence, the weight of this component in the RPI, as presently defined, will increase as societies make a greater number of loans for purposes other than house purchase. The RPI Advisory Committee are however currently looking at the treatment of housing costs in the RPI.

SECTION F EXPANSION OF FINANCIAL AND OTHER SERVICES

F1 Societies have increasingly widened the range of financial services they offer. From their insurance broking services, commissions accounted for about 2½ per cent of societies' income in 1984. On endowment policy sales, for example, societies normally receive 30 to 40 per cent of the first years' premium. After the legislation, societies will be able to provide a greater range of estate agency and mortgage management services. The likely impact of this will be to reduce transactions costs, both financial and in terms of time and effort associated with house purchase.

F2 As the supply of housing is relatively inelastic in the short run, it is likely that any savings of transactions costs will be passed on to the seller through higher house prices. The major reduction in the financial cost of transactions will be on estate agency fees. Currently estate agency fees range from 1½ to 2½ per cent of the house price. If competition by societies reduced such fees by say ½ per cent, house prices may be expected to rise by a similar amount initially.

F3 Non-pecuniary savings are likely to lead to an increase in activity in the housing market in general, which may also exert upward pressure on house prices. A rise in demand for houses and house prices is likely to increase the demand for mortgages though the extent of any such increase is unquantifiable.

F4 The other major development in the financial services area will be the extension of money transmission services offered by building societies. Developments will include:

(i) Extension of the number of cash dispenser machines;

(ii) All societies will be able to offer cheque book and cheque guarantee card facilities. However societies that do not qualify for class 3 lending will not be able to offer overdraft facilities.

F5 To the extent that individuals who currently have building society accounts, but not bank accounts, make use of these facilities, financial innovation of this type will lead to a reduction in average cash holdings and hence a rise in the velocity of MO. Offsetting this, building societies demand for cash may rise slightly. However, overall, the implication is likely to be a lower growth of MO for given money GDP.

Section G Constitutional Changes

G1. The most important constitutional changes for our purposes relate to mergers and conversion to company status. Apart from the effects on monetary aggregates the economic implications of constitutional changes are likely to small.

G2. Competitive pressures may cause societies to consider mergers seriously. The advantages of mergers to medium size societies are that it would enable them to pool management expertise, increase market share and power, avoid unnecessary duplication of branches and so on - all of which may be important as competition, both among societies and between banks, becomes more intense. The legislation in principle makes mergers more difficult as for the first time, the support of at least 50 per cent of borrowers voting will be required.

G3. It is not clear whether the management or shareholders of a society would find incorporation an attractive proposition. On balance management may be more inclined towards incorporation than members. From the management's point of view, a principal advantage is that the society would be able to diversify its provision of financial services and engage in more 'adventurous' and potentially profitable activities. Incorporation would also offer the opportunity for an expansion of the capital base commensurate with wider powers. To date the Abbey National is the only society to have publicly expressed an interest in incorporation.

G4. The members of a society may not be as enamoured by the possibility of incorporation. Some may prefer to be associated with, (and save with) building societies rather than banks. A loss of goodwill amongst ordinary members could lead to a damaging run on deposits, the prospect of which may deter management.

G5. After incorporation a society would become subject to the supervisory requirements of the Bank of England rather than those of the Commission. Incorporated societies would then cease to be OFI's, becoming instead part of the monetary sector. Each incorporation would therefore lead to a break in the series for the level of £M3. The new legislation will lead to a further significant blurring of the distinction between banks and building societies as financial intermediaries.

11/287

Meeting
10 January

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THE SIGNIFICANCE
OF BROAD MONEY

SUMMARY
AND
CONCLUSIONS

REFERENCE
WORK
(OCT/NOV 1985)

THE SIGNIFICANCE OF BROAD MONEY

SUMMARY AND CONCLUSIONS

(1) Velocity trends

Until 1980 there was evidence of an apparent upward trend in the velocity of broad money. Since then velocity has fallen in every year. In the light of the analysis in this paper it now seems likely that the velocity of the various measures of broad money or liquidity will continue to fall. There is little concrete evidence on which to base a judgement on the extent and duration of the likely fall in velocity.

2. The behaviour of some narrow aggregates - notably M1 - has caused problems of interpretation similar to those for broad money. The velocity trend for M0 has been fairly steady, though any major change in the rate of the relevant types of financial innovation would make the behaviour of M0 less steady and predictable.

3. During the post-war period the velocity of broad money has been significantly altered both by major changes in the aims and operation of macroeconomic policy and perhaps even more so by changes in the system of monetary control. For much of the period until the early 1970s various forms of credit control operated and they - rather than some "underlying" trend - were probably the dominant factor behind the rise in the velocity of broad money. The interaction of financial innovation (with the development of the wholesale money markets in the late 1960s) and financial liberalisation (in the form of CCC in 1971) was one contributory factor - along with a drastic loosening of the macroeconomic policy stance - behind the very sharp fall in velocity in the early 1970s. This sharp fall in velocity was quickly reversed. The subsequent rise in velocity in the late

CONFIDENTIAL

1970s was thought then, and even for some time in the early 1980s, to be a reversion to an "underlying" tendency for velocity to rise. In retrospect it looks as if the reimposition of controls - in the form of the corset - was probably the principal reason.

4. The fall in the velocity of broad money and credit since 1979 has been mainly the result of the major programme of financial liberalisation that began with - and was in part made inevitable by - the abolition of exchange controls in 1979. The private sector - and especially the personal sector - appears to have taken the opportunity presented by the liberal environment to build up its stocks of gross financial assets and debt closer to desired levels at prevailing levels of income and interest rates. The turn round from negative to positive real interest rates may also have been an important factor in the build up of liquid assets.

5. It is probable that the full effects of those measures of financial liberalisation enacted so far have not yet occurred. Further measures of liberalisation, such as those envisaged for the forthcoming building society legislation, are likely to contribute further downward pressure on the velocity of measures of broad liquidity (ie those that include building society liabilities). Although it seems likely that the velocity of broad money and liquidity will continue to fall it could be some time before it will be possible to predict short term changes in velocity - eg from year to year - with a tolerable degree of accuracy.

6. While the direction of the effect of liberalisation on the velocity of measures of wider liquidity and total credit is certain, this is not the case with £M3. It is conceivable, though on present evidence unlikely, that the more aggressive and competitive behaviour of building societies that has been made possible by liberalisation could have reduced the share of banks in retail financial markets by an amount that leaves total £M3 velocity higher than it would otherwise have been. On the evidence available so far it looks as if £M3 velocity

is lower as a result of liberalisation, though possibly not by as much as for measures of broad liquidity that include building society liabilities.

(2) The definition of broad money

7. It has always been extremely difficult to define broad money, and any dividing line between those financial assets included in and those excluded from 'money' has always been to some extent arbitrary. It would be very surprising if the most appropriate dividing line were constant through time, and it is essential to take account of the changing financial environment.

8. Because the pace of financial innovation and liberalisation has been particularly fast in recent years the problems of definition have if anything become more acute. All the available measures of broad money and liquidity exclude significant amounts of the consolidated liabilities of banks and building societies. The liabilities included in £M3 are a decreasing proportion of total liabilities booked with banks in the UK, and by no means all of the sterling deposits (because overseas residents' sterling deposits are excluded). Furthermore to a greater extent than in earlier periods there is now a vast number of slightly differentiated financial assets in both retail and wholesale markets that range from capital certain cash at one extreme to long maturity marketable securities at the other extreme, with no obviously appropriate dividing lines in between.

9. The building societies have over a number of years improved their share of retail financial markets at the expense of banks. Building societies now provide a wide range of retail banking services, and will offer even more in the future. Against this background it may become increasingly difficult to defend £M3 as the principal measure of broad money or liquidity.

10. Some have been attracted by a measure of "wider liquidity" that include all bank, building society, and national savings liabilities because this would supposedly end the quibbling about the appropriate definition of broad money. Even this drastic

CONFIDENTIAL

solution is difficult to justify on the basis of any simple principle. It would not be possible to justify such an aggregate, for instance, by the argument that all the included assets are capital certain. Some assets just outside the widest measures of money or liquidity, such as short dated gilts, are virtually indistinguishable from those marketable assets included in them. Moving to a very wide definition of liquidity by including all assets that could conceivably be included will not finally resolve the difficulties about the definition of broad money.

(3) The rationale for targeting and monitoring broad money

11. There were a number of considerations that led the authorities to go beyond simply monitoring broad money - which they had always done - first to adopting public targets for broad money in the mid-1970s, and then to retaining £M3 as the sole target aggregate when the MTFIS was launched in 1980. The rationale for the role of broad money was broadly based, and the arguments used to justify this role were more complex than the views of, say, certain American monetarists.

*DEE/IMF
early 1970's*

*Expressed back with
fiscal policy etc*

12. Developments in recent years have, however, altered the force of some of these supporting arguments first put forward in the 1970s.

(a) The apparent success of £M3 growth in predicting the inflationary upsurge in 1974/5 was one reason for its enhanced role in the mid-1970s. Subsequent experience has, however, called into question its superiority as a predictor of inflation. Partly because a high and rising proportion of the assets included in the main measures of broad money are interest bearing these aggregates almost certainly include assets that are held primarily for savings purposes though many can, if desired, quickly be used for transaction purposes. There is therefore less reason to expect there to be a close or simple relationship between measures of broad money and total transactions in the economy - and therefore money GDP and inflation - than in earlier years. (M2 was designed to record the movements

of retail transactions balances. There is not yet a sufficiently long run of data to see whether M2 will have a stable relationship with recorded transactions.)

(low M3) ✓

The available empirical evidence on the ability of measures of broad money to predict inflation, or money GDP, now shows them to have little predictive power. For the period since the mid-1970s M0 seems to perform best. (Other narrow aggregates do not perform as well. M1 continues to be a relatively poor predictor.) This contrasts with the perceived position in the 1970s when £M3 was considered by many to be the best predictor among the monetary aggregates monitored.

(b) Another reason for the pre-eminence of £M3 in the 1970s was the belief that the demand for it could be tolerably well explained and that the authorities could adequately control its growth. Stable demand functions for £M3 had apparently been found for the 1960s. These gave grounds for hope that the authorities could achieve the growth of £M3 that they wanted by manipulating short term interest rates. It has, however, subsequently proved impossible, except temporarily, to explain the demand for £M3 in the late 1970s and early 1980s. One reason for this is an inability to measure the shifts in demand for broad money associated with structural change and innovation.

In contrast there has been some apparent success in identifying the effect of financial innovation on M0, with the result that the demand for it has so far been reasonably predictable. This will, however, continue to be the case only if the relevant types of financial innovation continue at a steady and predictable rate. The increased interest bearing component in M1 has given it many of the characteristics - together with the associated problems of interpretation - of broad money.

(c) While counterparts exist in principle for all monetary

CONFIDENTIAL

aggregates, those for £M3 were considered to be particularly helpful as a means of ensuring consistent analysis of fiscal and monetary policy. This was important in the mid 1970s, and again immediately after the upsurge of inflationary pressure in 1978/79, when there was an obvious need to direct all of the available macroeconomic policy instruments to ensuring a large reduction in inflation. The need now is to exert steady downward pressure on inflation on a more modest scale. In current circumstances it is legitimate to analyse the effects of various mixes of fiscal and monetary policy that could exert the required downward pressure on inflation (though these different mixes could have important implications for the real exchange rate and real interest rates). It is not obvious that "counterparts analysis" would necessarily be the best framework within which to discriminate between the various potential mixes of monetary and fiscal policy in the new circumstances of the mid-1980s.

(d) Even before the debate in the 1970s about the desirability of adopting monetary targets there was awareness, dating back at least to Radcliffe, of the dangers if the economy becoming overliquid. With an overliquid economy there was always the risk that the private sector might seek to spend its liquid assets and thus suddenly increase inflationary pressures. If anything the reaction of the private sector to the opportunities presented by liberalisation has made this risk more acute. On the other hand in current circumstances a higher growth of any of the existing measures of broad money or liquidity per se is not necessarily evidence that the private sector is about to increase its spending on anything like the same scale. (This proposition appears to hold as well for some narrower measures of money, such as M1 and M2.) The authorities need to consider other indicators, as well as broad money, before being sure that there is a real risk of higher spending and increased inflationary pressures. In the current liberal environment the authorities can ensure that they detect any inflationary pressures quickly in order to take the necessary corrective

measures, but they cannot remove the "liquidity overhang" unless they put the process of liberalisation into reverse. *justly*

13. Regardless of the precise role of counterparts analysis in the analysis of the overall impact of fiscal and monetary policy, it will always be essential to monitor and assess the implications of the growth of credit and the funding of the government's borrowing requirement. *explain why*

(a) Financial liberalisation has had a very large positive effect on the growth of credit to the personal sector. It is likely that the authorities for some time to come will be in the unsatisfactory, but unavoidable, position of having to monitor credit without having clear ideas about the appropriate growth rate.

(b) There is a wide range of views on the effect (after the very short run) of funding on £M3 and other measures of broad money. At one extreme some believe that reduced funding could have negligible effects on broad money and money GDP in the long run. At the other extreme it is possible that reduced funding would have significant positive effects not only on the growth of broad money but on money GDP as well (though the effects on velocity could be similar to the first extreme). The most widely held view in the Treasury and Bank is that reduced funding - which will be the result of the decision to end "overfunding" - will have a significantly greater proportional effect on £M3 than on money GDP, ie that reduced funding will lead to lower velocity. The smaller (proportional) effect of reduced funding on money GDP than on broad money could in part be the result of short term interest rates needing to be higher than they would otherwise have been in order to maintain the same downward pressure on inflation. On this view, therefore, reduced funding is likely to reinforce the effects of other factors in causing the velocity of broad money to fall in the foreseeable future.

(4) The interpretation of monetary conditions and the control of broad money

14. The difficulties in explaining both the behaviour of broad money and the significance of its behaviour for the rest of the economy have led to greater weight being placed in the interpretation of monetary conditions on other monetary aggregates and other indicators of monetary conditions, notably the exchange rate. There was never exclusive concentration of £M3 in internal assessments of monetary conditions that led to decisions on interest rate policy, but there has been a notable change of emphasis during the 1980s. There has also been a change of emphasis in the public presentation of monetary policy, especially since the 1982 MTFs. The analysis in the paper suggests that there is no immediate prospect of a reduction in the difficulties in interpreting the behaviour of broad money and therefore no prospect of reverting to the earlier, more straightforward, approach.

15. In practice the authorities have to a greater extent than in the late 1970s relied in the monitoring of monetary conditions on non-monetary variables that appear to have given reasonable advance warning of major inflationary pressures in the past. As well as the exchange rate these include various asset prices and certain indicators of wage and input costs. There is, however, a range of views both on the extent to which these gave useful advance warning of the hikes in inflation in the mid and late 1970s, and on the adequacy of the advance warnings of inflation that they might give in the 1980s. Nevertheless they are likely to play an important role in the assessment of monetary conditions for the foreseeable future.

16. Developments in recent years have exacerbated the problems of controlling broad money. With the share of interest bearing assets having risen for all measures of broad money there can be no certainty that a rise in short term interest rates will reduce the growth of broad money sufficiently quickly for such a rise to be an effective policy instrument for within target

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period control. This uncertainty about the effects of short term interest rates on broad money does not mean that there is an equivalent uncertainty about the effect of short term interest rates on monetary conditions as a whole.

17. There are no obvious alternative instruments that in present circumstances are available for the control of broad money with a tolerable degree of precision. Fiscal policy cannot in practice be varied within year to achieve a desired effect on broad money. The decision to end overfunding has reduced the scope for discretionary funding as an instrument for the control of broad money. The use of quantitative controls - such as reserve asset ratios or credit controls - would reverse the liberalisation that has occurred since 1979, and in any case would be ineffective without the reimposition of exchange controls.

THE SIGNIFICANCE OF BROAD MONEY

Introduction

Since the early 1970s the monetary authorities have monitored the behaviour of broad money, and continuously since 1977 they have set public targets for the growth of £M3. The purpose of this paper is to explain both the changing behaviour of broad money and the significance of its behaviour for wider economic developments.

2. During the years covered by this study there have been major changes both in the overall aims and tightness of macroeconomic policy, and in the techniques of monetary supervision and control. The most notable change in the approach to overall macroeconomic policy was the adoption of the MTFs in 1979/80, though there were important changes of approach in earlier years. The most important changes in monetary control were the adoption of CCC in 1971 and the abolition of exchange controls and the corset in 1979 and 1980 which ushered in a period of adjustment to a major liberalisation of the financial system. It is not surprising that in the face of such "shocks" the behaviour and significance of broad money has altered significantly. Indeed because some of the most important shocks have occurred in recent years and their effects are still unfolding it is not possible to be at all sure how to interpret the behaviour of broad money at the moment. This paper sets out our interpretation of broad money on the basis of the available evidence.

3. The discussion in the paper is arranged as follows:

Section 1 summarises the behaviour of broad money since the mid-1960's, including its performance against the target ranges set by the authorities, and discusses the large changes in velocity that have occurred. There is a brief discussion of the trend changes in the composition of broad money. This covers both the important changes in the particular financial assets included in it and the changes in the relative importance of holdings by the main sectors of the economy.

Section 2 examines the familiar and longstanding problem of the appropriate definition of broad money and in particular of £M3. This is the problem of "where to draw the line", to which there is no obvious solution. This section discusses in particular the extent to which financial liberalisation and innovation together with the enhanced role of building societies, have made it more difficult to justify the use of £M3 as the principal measure of broad money or liquidity.

Section 3 examines some of the original arguments for monitoring and targeting broad money, and in particular £M3, and examines the extent to which recent developments have altered the force of some of these. This section discusses the role of "counterparts analysis" and assesses in some detail the behaviour of credit and the role of funding.

Section 4 examines the implication of the analysis of the behaviour of broad money in the earlier sections for the monitoring of monetary conditions, and assesses the extent to which the authorities' ability to control broad money with the available policy instruments has declined.

Much of the discussion in the paper concerns the changes that have occurred as the financial system has ceased to be highly controlled and has become one of the most liberal systems in the world. A note prepared in the Bank summarises the various controls on credit that operated at different times since 1945. This background material is attached as Annex I. Annex II lists some other working papers on particular topics that were written in the Treasury or the Bank while this paper was being prepared. Copies of these are available on request.

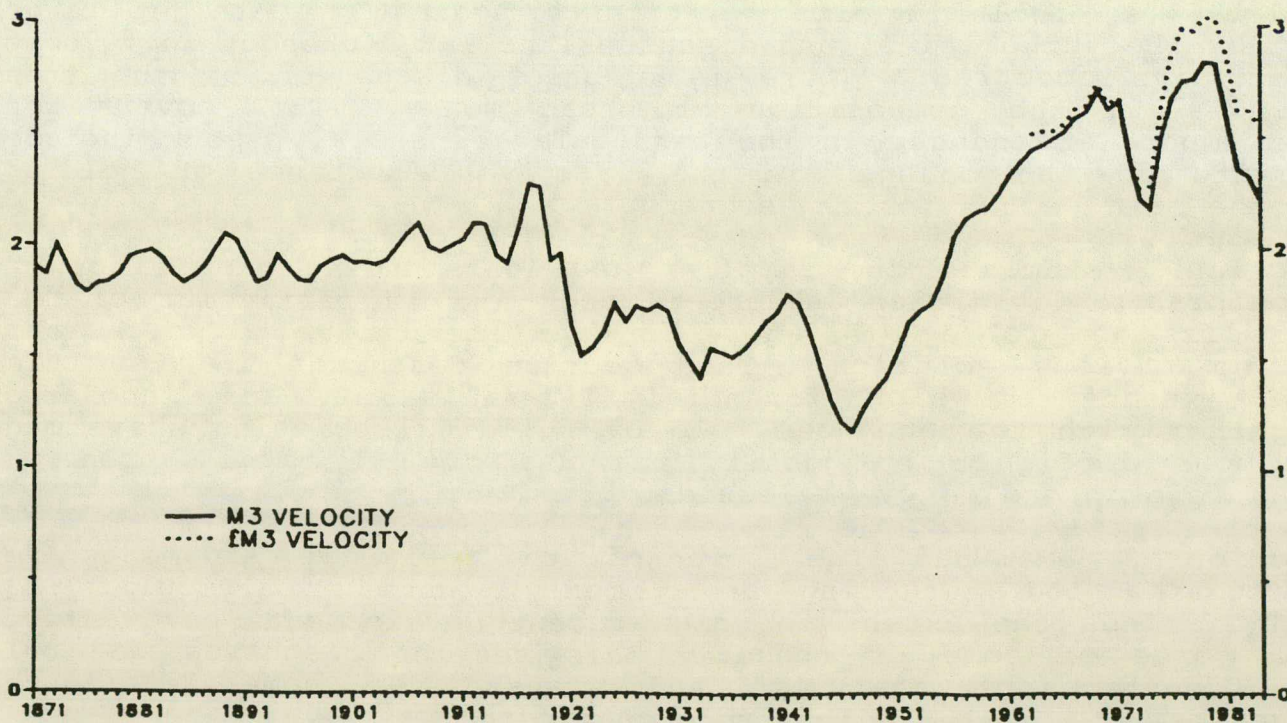
(1) PRINCIPAL DEVELOPMENTS SINCE THE EARLY-1960s

4. Four main measures of broad money - £M3, M3, PSL1 and PSL2 - are collected and published on a regular basis. From time to time alternative measures, such as the wider sterling aggregate, are made available. In this paper the emphasis is on £M3, PSL2 and another aggregate - "wider liquidity" - which is PSL2 plus all other deposits with building societies and all other national savings not included in PSL2. The precise definitions of all the broad money aggregates are set out in Annex III.

Overview

5. When examining the behaviour of broad money over the last twenty years or so it is worth bearing in mind the principal developments over a much longer period. Chart 1 shows the velocities of total M3 - the ratio of money GDP to M3 - from 1870 to the present day and of £M3 from 1963. Four main phases can be identified.

CHART 1 : M3 VELOCITY 1871 - 1984



- (i) From 1870 to the first world war velocity was broadly constant.
- (ii) Following a fall in velocity towards the end of the first world war and in the immediately following years, there was a further period of relative constancy until the second world war.
- (iii) Apart from a sharp fall in velocity in 1971-73, which was soon reversed, velocity rose from the end of the second world war until 1979.
- (iv) During the 1980s velocity has fallen sharply.

6. The initial post-second world war rise in velocity was not unexpected and probably reflected the fact that due to the continuance of wartime controls, which restricted the availability of consumer goods, the economy was over-liquid. A further rise occurred from the mid-1950s during a period when because the financial system was obviously becoming more sophisticated it was thought that technical developments were encouraging economies in the use of money. Probably a more important factor was that throughout much of the period to 1980 the banks were subject to a series of controls on their asset portfolio which inhibited the growth of their liabilities. (Annex I summarises these controls.) It is the apparent change in relationship between broad money and money GDP when the 1980s are compared with most earlier post-war experience that this paper examines and seeks to explain.

7. Table 1 summarises the behaviour of broad and narrow money, money GDP, inflation and interest rates over various sub-periods since the early 1960s. Chart 2 shows that the velocities of all three measures of broad money exhibited the same broad pattern - that is they rose during the 1960s (except for PSL2), fell during Competition and Credit Control (CCC), but rose over the 1970s as a whole, and fell during the 1980s. Chart 3 compares growth rates of money GDP and retail prices with those of narrow and broad measures of money. (The formal statistical evidence on the relationship between money and prices and money GDP is summarised later in the paper in section 3(ii) below.)

*Most tables in the paper use calendar quarter data for the monetary aggregates because they are available for a much longer period than banking month data and also because of the need to make comparisons with other economic variables such as money GDP. The main exception is table 2 which is concerned with monetary growth over target periods which were usually based on banking months. Annex III describes in more detail the data used in the charts and tables.

CHART 2 : VELOCITY OF BROAD MONEY AGGREGATES

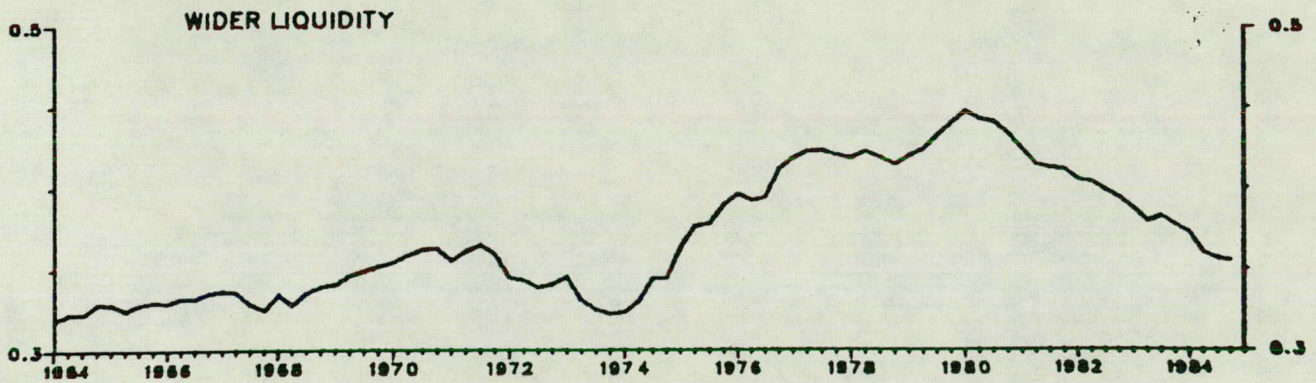
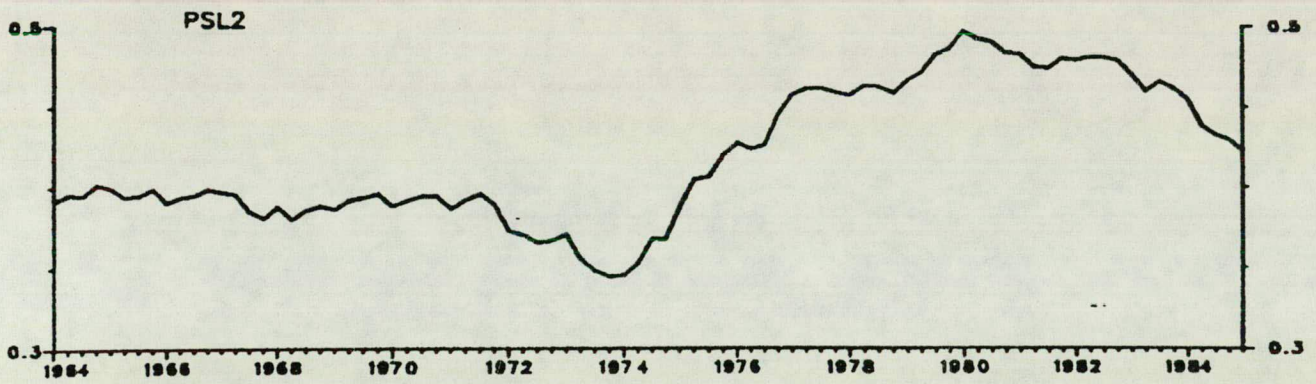
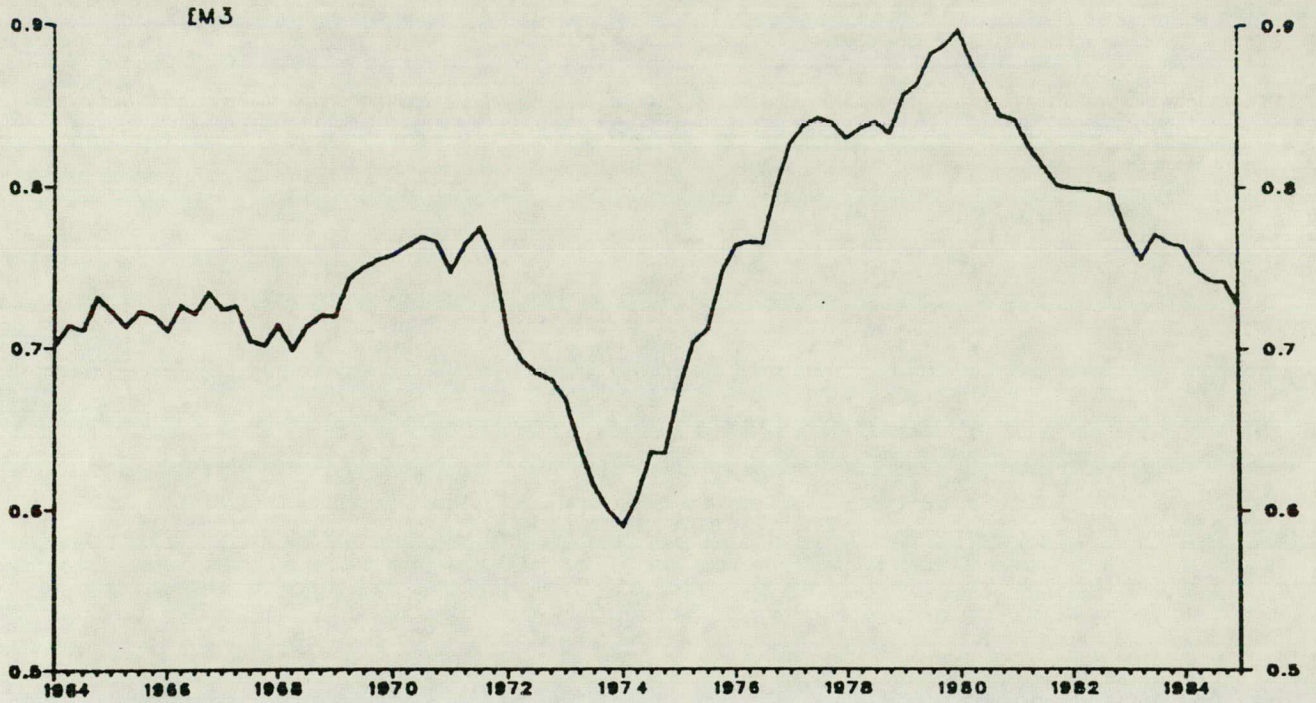
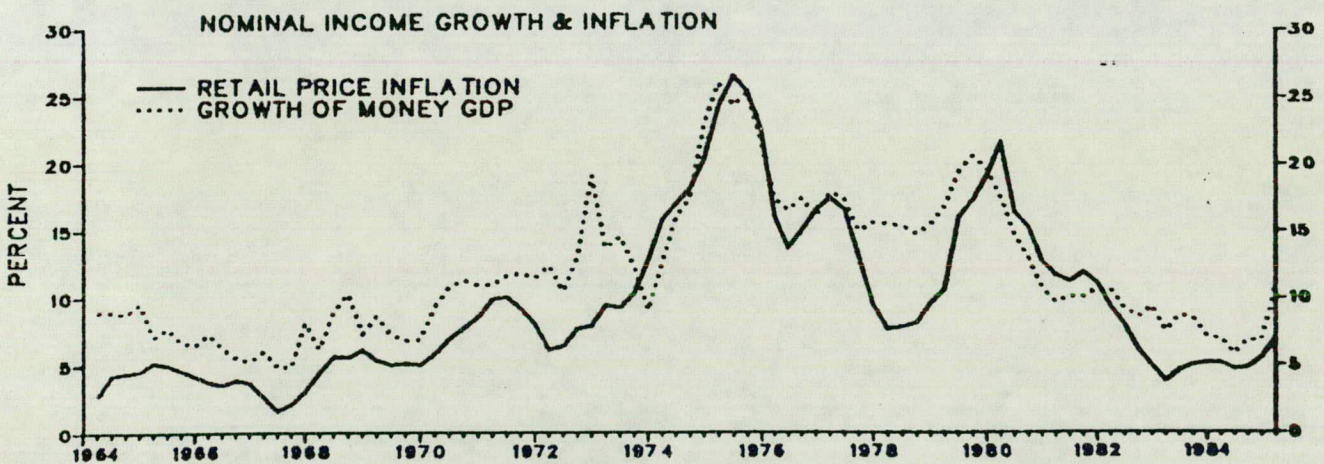
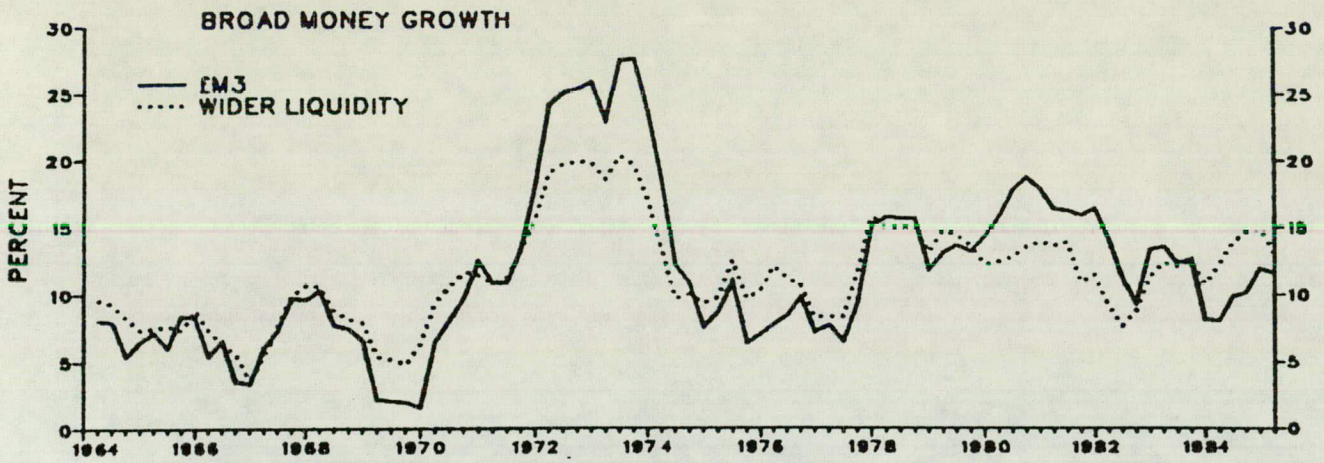
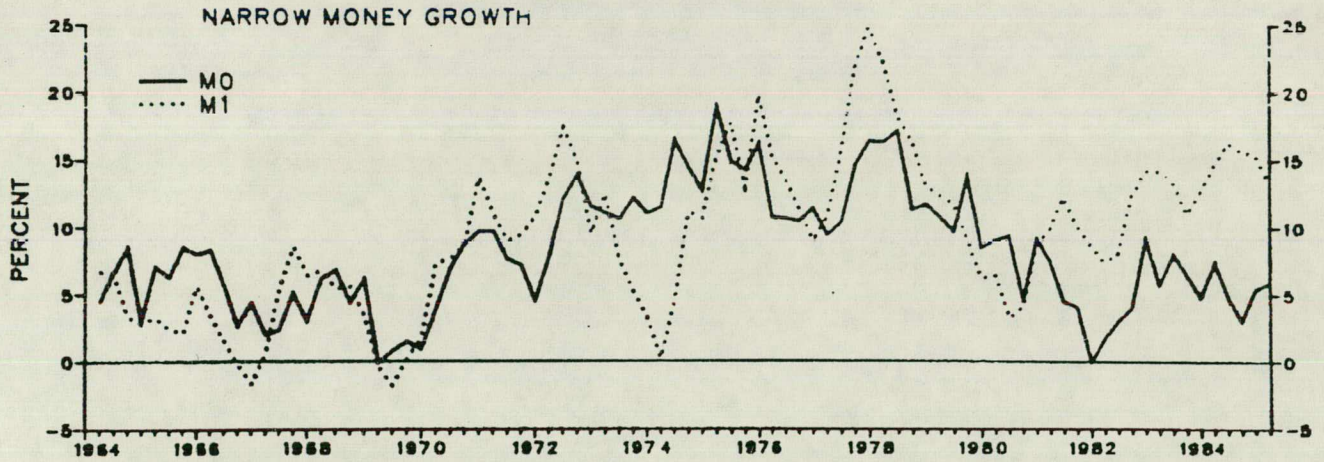


CHART 3 : MONETARY GROWTH AND INFLATION 1964 - 1985
(FOUR QUARTER CHANGES)



NOTE: M0 GROWTH RATES ARE ADJUSTED FOR BREAKS IN THE SERIES CAUSED BY CHANGES IN THE DEFINITIONS OF BANKERS BALANCES.

TABLE 1

BROAD AND NARROW MONEY, INFLATION, MONEY GDP (ALL AVERAGE ANNUAL % CHANGES)
AND INTEREST RATES

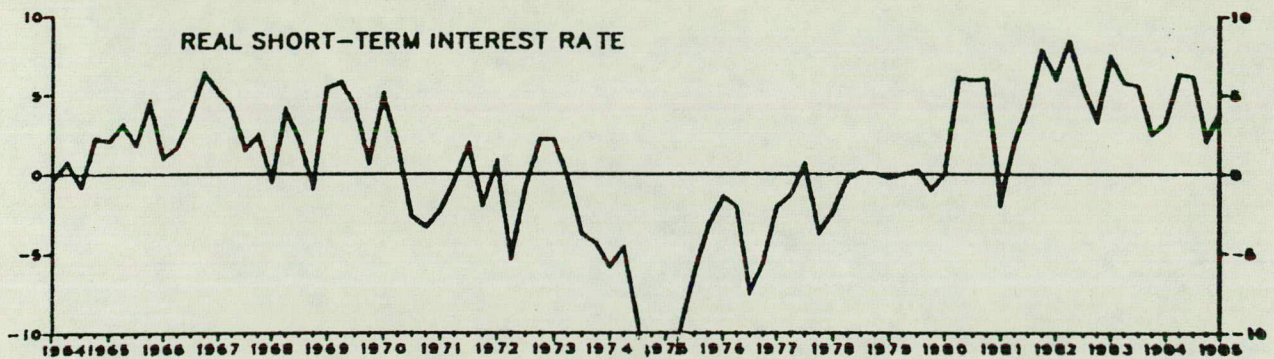
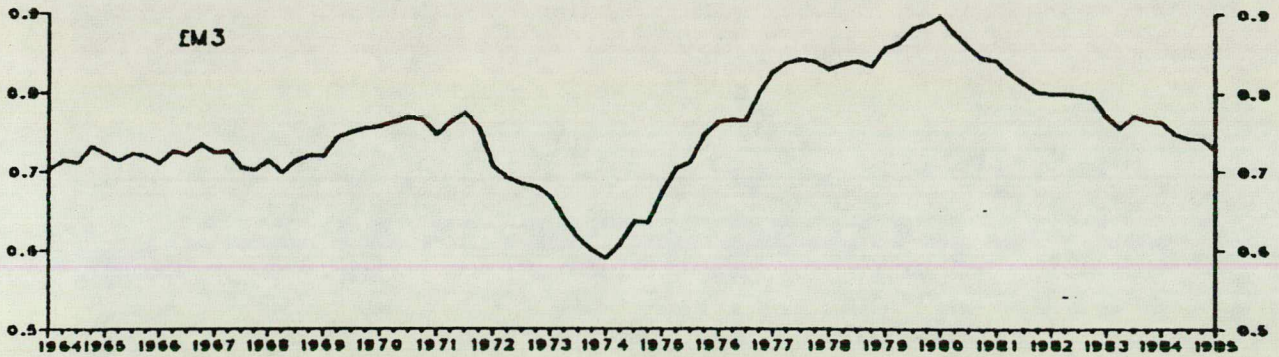
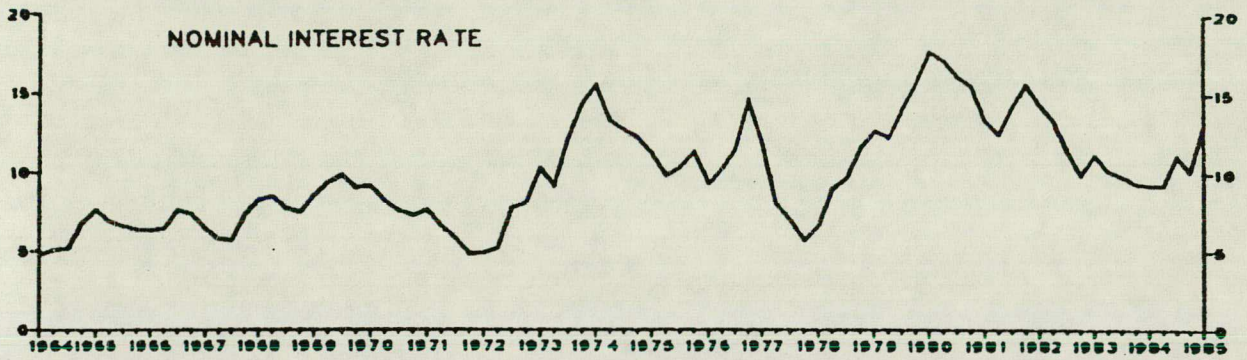
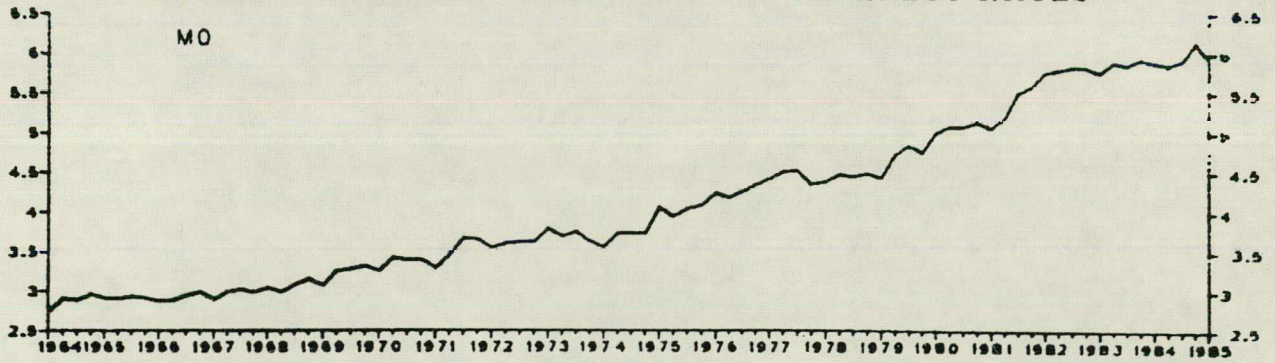
	Narrow Money		Broad Money			Money GDP	Inflation (RPI)
	MO	M1	£M3	PSL2	"Wider Liquidity"		
1963-70	5½	4	6½	8	7	8	5
1970-73	10	10	22	17½	17	12½	9
1973-79	13	14	11	12	12½	18½	16
1970-79	12	12½	14½	13½	14	16½	14
1979-84	4	10½	13½	12	14	9½	8½

	Narrow Money Velocity		Broad Money Velocity			Short Interest Rates	
	MO	M1	£M3	PSL2	"Wider Liquidity"	Nominal	Real
1963-70	2	3½	1	0	½	7½	2
1970-73	2	2½	-8	-4½	-4	8	-1
1973-79	4½	4	7	6	5½	11	-5
1970-79	4	3½	1½	2½	2	10	-3½
1979-84	5½	-1	-3½	-2½	-4	12½	5

8. Chart 4 compares narrow (MO) and broad money (£M3) velocities with the levels of nominal and real short term interest rates. MO velocity, which has been on an almost unbroken upward trend since 1963, is likely to be influenced more by nominal than real rates. As a non-interest bearing aggregate, MO is not used as a savings medium and so is unlikely to be related to financial wealth. A higher level of nominal interest rates will therefore cause substitution towards interest bearing financial assets, reducing the demand for MO for a given level of transactions. This points to a positive relationship between MO velocity and nominal interest rates. While such a relationship may not be at all obvious from Chart 4 there is some econometric evidence in its favour.

9. Broad money, with its large interest bearing element, contains more savings. It is likely therefore to be positively related to financial wealth, and to be unaffected by changes in the level of nominal interest rates, unless these involve changes in relative rates. (See section 3(iii) below for a fuller discussion of the possible effects of nominal interest rates on broad money.) There is now some evidence suggesting that high real interest rates reduce expenditure and encourage saving so if there is a positive relationship between real interest rates and financial wealth there would also be a positive relationship between real rates and broad money, ie a negative relationship with broad money velocity. This is, however, a difficult area in which to come to firm conclusions. It may be that changes in the expected real returns on other assets - such as property - between, for instance, the early 1970s and the early 1980s have also had important effects on the willingness to hold interest bearing financial assets.

CHART 4 : INCOME VELOCITIES AND INTEREST RATES



NOTE: THE MINIMUM VALUE OF THE REAL SHORT TERM INTEREST RATE WAS -10 IN 1975

1971-74: Competition and Credit Control

10. In 1971 there were major structural changes in the banking system as a result of the introduction of Competition and Credit Control: many direct controls on the banks were relaxed or abandoned. At the same time an expansionary fiscal policy was adopted. As chart 3 illustrates, there was a sharp rise in the growth of all measures of broad money - £M3 grew particularly quickly at over 20 per cent per annum. At the time it was not clear to what extent the acceleration in broad money growth represented a substantial easing of monetary policy rather than a once-for-all adjustment to the structural changes. Although it is still difficult, even with the benefit of hindsight, to disentangle these two factors it is now clear that there was a significant easing in monetary conditions in 1972 and 1973. An acceleration in M0 from early 1972, rapidly rising asset prices, and a falling exchange rate all point in this direction.

11. Towards the end of 1973 monetary policy was tightened significantly. Short-term interest rates rose from 9-10 per cent in the first half of 1973 to over 16 per cent by the end of the year. The corset was introduced for the first time in December 1973 and remained in place until February 1975. Partly as a result broad money growth more than halved to around 10 per cent by the end of 1974.

1974-79: Introduction of Monetary Targets

12. In April 1976 formal monetary targets were first introduced: it was announced that M3 would grow in line with money GDP. The first positive move to precise quantitative targets came in July of that year when the Chancellor announced that M3 should grow by 12 per cent during 1976-77. There was, however, some ambiguity about whether this was a forecast or target. This ambiguity was removed in December 1976 when a range for M3 consistent with the DCE ceiling agreed with the IMF was announced. Targets for M3 or £M3 have been a feature of monetary policy ever since. *(Ideally which the £M3 target formally replaced) DCE until which was 1977*

13. Table 2 compares targets and outturns for M3 and £M3. The experience in the 1970s was mixed. An undershoot in 1976-77 was followed by a significant overshoot in 1977-78 - largely due to substantial external inflows which eventually led to sterling being "uncapped" late in 1977. £M3 growth in financial year 1978-79 was, however, close to the middle of the target range, although growth in the year to October 1979 was slightly above the Labour Government's initial target range, and nearly two points above the new Conservative Government's lower target range for the same period.

14. The monetary targets announced in the 1970s were not accompanied by public money GDP forecasts so it is difficult to say on what assumptions about the behaviour of velocity the targets were based. Over the 1974-79 period as a whole money GDP grew much faster than £M3, and the average annual rate of increase of velocity was nearly 7 per cent. The average annual rates of growth of velocity for PSL2 and "wider liquidity" were in the range 5-6 per cent.

TABLE 2
 TARGETS AND OUTTURNS FOR BROAD MONEY AND VELOCITY - % GROWTH
M3/£M3 Money GDP(1)

Target Period(2)	Target	Outturn	Forecast	Outturn	Implied Target
1976-77	9-13	7½			
1977-78	9-13	16			
1978-79 I	8-12	10½			
1978-79 II	8-12	12½			
1978-79 III	7-11	12½			
1979-80	7-11	10			
1980-81	7-11	18½			
1981-82	6-10	13	15½	10½	+ 4 to + 8
1982-83	8-12	11	12½	10½	+ 2 to + 6
1983-84	7-11	10	8½	9½	- 3 to + 1
1984-85	6-10	12	9	7	- 2 to + 2
			6½	8	- 3 to + 1

(1) Explicit money GDP projections were first published in March 1980 but implicit projections could be calculated approximately from the 1980 and 1981 MTFSS. These figures are unpublished growth rates to W4 of each year. These are not the whole year on whole year figures in the MTFSS.

(2) See Annex III for precise definition of target periods.

15. Taking the 1970s as a whole velocity grew faster on average than in the 1960s. This may in part have been due to the emergence of zero or negative real short-term interest rates in the 1970s (see Chart 4) which could have encouraged real expenditure and increased the demand for real assets at the expense of financial asset holding. This acceleration was more marked for the wider aggregates than for £M3 probably because of the effects of relaxing the controls on banks at the beginning of the decade.

1980-85: The Medium Term Financial Strategy and financial liberalisation

16. The Conservative Government took office in 1979 committed to reducing the rate of inflation by progressively reducing the rate of growth of the money supply. In the early stages of this strategy only £M3 was targeted, although the 1980 MTFSS noted that the way in which the money supply would be defined for target purposes might need to be adjusted from time to time as circumstances changed. Initially, however, rather than falling, the rate of growth of £M3 rose. In late 1980 it reached 17-18 per cent (see chart 3). This rapid expansion reflected in part the unexpectedly large amount of reintermediation which followed the abolition of the corset in June 1980. The rates of growth of the wider liquidity aggregates did not rise at this time by as much as that of £M3. More recently they have grown faster than £M3 and at much the same rate as in the 1970s. The record of hitting the £M3 target has not been as bad as the foregoing discussion might suggest. Table 2 shows that of the five targets announced for the year immediately ahead in the MTFSS two have been hit and three exceeded, although the success in the 1982-83 MTFSS is explained in part by the upward revision of the target ranges.

17. Despite the overshoots of the intermediate targets, the rates of growth of money GDP and prices behaved much as intended. After an

initial surge - largely associated with the second oil price shock, the earlier rises in earnings and the implementation of the Clegg awards for public sector pay, and the increase in VAT to 15 per cent - both have fallen back well below the growth rates experienced in the 1970s. Comparing 1980-84 with 1974-79, growth rates of money GDP and retail prices have virtually halved.

18. The 1980s have been a period of major financial innovation and liberalisation. At least part of the high growth of £M3 and other measures of broad money can be attributed to the liberalisation of the domestic financial system, which became inevitable once exchange controls were abolished in 1979. The most obvious effect of liberalisation has been on the personal sector. It has become much easier for the personal sector to come close to holding the amounts of gross financial assets and liabilities that they want at prevailing incomes and interest rates. This has led to a rapid growth in the gross financial wealth and gross indebtedness of the personal sector over the last five years or so. It is estimated that by the end of 1983 the gross financial wealth of the personal sector was about 20 per cent (£23½ billion) larger than it would otherwise have been on this account.* The building societies and the life assurance and pension funds have benefitted from the higher personal sector gross wealth. Even if these institutions had maintained an unchanged composition for their asset portfolios, their holdings of liquid assets would have grown rapidly simply because of the scale of inflows from the personal sector. In the event they increased the share of holdings of cash and bank balances, which have as a result grown faster than their total assets. This has contributed to an increased OFI share of £M3.

19. Other developments in these years that may not have been directly, or even indirectly, the result of liberalisation have almost certainly inflated £M3 (and therefore wider aggregates). There has been a growth in a number of financial practices available to large companies and OFI's - swaps, hedges, etc (analysed in paper 3 listed in Annex II). There has been competition among banks for corporate and OFI deposits. This has led to a fall in the list of financial transactions for companies. Such developments have encouraged more active liquidity management on the part of corporate treasurers and OFIs and is likely to have inflated banks' balance sheets and reduced velocity.

20. All broad measures of money have been affected by the financial innovation and liberalisation of recent years, but while it is fairly certain that the velocities of the wider aggregates (PSL2 and wider liquidity) have been reduced by the changes, the same is not necessarily true of £M3. One of the effects of liberalisation was to give an added impetus to the changes that were taking place in the building societies, thus leading to the ending of their interest rate cartel. This has led to the building societies continuing to increase their share of the retail savings market. So liberalisation (insofar as it primarily influenced retail banking) will, broadly speaking, only have influenced £M3 (compared with what it would otherwise have been) if the effect of their loss of share in the retail market was not sufficient to offset the effect of the larger total retail market (roughly bank plus building society retail deposits). At times in recent years eg in 1984 - some commentators have argued that £M3 has been depressed by competition with building societies in the new liberal environment. (Some even argued that the government

*The effect of liberalisation on the personal sector is discussed in Barry Johnston's paper The demand for personal sector liquidity aggregate in the UK. The paper presents tentative estimates of some of the effects of liberalisation.

kept £M3 as its principal target because it was a misleading indicator of tightness and therefore enabled it to have a looser monetary stance than at first appeared to be the case.) In the light of all the developments in recent years - including those relating to company sector behaviour described in paragraph 19 - it seems fairly certain that £M3 has been inflated, though probably not by as much as the PSLs and wider liquidity.

The composition of broad money

21. In the light of the foregoing analysis it is useful to summarise the main changes in the composition of broad money. There have been major changes in the composition by asset - notes and coin, non-interest bearing deposits, interest-bearing deposits and other instruments - as well as in the proportions held by the principal sectors of the economy - the personal sector, companies, and other financial institutions (OFI's).

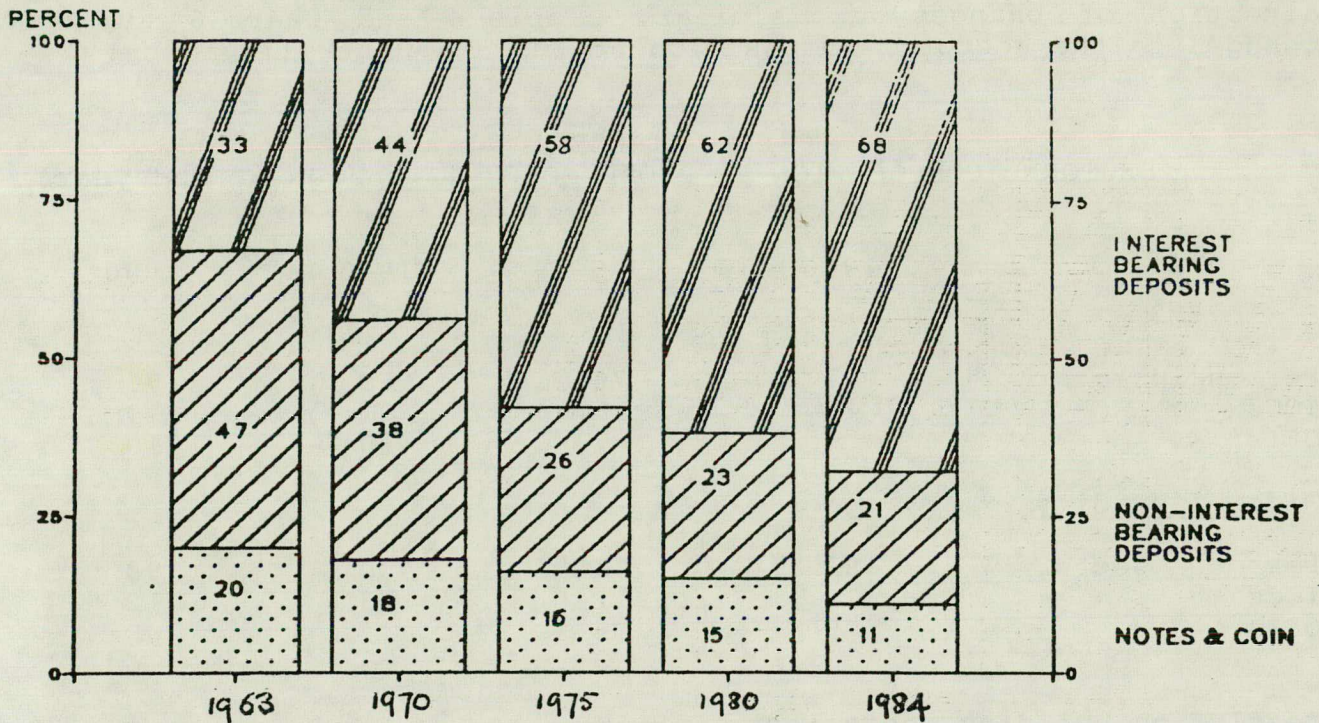
22. Reliable data on the split of £M3 between non-interest-bearing (NIB) and interest-bearing (IB) money are not available prior to 1975, but the split can be approximated by assuming that before 1975 no current accounts paid interest. Table 3 and Chart 5 summarise developments in the asset composition of £M3.

TABLE 3
COMPOSITION OF £M3 AND "WIDER LIQUIDITY" (% shares at end year)

	<u>1963</u>	<u>1970</u>	<u>1975*</u>	<u>1980</u>	<u>1984</u>
<u>£M3</u>					
Notes & coin	20	18	16	15	11
NIB deposits	<u>47</u>	<u>38</u>	<u>28/26</u>	<u>23</u>	<u>21</u>
Total NIB	67	56	44/42	38	32
IB deposits	33	44	56/58	62	68
<u>Wider Liquidity</u>					
Notes & coin	11	9	7	8	5
NIB deposits	<u>27</u>	<u>20</u>	<u>14/13</u>	<u>12</u>	<u>10</u>
Total NIB	38	29	21/20	20	15
IB	62	70	78/79	80	85

*Annex III explains the changes in definition underlying the alternative estimates for 1975

CHART 5 : COMPOSITION OF £M3



NOTE: PRIOR TO 1975 NON-INTEREST BEARING DEPOSITS ARE APPROXIMATED BY CURRENT ACCOUNTS.

23. The proportion of non-interest bearing money in £M3 has fallen dramatically from about two-thirds in 1963 to about one-third in 1984. The shares of notes and coin and NIB deposits have both fallen. The rate of decline of the NIB share in recent years has been quicker than in the 1960s and 1970s.* The counterpart has been a rise in the interest-bearing share which had reached nearly 70 per cent by the end of 1984. The disaggregation of interest bearing £M3 between retail and wholesale deposits is available only from November 1981, since when the wholesale share of £M3 has risen from 33 per cent to over 40 per cent. This rise in the interest bearing - and in particular the wholesale interest bearing - share of £M3 has had important implications for the significance of the behaviour of £M3. (Section III below discusses the extent to which £M3 has been a useful measure of balances held for transaction purposes.)

24. There has been a similar sharp rise in the share of interest bearing assets in wider liquidity. Because all the assets which are added to £M3 to get "wider liquidity" are - and always have been - interest bearing, the share of interest bearing assets is considerably higher than for £M3. At the end of 1984 85 per cent of wider liquidity was interest bearing.

25. The allocation of £M3 between sectors has changed quite markedly since the mid-1960s and in particular since 1980. There has been a rise

*About one percentage point of this is the result of the redefinition of the monetary sector in 1981.

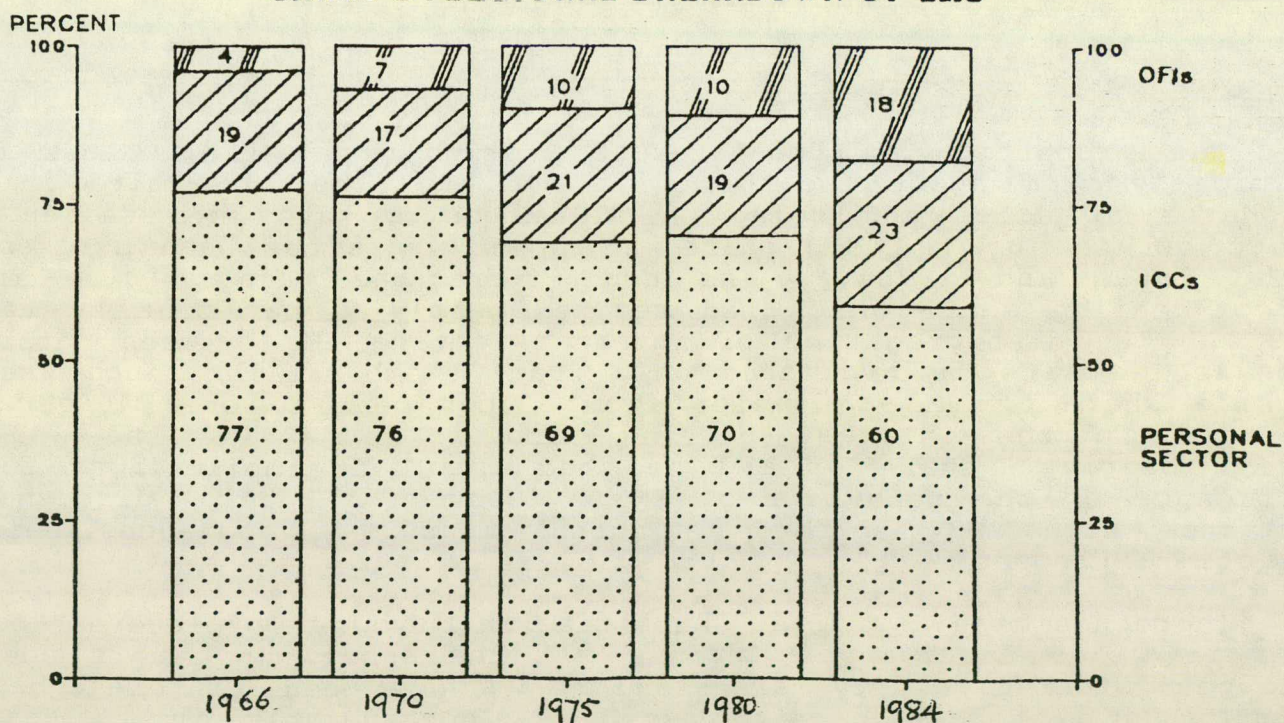
in the proportion of £M3 held by OFIs and a decline in the personal sector share. The shares of wider liquidity have changed less, although the direction of changes are similar. Table 4 and Chart 6 summarises the changes in the sectoral composition of £M3 and wider liquidity.

TABLE 4
SECTORAL COMPOSITION OF BROAD MONEY (% shares at end year)

	1966	1970	1975	1980	1984
£M3					
Personal sector	77	76	69	70	60
ICCs	19	17	21	19	23
OFIs*	4	7	10	10	18
Wider liquidity					
Personal sector	83	84	80	83	80
ICCs	12	11	13	12	13
OFIs	5	6	7	5	7

*excluding building societies.

CHART 6 : SECTORAL BREAKDOWN OF £M3



(2) THE DEFINITION OF BROAD MONEY

26. In principle what distinguishes broad from narrow money is that it includes, in addition to financial assets which can be used directly in transactions such as cash and sight deposits with banks, assets which can easily be used to finance expenditure without risk of significant capital loss. In practice, however, it has always been extremely difficult to define broad money and any dividing line between financial assets included in and excluded from 'money' has always been to some extent arbitrary. As banks for most of the period under review provided the only money transmission mechanism apart from cash and have also been fairly relaxed about their customers switching the form of their deposits there has been a strong case for including in the main broad money measure all residents' sterling deposits with banks. However the rising share of interest bearing money in £M3 means that many forms of bank deposit are now used as much as, and in some cases primarily as, savings media as for potential transactions. Their use as savings media is even more likely when real interest rates are high as in the 1980s. The relationship between £M3 and transactions may therefore be weak.

27. One obvious response has been to attempt to construct a narrow "transactions" measure of money. M2 is, however, a young aggregate and its behaviour and suitability as a measure of transactions balances is not proven. But it has become increasingly difficult not to go wider than £M3 and also include in broad money building society deposits and certain forms of national savings which have increasingly taken on the characteristics of banks deposits.* Moreover the tendency for building societies to provide retail banking services is certain to become more pronounced in the future. This argument has already been given official recognition by the introduction in 1979 of the two liquidity aggregates PSL1 and PSL2. It is difficult now to make a case in favour of PSL1 which was mainly useful at a time when private sector commercial bill holdings were expanding quickly as a result of the effects of the corset. Even PSL2, a fairly wide aggregate, is not without its problems. For example there has been a tendency for building societies to make it easier to withdraw funds from term shares. Nevertheless term shares continue to be excluded from PSL2. Some national savings instruments, notably certificates on extension terms and index-linked certificates over a year old, both excluded from PSL2, present similar problems. These factors have tended to make PSL2 velocity higher than it otherwise would have been. Yet, as with £M3, PSL2 velocity has fallen in the 1980s, breaking its long-term trend and making interpretation of its behaviour difficult.

28. Going even wider than PSL2 by including all building society deposits and all national savings, as in the 'wider liquidity' aggregate used in this paper, will not resolve all the problems however. Some assets within wider liquidity such as CDs and bills are marketable and are not easy to distinguish from other excluded marketable assets that are virtually capital certain, such as short gilts. There is therefore no feasible definition of broad liquidity that will be wholly immune to the criticism that it excludes assets that should be included. Furthermore as the definitions are expanded to include hitherto contentious assets the more exiguous will the relationship between the aggregate and transactions.

29. The desire to have an aggregate which is more closely related to transactions lay behind the decision taken in 1977 to create a new

*M2 does of course include very liquid building society deposits while attempting to exclude bank and building society liabilities that are less likely to be held to finance transactions.

aggregate, £M3, by excluding residents' deposits in foreign currency from M3. The rationale was that deposits in foreign currencies need to be converted into sterling prior to being spent and under floating exchange rates the sterling value of foreign currency deposits is uncertain (unless covered forward) and therefore such deposits are no more capital certain than, say, short gilts. Furthermore, if foreign currency deposits were converted into sterling the resulting rise in the exchange rate would provide an early warning of such behaviour and would act to offset any adverse monetary consequences. More generally, it was thought that foreign currency deposits were related to UK residents' activities abroad and might have little bearing on current or future domestic expenditure. This is likely to be less true, however, since the abolition of exchange controls.

30. Similar considerations have led to the exclusion from the main broad money aggregate of non-residents' holdings of foreign currency and sterling deposits in the UK. Non-residents' holdings of foreign currency deposits in particular may not have much bearing on expenditure within the UK. It is not clear, however, that this argument has the same force with non-resident sterling deposits. Offshore sterling deposits may also have implications for domestic monetary conditions.

31. Table 5 shows how the deposits excluded from £M3 have grown in relative importance in recent years. The banks' foreign currency liabilities in particular have risen rapidly, from virtually nothing in 1963 to over \$500 billion last year. As a result the deposits in £M3 are a relatively small proportion of the value of banking business booked in the UK (though of course it was never the intention that £M3 should measure this). Very much the same is true of the asset side of the balance sheet with sterling lending to residents accounting for only 21 per cent of the total.

TABLE 5
TOTAL ON-SHORE LIABILITIES AND STERLING OFF-SHORE LIABILITIES OF BANKS

\$ billion End year	<u>On-shore Liabilities</u>		<u>Off-shore Liabilities</u>		<u>Total Sterling</u>
	<u>To residents</u>	<u>To non-residents</u>	<u>To residents</u>	<u>To non-residents</u>	
	<u>Sterling*</u>	<u>Foreign Currency</u>	<u>Sterling</u>	<u>Foreign Currency</u>	
1963	31	-	5	4	n/a
1970	41	1	5	36	n/a
1977	84	8	11	171	10
1984	130	24	35	496	19

* £M3

32. Not only does £M3 represent a relatively small part of total deposits booked with banks in the UK, it is also by no means all of their sterling business. Table 6 shows that it was 79 per cent of total sterling deposits booked in the UK at end 1984, with the other 21 per cent accounted for by non-resident deposits. The current share of residents' sterling deposits in total sterling deposits booked in the UK is now lower than it was in the 1970s when it was just under 90 per cent. If account is taken of Euro sterling deposits the share of £M3 in total sterling deposits is lower still at just over 70 per cent. With the banks now to a very considerable extent engaging in liability management of their balance sheets using vast international wholesale money markets it is unlikely to be of any significance to them whether the sterling funds they raise are from residents or non-residents. £M3 is now, and to a certain extent always was, a rather narrowly defined broad monetary aggregate.

TABLE 6
SHARE OF £M3 DEPOSITS - END YEAR (%)

	<u>In residents' total onshore deposits</u>	<u>In total onshore deposits</u>	<u>In total onshore sterling deposits</u>	<u>In total sterling deposits (including euro £)</u>
1963	99	78	86	n/a
1970	97	49	89	n/a
1977	91	31	88	80
1984	84	19	79	71

33. A wider sterling aggregate that comprised £M3 plus overseas non-bank sterling deposits with UK banks plus overseas' banks net sterling deposits with the UK banks was examined in the December 1983 Bank of England Quarterly Bulletin. Table 7 summarises the behaviour of the wider sterling aggregate, only available from 1975, and total M3 (£M3 plus residents' foreign currency deposits with UK banks). Although residents' foreign currency deposits grew much faster than £M3 during both periods shown in table 7, the difference was not sufficient, given their small share in M3, to generate a significant difference between £M3 and M3 growth rates in the first period. In the 1980s, however, M3 has grown markedly faster than £M3, though much of this represents what was probably a once-for-all adjustment to the abolition of exchange controls. The wider sterling aggregate and £M3 grew at much the same rate between 1975 and 1979 but the wider sterling aggregate has accelerated relative to £M3 in the 1980s. It is difficult to conclude from the foregoing analysis that the wider sterling aggregate would have had a close relationship to money GDP or been a more suitable aggregate to monitor than £M3.

TABLE 7
A WIDER STERLING AGGREGATE AVERAGE ANNUAL GROWTH RATES

	<u>1975-79</u>	<u>1980-84</u>	<u>End 1984 level £ billion</u>
1. £M3	11½	11	113
2. Residents' foreign currency deposits*	17½	22	21
3. M3*	12	13½	134
4. Wider Sterling Aggregate	11½	12½	145

*Transactions only, excluding valuation changes in residents' foreign currency deposits.

34. The period during which the banks have expanded the proportion of their business conducted in foreign currency and with non-residents has also seen the banks' lose ground to the building societies in the domestic retail deposit market. Table 8 below shows the extent to which building societies have replaced banks in the market for retail deposits.

TABLE 8
THE RETAIL DEPOSIT MARKET

Personal Sector Deposits with:

	<u>Banks</u>		<u>Building Societies</u>		<u>Total £ billion</u>
	<u>£ billion</u>	<u>% share</u>	<u>£ billion</u>	<u>% share</u>	
1966	13.7	70	5.9	30	19.6
1970	16.3	62	10.1	38	26.4
1977	28.0	47	32.2	53	60.2
1984	57.0	38	91.4	62	148.4

(3) ORIGINAL ARGUMENTS FOR TARGETING £M3

35. Six main reasons lay behind the authorities' decisions first to adopt public targets for £M3 in the mid-1970s and then to retain £M3 as the sole target aggregate when the MTFIS was launched in 1980. These are as follows (not in order of importance).

(i) £M3 was an aggregate which was thought to contain the main financial assets available for transactions and therefore to be closely related to the total value of transactions in the economy.

(ii) Partly as a result of (i) £M3 was considered to be a good predictor of inflation and money GDP.

(iii) The available econometric evidence suggested that there was a reasonably stable and predictable demand for £M3, that interest rates were one factor determining the demand for £M3, and that as a result the authorities would be able to control £M3 by varying interest rates.

(iv) £M3 was thought to be a good proxy for total liquidity which was important in its own right as an indicator of the potential spending power in the economy.

(v) The counterparts analysis of £M3 was a useful framework that helped the authorities pursue consistent macroeconomic policy.

(vi) £M3 was closely related to credit which, like liquidity, was important per se.

Some of these apply to most measures of broad money. In practice however, at least in the mid-1970s, the only available broad money aggregates were M3 and £M3. No one reason was crucial but taken together they were seen as providing a strong case for the targeting of broad money. It is worth reviewing them in turn in the light of later experience.

3(i) £M3 as a measure of transactions balances

36. The ease with which time deposits could be converted into cash or current accounts was seen as a strong reason for including all bank deposits in the main measure of money supply. The reasoning underlying this is still valid and, as argued in the previous section, would now also point to the inclusion of building society deposits in broad money. But as mentioned earlier the large interest bearing element in £M3 means that many of the assets are held primarily as savings, as building society deposits always have been and may still be to a very considerable extent. This suggests that the relationship with transactions may now be weak. The experience of the last few years has shown only too clearly that while many liquid interest bearing financial assets could be used for transactions purposes that is not necessarily why they are held.

3(ii) £M3 as a predictor of inflation and money GDP

37. The apparent success of £M3 in predicting the upsurge in inflation in 1974/75 was a major reason for its pre-eminence in the 1970s. Formal statistical analysis carried out recently in the Treasury and the Bank shows however that none of the monetary aggregates is a particularly good predictor of inflation or money GDP. Over the last decade the very narrow aggregates (M0 and notes and coin) are marginally superior to the broad aggregates as predictors. If the analysis concentrates on the 1970s it is the broad aggregates which have the better record. It

is the influence of the early-1970s and the exclusion of most of the 1980s from the data period which probably explains why the most recent published study, that by Mills at the Bank, concluded that the broad aggregates contained most information about future movements in prices and money GDP. (Paper 2 in Annex II summarises the available work in this area.)

3(iii) Econometric evidence on the demand for money*

38. Econometric studies using data for the 1960s suggested the existence of a stable demand for M3 dependent on income and competing interest rates. In the absence of an "own" rate effect its interest sensitivity appeared to imply that adequate control could be obtained without excessive movements in interest rates. While these equations completely failed to track the early 1970s, this was attributed at the time either to an excess supply of money during these years or to a shift in money demand associated with the structural changes initiated by CCC (or some combination of the two). In general this experience was not interpreted as casting doubt on the stability of the underlying demand for M3.

39. Subsequent studies, covering the whole of the 1970s and the early 1980s as well as the 1960s, have however had only transitory success in explaining the behaviour of £M3. All the available equations fail completely to track the 1980s' experience. There are at least three possible explanations for the failure to identify a stable demand for £M3. First it may be that demand was never stable in the way suggested by the earlier studies. Second, demand may be difficult to identify because it shifts fairly frequently in response to institutional changes and innovations, some of which have been the direct result of policy changes, such as the imposition and removal of the corset. Third, there may have been at various periods an excess supply of money, thus making it difficult to observe demand. It is virtually impossible to establish the extent to which each of these explanations applies in current circumstances. Shifts in money demand associated with institutional changes and innovation have undoubtedly played a major role in recent years, and are likely to continue to do so. Apart from the innovative track record of the financial sector we know that there are going to be significant changes, foreshadowed in the Green Paper, in the way building societies operate. The second factor may therefore have been and is likely to continue to be the most important. The third explanation, an excess supply of money, may temporarily have been a factor in the early 1970s. It is difficult to believe it can have been important in the early 1980s given the much lower rates of growth of money incomes and prices in the 1980s compared with the 1970s. As for the first explanation perhaps the key phrase is "in a simple way". It would be surprising if the demand for broad money were not related to incomes and interest rates at all, but it should not be too surprising if the relationship turns out to be too complex to capture empirically.

3(iv) £M3 as an indicator of liquidity

40. Liquidity has often been seen, in the Radcliffe Report for example, as an indicator of potential spending power in the economy. In periods of credit rationing, in particular, the level of broad liquidity might be a constraint on spending. While £M3 has always been a rather narrow measure of ^{broad} liquidity there is no doubt that one justification for its use has been as an indicator of liquidity rather than as a measure of transactions balances. (This line of justification therefore differs from that in 3(i).) Few, if any, contemporary theoretical models of the economy give liquidity a key role however and those empirical studies of spending which have found liquidity to be important have tended to

*Paper 1 listed in Annex II summarises the literature on the demand for £M3.

concentrate on net rather than gross liquidity. Nevertheless in a world in which no indicator of monetary conditions gives an unambiguous message, there is a case for paying attention to all possible indicators.

3(v) Counterparts analysis

41. Counterparts are derived by rearranging the banks' (or banks' plus building societies) balance sheet identity to obtain an expression for those deposits included in the particular aggregate in terms of all other items in the balance sheet. Counterparts can therefore be derived for all the monetary and wider liquidity aggregates. Because £M3 contains all residents' sterling deposits the balance sheet can be rearranged to get an expression for £M3 in terms of the banks' net transactions with non-residents and its domestic assets, that is lending to the private and public sectors (net of non-deposit liabilities). Further substitution, by which bank lending to the public sector is replaced by the PSBR less sales of debt to non-bank residents and overseas, produces the familiar £M3 counterparts. If the principal broad aggregate were some measure of broader liquidity it would be natural to pursue counterparts analysis similar to that now used for £M3.

42. Counterparts analysis tends, however, to be less interesting and helpful the narrower is the aggregate. There has, for instance, been little inclination to analyse M0 or even M1 in terms of their counterparts.

43. The analysis of the £M3 counterparts has had a great appeal both as an analytic tool and as a helpful means of presenting macroeconomic policy.* The attributes of the £M3 counterparts were a major reason for the choice of £M3 rather than a narrow aggregate as the target aggregate in the mid-1970s. At the time the principal narrow aggregate was M1. In the case of M1 time deposits are a counterpart, making it necessary to have some explanation for the behaviour of time deposits and making it less easy to present them as credit counterparts. Analysis within the counterparts framework also was consistent with the approach adopted by the IMF, with whom the UK concluded agreements in 1969 and 1976. Domestic credit expansion (DCE), which was subject to agreed ceilings in Letters of Intent to the IMF is a subset of the £M3 counterparts.

44. It is important to emphasise that from the earliest days there has always been a widespread recognition that the behaviour of the various counterparts was not independent. Taken on their own therefore high growth of credit or high government borrowing that was not offset by funding need not necessarily feed through to produce an equivalent increase in broad money. There has always been recognition of the existence of "offsets".** The possible extent of the "interdependence" of the counterparts may well be more keenly appreciated now than in the mid 1970s.

45. As the analysis in this paper makes clear it remains important to monitor - and where possible explain - the significance of the principal "counterparts", namely the growth of credit and the extent to which the government funds its borrowing. It is rather more doubtful whether the

*See Middleton 1978: "As a policy variable £M3 has the advantage of direct links with key areas of economic policy..... There is thus a direct link with fiscal policy, through the size of the PSBR; with the authorities' open market operations; with bank lending to the private sector; and with external flows and exchange rate policy - the external adjustments are essentially the private sector's balance of payments on current and capital account".

** For what it is worth the offsets currently assumed - partly on the basis of empirical work - in the Treasury/Bank monthly forecasts are that deviations of the PSBR from trend are 60% offset in bank lending and 10% offset in the externals. No assumptions are made about the offsets between other counterparts.

complete counterparts analysis of broad money remains the best way of ensuring the government takes the correct decisions - given its aims - in fiscal and monetary policy. The adoption of public targets for broad money in 1976 followed a period when, in the absence of any intermediate target since the final adoption of a floating exchange rate in 1972, both fiscal and monetary policy had been allowed to become too lax. While there was a fairly widespread - though not universal - recognition that this was the case, it was still difficult to bring about the necessary tightening of the macroeconomic policy stance and to justify this in public. The existence of public targets for a measure of broad money went some way to help the authorities take the necessary decisions to tighten fiscal and monetary policy and to justify these in public. (It was not realised at the time, however, that the reimposition of credit controls was having a more marked effect on broad money than had been expected. The lower growth of broad money in the late 1970s, when compared with growth in the first half of the decade, did not therefore render impossible the upsurge of domestic inflationary pressures in 1978/79.)

46. In the mid-1980s most of the adjustment to a lower rate of inflation has been made. The economy is more stable and displaying both sustained growth and fairly low inflation. The aim now is to devise policies that will reduce inflation further. The required reduction in inflation is on nothing like the scale of the reductions needed in the mid and late 1970s. (This does not of course alter the fact that the further reduction now required would be difficult to achieve.) In current circumstances there are important decisions to be made about the appropriate mix of fiscal and monetary policies for the rest of the 1980s. More than one mix is probably consistent with achieving the desired reduction in inflation by the end of the decade. Different mixes could have important consequences for the real exchange rate and real interest rates. It is not at all obvious that counterparts analysis is the only or even the best framework within which to discriminate between the various potential mixes of monetary and fiscal policy in the new circumstances of the mid-1980s.

47. Whatever view is held on the usefulness of counterparts analysis it will remain vitally important to analyse the behaviour of credit and to establish the influence of funding on the evolution of broad money.

Credit

48. For much of the period under consideration the quantity of credit, particularly to the personal sector, has been rationed either as a result of direct controls by the authorities or as a result of lack of competition in the credit market. From time to time however the controls have been lifted or eased and a greater degree of competition introduced with the effect that the growth of credit surged (see Chart 7). The most obvious example of this is 1971-73 when the average growth of bank credit quadrupled compared with the preceding four years (see Table 9 below). Something similar happened in the 1980s with bank credit growing on average nearly twice as fast as in the 1974-79 period. Lending by building societies has been much less erratic, although there was a significant acceleration in 1971-73. Periods of high broad money growth have been associated with high credit growth, but the acceleration in credit has usually been greater than that of broad money. The recent acceleration in bank lending has taken the stock of lending (including Issue Department holdings of commercial bills) above the stock of £M3. Fast growth of bank lending to the private sector relative to £M3 has been made possible mainly by much of the lending going 'off-balance sheet'; with the bank accepting bills which are then held by the Issue Department. A reduction

in bank lending to the public sector and a rise in own resources, partly from capital issues, have also helped.

CHART 7 : ANNUAL GROWTH OF £M3 AND BANK LENDING TO THE PRIVATE SECTOR

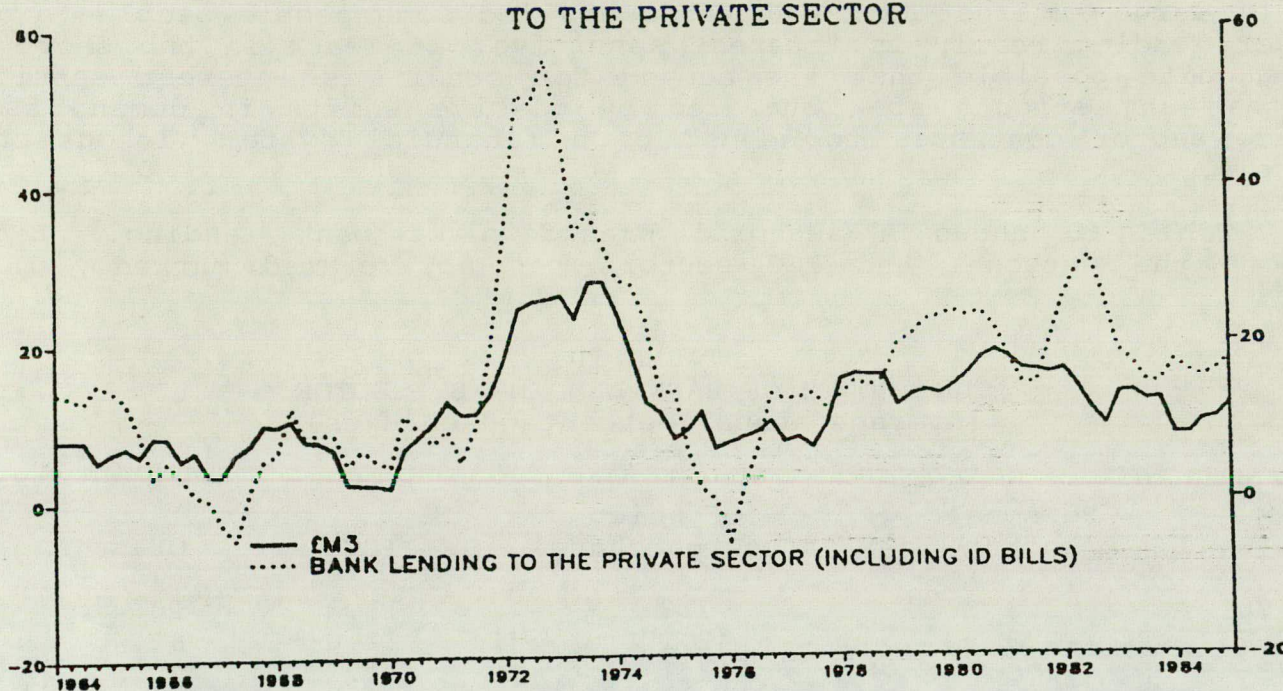


TABLE 9
THE GROW OF CREDIT AND MONEY GDP (Average annual percentage changes)

	Bank lending to private sector	Building Society lending	Total bank and building society lending*	Total lending for house purchase	Money GDP
1967-70	6½	14	9½	11½	8½
1970-73	36	18½	28	18	12½
1974-79	12½	17	14	15½	18½
1970-79	20½	17½	19	16	16½
1979-84	19½	17½	20	19	9½

*Bank lending to building societies netted out.

49. Coherent explanations, at least in quantitative terms, of the evolution of credit are conspicuous by their absence. Shifts in both demand and supply have probably been important, and the financial liberalisation that has taken place since 1979 has undoubtedly been a major factor, particularly as regards lending to the personal sector. As argued above liberalisation has allowed both borrowers and lenders to get closer to desired stocks of credit and gross liquid assets given prevailing interest rates. The sensitivity of bank lending to changes in the level of interest rates is crucial for the control of broad money. While empirical studies nearly always find significant long run interest rate elasticities, the recent continued buoyancy of bank lending in the face of large interest rate increases has led some people to doubt whether lending really is interest sensitive, at least in the short run. It is quite possible that the demand for credit is interest sensitive, but that any effects are concealed by massive shifts in demand as the private sector continues to adjust to a financial system without credit controls.

50. Table 10 shows a sectoral breakdown of bank lending. Lending to both the personal and ICC sectors has accelerated markedly in the 1980s.

TABLE 10
THE GROWTH OF BANK LENDING BY SECTOR
(Average annual percentage changes)

	Personal sector	(Of which house purchase)	ICCs	OFIs	Total
1967-70	3.3	7.3	11.3	10.4	9.1
197-73	49.9	42.1	31.0	61.4	37.1
1973-79	12.5	13.1	11.2	20.9	12.6
1970-79	25.0	22.8	17.8	34.1	20.7
1979-84	30.5	52.7	17.3	30.9	23.5
1975-79*	16.3	16.4	12.7	27.5	16.1
1979-84*	30.4	52.7	15.1	19.2	21.0

*£ bank lending from 1975 on,
£ and other currencies prior to 1975.

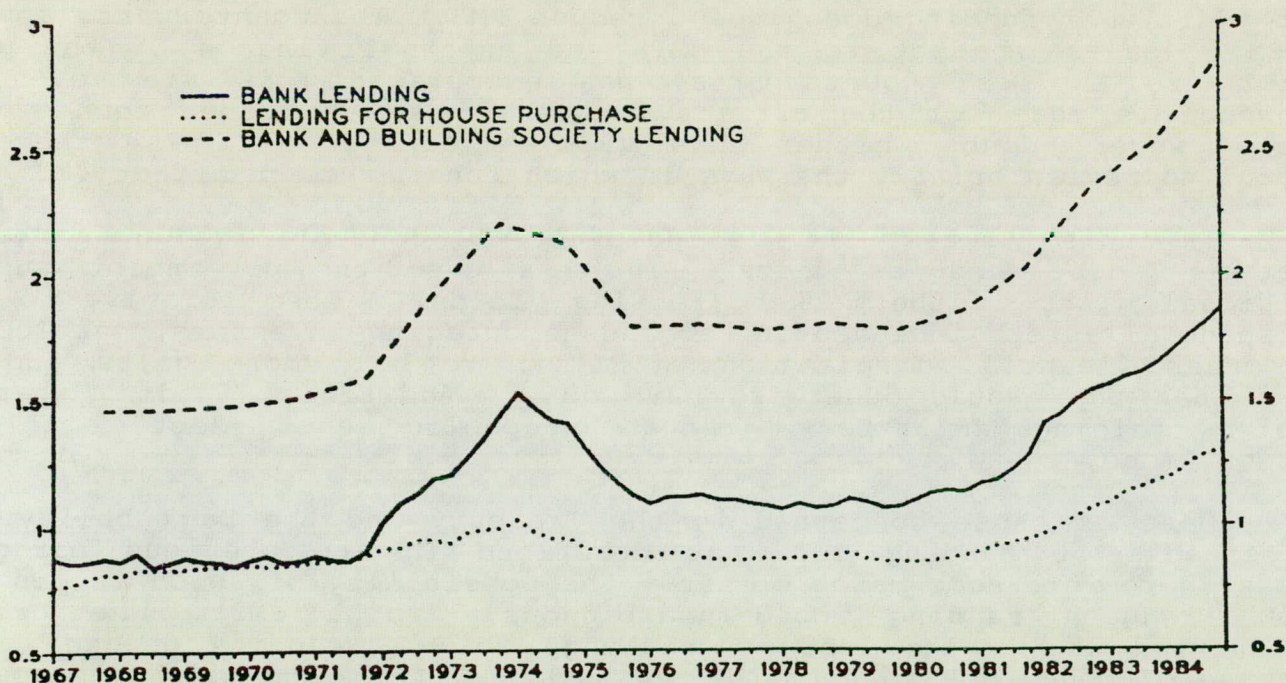
51. While the rapid growth of bank lending for house purchase (and home improvement) shown in table 10 may at first have been partly at the expense of lending by building societies, total lending for house purchase has been growing much faster than personal income. It has also exceeded the increase in the value of the housing stock, thereby allowing a larger proportion than formerly of equity in housing to be realised and used for other purposes. Earlier analysis of the potential increase in lending for house purchase in future years (carried out in the Treasury at the end of last year) concluded that because (i) the proportion of the housing stock which is owner-occupied is still only 60 per cent and (ii) there is considerable scope for further exploitation of tax relief on mortgages, lending for house purchase could well continue to

grow at high rates for some years to come.

52. With the growth of credit in recent years even higher than the growth of broad money its "velocity" has fallen even more sharply. Chart 8 illustrates the increase of credit velocity in the conventional way, by the debt/income ratio. It has risen substantially to the highest level yet recorded.

53. Both in the 1970s and more recently there have been suggestions that there could be a close relationship between credit and total spending. There is in fact little empirical evidence to substantiate this view. No-one, for instance, has replicated for the UK Ben Friedman's work on the US. This is not surprising perhaps when the figures have been distorted by the imposition and removal of controls. As argued earlier recent growth of credit has been broadly matched by a build-up of financial assets rather than by a rise in total spending.

CHART 8 : RATIO OF LENDING TO MONEY GDP



3(vi) Funding

54. Borrowing by the public sector results in money creation unless it is funded. For £M3 funding is finance raised by the Government by means of sales to sectors other than the monetary sector of public sector debt such as gilt-edged securities, certificates of tax deposit, and national savings certificates. As noted earlier the precise definition of all the counterparts, including funding, is different for each monetary or liquidity aggregate. If the focus was on some measure of wider

liquidity, rather than on £M3, sales of government debt to the building societies would be treated similarly to sales to banks. Furthermore sales of at least the same, and conceivably all, national savings instruments would not constitute funding if these were included within the measure of wider liquidity.

55. In recent years, however, the authorities have attempted to offset the effects on £M3 of high bank lending by overfunding, ie by selling more debt than is needed to finance the PSBR. The definition of 'overfunding' used in this paper is the PSBR less sales of public sector debt to the non-bank private (NBPS) and to the overseas sectors.* Table 11 shows the history of the PSBR and its funding since 1952. The PSBR has been heavily overfunded in each of the last four years. It was a relatively rare occurrence between the mid-1960s and 1980. On the other hand there was significant overfunding (as a share of money GDP) in six of the ten years after 1954. The scale and frequency of overfunding in recent years is therefore not wholly unprecedented.

56. The active funding policy followed in recent years, which resulted in significant amounts of overfunding has been based on the assumption that additional funding does indeed reduce £M3. The counterparts approach to £M3 (sales of debt to the NBPS and external finance of the public sector are explicit counterparts) has encouraged this view even when allowance is made for the offsets between these and other counterparts. Some, however, doubt whether this view is correct. It is, therefore, helpful to review briefly the ways in which funding might affect £M3.

57. In this context it is helpful to concentrate on marketable government debt such as gilts. In this case the government supplies additional gilts to the market, raising yields on them relative to those on financial assets included in £M3 and encouraging investors, particularly the other financial institutions (OFI's), to hold more gilts and less money than they would otherwise have done. Additional funding therefore involves raising the rate of return on public sector debt relative to that on 'money'.

58. Most of those concerned in the Treasury and the Bank believe that the effects of funding occur as described in the previous paragraph. Unless there were some major offset - the possibility of which is discussed below - reduced funding would unambiguously raise £M3. Whether such a reduction would also lead to a change in £M3 velocity depends on the response of money GDP to a change in funding. For example, it is possible that any induced fall in long-term interest rates relative to short rates has little effect on real expenditure or prices.** On the other hand there could of course be important indirect effects on money GDP if by one means or another the change in funding had an effect on the exchange rate and therefore on prices. Some such effect is quite plausible. However within a monetary policy framework such as is currently operated any tendency for the exchange rate to fall would induce some rise in short term interest rates which would damp down, and possibly remove altogether the effects on the exchange rate and domestic prices.+

*The precise scale of 'overfunding' depends on the definition of public borrowing used. The differences between the figures for overfunding on different definitions can be very large.

**This is the effect in the Treasury and other macroeconomic models of the UK that include a monetary sector.

+Depending on the precise way in which the yield curve is determined - a matter on which there is a very wide range of views - any rise in short rates could reduce the extent to which long rates are lower as a result of less funding. This would damp down the positive effects of reduced funding on £M3 and (probably on a more modest scale) on money GDP.

Table 11:

Funding and the PSBR since 1952*

<u>Calendar Years</u>	£ billion			
	<u>PSBR⁺</u> £b.	<u>Sales of debt to NBPS and overseas</u> £b.	<u>Over (+)/Under(-)Funding</u> (Column 2 less column 1) £b.	<u>% of money GDP</u>
1952	0.8	0.1	- 0.7	-4.5
1953	0.6	0.2	- 0.4	-2.4
1954	0.4	0.2	- 0.2	-1.0
1955	0.5	0.8	0.4	1.9
1956	0.6	0.6	0.0	0.0
1957	0.5	0.2	- 0.2	-1.1
1958	0.5	0.4	- 0.1	-0.3
1959	0.6	0.8	0.2	0.8
1960	0.7	1.0	0.3	1.0
1961	0.7	0.6	- 0.1	-0.3
1962	0.5	0.5	0.0	0.2
 <u>Financial Years</u>				
1963-64	1.0	0.6	-0.4	-1.3
1964-65	0.9	1.1	0.2	0.7
1965-66	0.9	0.2	-0.8	-2.1
1966-67	1.1	0.7	-0.5	-1.2
1967-68	2.0	1.9	-0.1	-0.3
1968-69	0.4	0.3	-0.1	-0.2
1969-70	-0.6	-0.4	0.1	0.3
1970-71	0.8	-0.0	-1.4	-2.7
1971-72	1.0	-0.2	-1.2	-2.0
1972-73	2.4	2.6	0.2	0.3
1973-74	4.4	3.9	-0.4	-0.6
1974-75	8.0	6.8	-1.2	-1.3
1975-76	10.3	6.5	-3.9	-3.4
1976-77	8.4	8.3	0.0	0.0
1977-78	5.4	2.3	-3.1	-2.0
1978-79	9.2	9.1	-0.1	0.1
1979-80	10.0	8.8	-1.2	-0.6
1980-81	12.7	11.0	- 1.6	-0.7
1981-82	8.6	12.4	3.8	1.5
1982-83	8.9	10.7	1.9	0.7
1983-84	9.7	13.9	4.2	1.4
1984-85	10.3	14.2	4.0	1.2
 <u>Period Averages</u>				
1952-1962	0.6	0.5	-0.1	-0.6
1963-64 - 1970-71	0.8	0.5	-0.4	-0.9
1971-72 - 1979-80	6.6	5.4	-1.2	-1.1
1980-81 - 1984-85	10.0	12.5	2.4	0.8

* Totals may not add due to rounding

+ Up to 1962 old definition including public sector bank deposits.

It is quite likely therefore that any proportionate change in money GDP will be small relative to the proportionate change in £M3. On this view a change in funding will have an effect, that could be substantial, on £M3 velocity. The same result would hold mutatis mutandis for the effect of changes in funding on other measures of broad money and liquidity. It is worth pointing out that this widely held view in which changes in funding have a significant effect on velocity and possibly little effect on money GDP is not a very satisfactory basis for the targeting of broad money.

much the same could be said of ST interest rates

59. There is, however, very little reliable evidence on the effects of funding and there are other possibilities. Two very different possibilities that involve little change in velocity are worth considering. The first possibility is that less funding increases £M3, in the way described above, but that any fall in long rates and rise in £M3 have a significant effect on money GDP, so that there is little or no change in velocity in the long run. In this case reduced funding - unless wholly offset by some other policy change - would only be justified if the prospective growth of money GDP were less than desired. A second possibility is that a change in funding sets in train processes which largely offset any direct effect on £M3 from the initial change in the relative returns on money and gilts. In this case again there is little change in £M3 velocity, but it is the effect on £M3 rather than on money GDP that bring about this result. There are a number of possible ways in which the effects of reduced funding on £M3 could be offset. One which has been discussed for some time is that lower long-term interest rates might, by raising equity prices and reducing yields, cause a switch of corporate borrowing towards equity issues (and/or potential bond issues) and away from bank credit.

60. Table 12 summarises the effects of the three scenarios discussed in the previous paragraphs. As stated above most in the Treasury and Bank believe the "consensus case" to be nearest the truth. Some who hold this view believe that variant 1 is a real possibility so that if funding is less the authorities are quite likely to have to have higher short rates than would otherwise have been necessary to maintain the same downward pressure on inflation. Everyone, however, is conscious that the empirical basis of the key assumed relationships underlying all of these views on the effects of funding is so weak that no-one can be confident about the precise effects.

TABLE 12
POSSIBLE LONG RUN EFFECTS OF REDUCED FUNDING ON £M3

	Effect on <u>£M3</u>	Effect on <u>Money GDP</u>	Effect on <u>£M3 Velocity</u>
Consensus Case	Rise	Little change	Fall
Variants 1 (large effect from funding to money GDP)	Rise	Rise	Little change
Variants 2 (little long run effect of funding on £M3)	Little change	Little change	Little change

(4) THE MONITORING OF MONETARY CONDITIONS AND THE CONTROL OF BROAD MONEY

61. Developments in the behaviour of the velocity of broad money, in particular changes in its trend that appear to be related to changes in the system methods of monetary control, have obvious implications for the assessment of monetary conditions. This section examines how, over the last five years, the authorities have in reaction to events varied the emphasis in the assessment of monetary conditions, and discusses the associated changes in views on the effectiveness of techniques for control of broad money.

(a) The overall strategy and the public stance

62. The first Medium-Term Financial Strategy (MTFS) in 1980 contained target ranges only for £M3, the measure of money supply that had been targeted throughout the late 1970s. It did, however, reiterate the point made in the 1980 Green Paper on Monetary Control that "the way in which the money supply is defined for target purposes may need to be adjusted from time to time as circumstances change". In spite of the very high growth in £M3 during 1980-81, a time when there was ample evidence of strong downward pressure on inflation, the 1981 MTFS had target ranges only for £M3. The problems of 1980-81 were interpreted as temporary distortions as a result of the removal of the corset. Indeed the 1981 MTFS expressed the hope that it might be possible to "claw back" some of the excess growth that had occurred in 1980-81 should circumstances permit. There was, however, acknowledgement of the role of other indicators of monetary conditions. The behaviour of the exchange rate, interest rates, house prices and other asset prices were all argued to have provided evidence that monetary conditions were very tight during 1980-81.

63. In the 1982 MTFS £M3 lost its role as the sole targeted aggregate. A single target range was set for the growth of M1, £M3 and PSL2. Furthermore the target ranges for 1982-83 and subsequent years were raised significantly - by 3 percentage points. The exchange rate was again mentioned as an important indicator of monetary conditions.

64. The problems of interpretation and prediction with M1 and PSL2 led to a further change in the 1984 MTFS. M1 was replaced by M0 as the targeted narrow measure of money and PSL2 was downgraded to a 'check' on the targeted aggregate, £M3. M2 fulfilled a similar role for M0. Broad and narrow money were given "equal importance" in the assessment of monetary conditions and the exchange rate was again singled out as the main other indicator of conditions.

65. Finally, the most recent MTFS reiterated the position of the 1984-85 version, although M2 and PSL2 lost their special role as "checks" on the targeted aggregates.

(b) The assessment of monetary conditions

66. This paper does not discuss the principles - which changed considerably from time to time - that governed interest rate decisions in the years before 1979. It concentrates on the evolution of monetary assessment in the years since then. It was never the practice to base the assessment of monetary conditions and decisions on interest rates

solely on the behaviour of £M3 even while it was the sole target aggregate. Nevertheless there has been a marked shift in emphasis during this period. This shift began to occur once the removal of the corset ushered in a period of high growth of broad money.

67. There was a fairly widespread underestimation of the extent to which the ending of the corset would boost £M3 and other measures of broad money. It was not only that the initial effect on £M3 in mid-1980 was much greater than expected. There was an almost completely unexpected continuing effect in subsequent years. The more liberal environment did not just influence the behaviour of banks. Indirectly the removal of the corset led to more unexpected behaviour not only by banks but by building societies as well. As a result decisions on interest rates became much more dependent on the interpretation of a range of monetary and non-monetary indicators and less dependent on one measure of broad money. This has now reached the stage where policy is based on a careful study of the recent behaviour of all the components of monetary growth and all the information provided by other indicators such as the exchange rate, real interest rates, input and output prices, the growth of earnings and wage costs, and changes in physical asset prices.

68. It is therefore worth considering whether a similar eclectic approach to the assessment of monetary conditions, which did not rely chiefly on the behaviour of broad money, would have given adequate warning of the upsurge in inflation in 1974 and 1975 (to the extent that this was the result of domestic developments.)* While the broad aggregates appeared to have given a very clear signal of the loosening of conditions in 1972 and 1973 it can also be argued that other indicators also performed reasonably well. It is certainly not possible to argue that the behaviour of M1 - which was at the time the most closely monitored measure of narrow money - gave adequate and timely warning. On the other hand if the behaviour of M0 had been monitored in the second half of 1972 and throughout 1973 - which was not the case - the rise in its growth rate to levels well above those recorded in the 1960s would have given some warning of an upsurge in inflation. Of other indicators short term interest rates were kept (deliberately) very low throughout 1970-73. As a result real short rates were lower than they had been in most of the 1960s. Asset prices grew at phenomenal rates in 1972 and 1973, a fact that was universally known at the time. The exchange rate index fell sharply in the same years although it was not widely monitored then. The sterling/dollar rate actually rose during this period and gave a completely false impression of the state of monetary policy.

69. The 1980s have been different from the 1970s because, although broad money growth has been strong and its velocity has declined, the behaviour of nearly all these other indicators has suggested that monetary conditions have been adequately tight for most of the time. Even when there have been periods when monetary conditions have - at least in retrospect - clearly been looser than desired, the extent of the loosening has been on nothing like the scale of 1972/73.

(c) The control of broad money growth

70. Many of the factors that have contributed both to the changed behaviour of broad money and to the change in its velocity trend have at the same time led to a decrease in the ability of the authorities to control it.

71. Generally speaking, controlling the various measures of the money supply by the use of short term interest rates is likely to be easier the narrower is the aggregate being controlled and the lower the proportion

*Paper 4 listed in Annex II discusses in more detail the surge in inflation in the early 1970s.

of interest bearing money within it. The interest bearing share of £M3 and the measures of broad liquidity has risen considerably during the last twenty years.

72. The current scepticism about the ability to control broad aggregates by means of adjustments in short term interest rates contrasts with the views held in the 1970s. As section III showed it was believed then that the manipulation of short term interest rates would contribute to the achievement of the desired growth of broad money. It is now realised, however, that short term interest rates are a far from perfect instrument for controlling the growth of broad money. The main problem is that changes in deposit rates and borrowing rates are very highly correlated. Higher short term interest rates will mean both higher deposit rates, which will make deposits more attractive and thus cause funds to be switched from longer term financial assets, and higher borrowing rates, which will tend to reduce demand for credit (although they may well be perverse short-run effects on credit, eg distress borrowing by companies). In the longer run broad money growth should be reduced by higher short rates because of the increased cost of credit. However, the extent of the reduction will be determined by the interest sensitivity of credit demand and this is an unknown factor because studies of credit demand in the UK have on the whole not been very successful. (This lack of success is perhaps not surprising in view of the major changes in the monetary regime that have taken place over the last twenty years.) But the ultimate effect on broad money of higher short-term rates will also depend on the consequences of interest rates change for income, wealth, the costs to companies of raising finance on the stock exchange etc. These are likely to lead to reduced demand for bank credit and thus to a reduction in broad money. However, these effects will take some time to work through to bank credit demand and it is highly likely that demand would not be reduced on a sufficient scale within a target period. So while there can be reasonable confidence that higher short rates will have the required effect on monetary conditions, there can be no guarantee that this effect will be reflected, except in the very long-run, in the behaviour of bank credit and broad money.

73. In recent years, the control of broad money growth has been achieved, in part, by the authorities selling more debt than needed to fund the PSBR. However, this method is no longer available following the recent decision to sell only enough debt to fund exactly the PSBR.

74. In the past direct quantity controls were used as an additional instrument for control of broad money. Controls have been operated on both sides of the banks' balance sheets. Between 1950 and 1970 a variety of controls were imposed on bank lending and in the latter part of the 1970s bank deposit growth was controlled by ceilings on interest-bearing eligible liabilities (IBELS). The problem with both types of control is that they are likely to be ineffective, inequitable, and inefficient, and will result in major distortions of official monetary statistics.

75. Another method of control would be use of reserve asset ratios of the type employed by the Germany monetary authorities. This would involve constraining the banks to hold a given proportion of their assets in a certain form, like notes and coin, government securities etc, and would reduce their ability to allow credit to grow. However, such a system would be imprecise. Both direct controls and reserve asset ratios would lead to considerable amounts of banking business be driven offshore unless exchange controls are reimposed. They would, therefore, tend to distort the meaning of the broad monetary aggregates, rather than truly containing broad money growth.

76. Finally, fiscal policy could, in theory, be used to achieve some control over broad money, but in practice it cannot be varied within year to achieve a desired effect on broad money.

ANNEX 1

CONTROLS ON BANK LENDING AND OTHER FORMS OF CREDIT

INTRODUCTION AND ASSESSMENT

The experience of the last few years, in which the banks and other financial institutions have been free to lend at will, contrasts markedly with much of the post-1945 period, in which direct controls on lending were regularly used as an instrument of monetary policy. The use of such controls reached a peak in the second half of the 1960s: subsequent disillusionment with their effectiveness together with a desire to foster greater competition in banking led to their abandonment in the summer of 1971, but they were reimposed at intervals between 1974 and 1980. Although qualitative guidance on the direction of lending by financial institutions remains in force today, the period since 1980 is the longest period of otherwise untrammelled bank lending for over thirty years. This annex briefly reviews the use of such direct controls.

Such controls were seen to have clear advantages: they were unequivocal, both to the banks and their customers; their coverage could be extended in equity beyond banks to cover other financial intermediaries; and they tended to work quickly. In addition at times they have seemed to offer the only possibility of controlling bank lending because of its apparent insensitivity, certainly over the short run, to interest rate movements. On the other hand direct controls were not themselves without drawbacks. For a long time they were held to be effective as an emergency, temporary, measure when severe restraint was necessary; but they came to be a more permanent feature of monetary policy than was ever initially intended. Held in operation over a long time, they stifled competition and efficiency in the financial system, with bank managers forced into

ANNEX
1
CONTROLS
ON BANK
LENDING
AND
OTHER
FORMS OF
CREDIT

the role of turning business away rather than encouraging it. In addition they tended to divert business into other channels, encouraging the development of fringe institutions and secondary markets, so that their effectiveness was in any case partly cosmetic. Direct controls were also highly selective in their effect; and the numbers chosen for the permissible growth in lending inevitably essentially arbitrary.

Nevertheless, even though it is impossible to measure precisely their impact on monetary growth and expenditure decisions, the periods when they were in force do seem to coincide roughly with slower broad money growth in relation to incomes than in other periods. It would be hard to deny therefore that direct controls may have had some effect in restraining broad money growth, or at least diverting it to other channels.

DETAILED HISTORY OF USE OF DIRECT CONTROLS

The 1950s

The UK emerged from the Second World War used to private expenditures being kept in check by administrative government controls (rationing, licensing and similar arrangements); and it seemed natural to extend direct control over financial institutions, particularly over their lending behaviour, as a monetary instrument. In the immediate post-war years, short term interest rates were held at a very low level, to aid the reconstruction and recovery process, so that when, for the first time, monetary restraint was felt desirable in 1951, rather than raise interest rates, the "requests" issued to the banks during the war as to their lending were given new emphasis, with sterner guidance issued as to what constituted 'essential purposes'. Even when in late 1951 and early 1952 tentative steps towards greater use of the interest rate weapon were made, the banks continued to limit their lending according to these criteria; and in February 1952 restrictions were for the first time imposed on hire purchase terms for consumers' durable goods (although restrictions on bank borrowing by hp companies had been in force since 1947). Throughout this period, extending to September 1954, banks were asked to withhold credit for speculative

purchases of securities, real property or commodities; and to limit finance for hire purchase.

After only a short period of relaxation, hp controls and restrictions on bank borrowing by hp companies were reimposed in February 1955; and the Chancellor subsequently requested the London Clearing Banks for a 'positive and significant reduction in their advances over the next few months'. For the first time, an element of quantitative restriction thus crept into the hitherto qualitative control. Early in 1956 hp restrictions were further extended and banks were asked to maintain the stringency of their scrutiny of applications to borrow, although apparently with little effect on recorded bank lending. Only after representatives of the LCB's and main banking associations had been summoned before the Chancellor in July that year to ensure that 'the contraction of credit be resolutely pursued' did bank advances begin to fall. But in the wake of the Suez crisis, economic recovery was again accompanied by substantial growth in bank lending so that in the autumn of 1957, Bank Rate was raised sharply to 7% and the banks were required to hold the level of advances for the next twelve months at the average level for the preceding twelve months. In fact bank advances fell by 5% in the last quarter of 1957 under the cumulative effect of a long period of credit restriction and the onset of a mild recession. In the ensuing moves towards stimulation, Bank Rate was reduced and, in July 1958, all restrictions on bank credit were completely lifted: for the first time since the war the banks were free to lend, except for 'purely speculative' purposes. The banks quickly introduced personal loan schemes and substantially increased their lending; and that same autumn hp controls were also removed.

The 1960s

Direct controls on the banks remained in suspense for just three years. They were reimposed in 1961 to supplement the effectiveness of a call for Special Deposits, which had been first made in April 1960 (when hp restrictions had also been reimposed). It was thus stated that the authorities wished the impact of the call for Special Deposits to fall primarily on

advances, with the aim of sharply curtailing the growth in lending. The banks were asked to treat particularly severely requests for lending related to personal consumption, including hire purchase, and for speculative building, property development and other speculative purposes. In response to the growth in the activity of banks outside the LCBs and by hp finance houses, direct credit controls were extended to cover deposit-taking finance houses and the non-clearing banks; and the banks were made aware of the authorities' desire not to allow the restrictions on advances to be weakened by the developing business in commercial bills.

These strictures on the banks were relaxed in May 1962, although the banks were asked to remain selective in their lending; the requests for restraint in bank lending were later withdrawn completely in October that year. This period of freedom from constraint was again relatively short-lived. Controls were reimposed towards the end of 1964 as part of a crisis package to deal with a deteriorating external situation: banks were informed that official policy was for a deceleration in bank lending overall and for a curtailment, within the total, of facilities for purposes of lesser national importance than exports, productive investment and regional development. Notification to this effect was extended to the banks, the British Insurance Association, and the Building Societies Association (with the latter told that it was not the intention to affect the societies' lending for home ownership). These requests were reinforced with fuller quantitative rigour in May 1965, following a further call for Special Deposits, when the Governor requested the banks to co-operate in restricting credit expansion to 5% during the following twelve months, emphasising that the earlier qualitative guidance still stood. Hire purchase restrictions were simultaneously tightened. The Governor sent out further letters only two months later reiterating the importance of encouraging exports and restricting finance for imports.

Such requests continued throughout the rest of the decade. The Governor wrote to the relevant associations (of banks, including merchant and overseas banks, LDMA, hp finance houses, insurance companies, pension funds and building societies) again in February

1966 seeking, until further notice, a ceiling on lending at the March 1966 level, reiterating the qualitative directional guidance. Hp and rental terms were also further restricted. Two reminders were issued later in the year.

Even when the ceiling on lending by the LCBs was discontinued in April 1967, the need for continued restraint was emphasised, with 'no appreciable increase' expected in lending for consumption or property development; whilst credit for manufactured consumer imports and stockbuilding was to be restricted 'to the greatest extent possible'. It was also made clear that, should it become necessary, additional Special Deposits would be called, and could be adjusted more frequently than in the past to keep credit conditions continuously in line with the changing needs of the economy. In fact, in association with the announcement of sterling devaluation in November that year, severe lending ceilings (for all but priority borrowers) were reimposed, and it was made clear that 'the recent upward trend in lending to persons should be halted without delay'. These arrangements were modified the following spring to bring about a greater reduction in non-priority borrowing than had taken place, whilst leaving room for lending to finance exports: sterling lending to the private and overseas sectors was not to exceed 104% of the November 1967 level until further notice, and the directional guidance was reiterated. In the light of the continued strength of personal consumption and deterioration in the external balance, this credit ceiling was further tightened in November 1968; new, lower, ceilings implying a net reduction in lending outstanding were announced, forcing the banks to restrain their low priority lending more severely than before, and designed to ensure that lending for consumption, direct or indirect, was substantially reduced. Finance houses were also to observe similar, stricter ceilings on their lending. Symbolically, the chairman of the CLCB wrote to the Governor assuring him that the LCBs would do their best in the national interest to comply with the official request, but pointing out that further contraction of the credit base might not be possible without causing disruption in the financial markets.

On three occasions in 1969, in January, February and May, reminders were issued about the lending ceilings, and the banks agreed to intensify their efforts to reduce lending to the required level. On the last of these occasions, the Bank announced a halving of the interest paid on Special Deposits made by the LCBs, with a restoration of full interest conditional on compliance with the ceiling. Whilst effective in the short run, lending again rose sharply in the summer, forcing the Governor to seek an explanation from the banks, and resulting in an increase in their lending rates. Quantitative lending ceilings were renewed in the August in 1970 - a gradual and modest increase of around 5% in the year to March 1971 was to be allowed in sterling lending by the banks (to the private and overseas sectors) and leading finance houses. It was not intended that there should be any increase in finance for personal consumption. Again however, faced with a very sharp rise in LCB lending in July 1970, the Bank was forced to remind the banks that the request to restrain their lending remained in force: the banks were asked to 'take all possible steps' to reduce the growth in lending in the ensuing months.

The 1970s

By this time however the defects in the post-Radcliffe methods of monetary management were becoming apparent. The over-reliance on direct controls stultified both competition and efficiency in the financial system, and it also encouraged fringe avoidance and the diversion of credit flows through other channels. The whole climate of opinion - intellectual, legal, political and banking - began to shift towards the encouragement of free competition, away both from the restrictive cartel-type arrangements by which the banks had jointly reached decisions and from the counter-competitive techniques of monetary policy described above. As a result the Bank began to plan for a major change in approach, involving scrapping direct controls and abolition of the clearing bank cartel, and relying instead for monetary control on greater use of the price mechanism: both the total amount of credit and its allocation would be determined by the interest rate cost. This new modus operandi, Competition and Credit Control, was introduced during 1971; but was followed immediately by very

rapid growth in bank lending and broad money. There was a prima facie case that the new credit control arrangements were seriously deficient; and by the second half of 1973 the rise in interest rates which would have been necessary to check the ballooning development of bank lending appeared incalculable. In the event it was decided to revert to some more direct means of controlling monetary expansion: after a short review of other possibilities, the Supplementary Special Deposits Scheme was devised and introduced in December 1973. Although designed to curb the growth in the sterling deposit base of the banks, with penalties incurred by each bank for excess growth over a prescribed rate, the Scheme was intended indirectly to restrain the growth in bank lending, whilst having the minimum impact on the structure of financial markets. This Scheme was in operation periodically during 1974-80 (from December 1973 to February 1975; from November 1976 to August 1977; and from June 1978 to June 1980). In the first two periods of operation the demand for credit fell of its own accord and few SSD penalties were paid: only in the third period were significant amounts paid and the Scheme did then appear to reduce the banks' aggressiveness in seeking business. However it gradually encouraged the diversion of financial intermediation into other channels and this was further encouraged by the abolition of exchange controls in October 1979 which permitted offshore disintermediation. It seemed that the maintenance of direct controls on the sterling operations of banks in the UK was inconsistent with the ability of residents to transact abroad at will, and the Scheme was abolished in June 1980.

At the same time however, the qualitative directional guidance to banks and deposit-taking finance houses, which had remained in force throughout the 1970s, was reaffirmed. This guidance asked these institutions to provide finance for working capital and fixed investment by manufacturing, and for the expansion of exports and saving of imports; whilst exercising strict restraint on lending for other purposes including, in particular, to persons, property companies and for purely financial transactions.

Subsequently in January 1982 the Bank requested banks and licensed deposit-takers to ensure that lending for house purchase was not significantly inflated by borrowers extracting cash, on moving

house, for non-housing purposes. The Treasury simultaneously made a similar request to the Building Societies Association.

[These requests on directional guidance remain in force but have not since been reaffirmed: they are by now quite ineffective but the authorities' concern, in withdrawing them, would be to avoid giving any signal of a more relaxed attitude to broad money and credit growth.]

ANNEX II WORKING PAPERS AND OTHER REFERENCES

This annex lists working papers on particular topics that were written in the Treasury or the Bank while the paper was being prepared as well as the other papers referred to in the text.*

Working papers

1. A survey of empirical studies of the determination of broad money in the UK (prepared in the Bank).
2. Monetary aggregates as predictors of inflation (prepared in the Treasury).
3. New financial instruments: financial futures, options and swaps, (prepared in the Treasury).
4. The inflation of the early 1970s (prepared in the Treasury).
5. The sectoral composition of broad money (prepared in the Treasury).
6. Other financial institutions (prepared by the Bank and the Treasury).

* Copies of these can be obtained from Dr Rowlatt.

References

1. R B Johnston, 'The demand for liquidity aggregates by the UK personal sector', Government Economic Service Working Paper No 81, June 1985.
2. 'External flows and broad money', Bank of England Quarterly Bulletin, December 1983. (This presents the wider sterling aggregate).
3. R B Johnston, 'The demand for non interest bearing money in the United Kingdom'. Government Economic Service Working Paper No 66, February 1984.
4. T C Mills, 'Composite monetary indicators for the United Kingdom: construction and empirical analysis', Bank of England Discussion Paper, May 1983.
5. P E Middleton, 'The relationships between monetary and fiscal policy', in Essays in Fiscal and Monetary Policy, eds M T Artis and M H Miller, 1978.
6. B M Friedman, 'The role of money and credit in macro economic analysis' in Macro economics, Prices and Quantities ed J Tobin, 1983.

ANNEX III DATA SOURCES AND DEFINITIONS

Definitions

The following are precise definitions of the broad money aggregates, £M3, M3, PLS1, PSL2, PSL2A, 'wider liquidity' and the 'wider sterling aggregates'. Data for the first four aggregates are published regularly in official statistics. The 'wider sterling aggregate' was the subject of an article in the December 1983 issue of the Bank of England Quarterly Bulletin but figures for it are not published regularly. PSL2A is used internally; figures are not published. 'Wider liquidity' is an aggregate compiled especially for this paper.

Sterling M3 Comprises notes and coin in circulation with the public, non-interest bearing and interest bearing sterling sight deposits of the private sector, private sector sterling time deposits and private sector sterling certificates of deposit with banks in the UK.

M3 consists of sterling M3 plus private sector foreign currency deposits with UK banks.

PSL1, introduced in 1979, includes the components that are in £M3 apart from excluding time deposits with an original maturity of more than 2 years. It includes in addition private sector holdings of money market instruments (Treasury and commercial bills and local authority deposits) and certificates of tax deposits.

PSL2 was also introduced in 1979. It includes PSL1 but also incorporates building society deposits and National Savings (excluding term shares, longer term deposits and SAYE) held by the private sector. Building society holdings of bank deposits and money market instruments are netted off to avoid double counting.



PSL2A is PSL2 plus all other building society deposits.

'Wider Liquidity' adds all remaining national savings instruments to PSL2A.

The 'wider sterling aggregate' is £M3 plus overseas sterling deposits with UK banks less overseas banks' sterling borrowing from UK banks.

Sterling M3 and M3 were redefined in March 1984 to exclude public sector bank deposits. (At the same time the PSBR was redefined to exclude changes in public sector bank deposits). These deposits fluctuated by a large amount in the short term but did not have much effect on growth rates over longer periods, and their average level is very low.

The definition of wider liquidity recognizes that building society terms shares in particular, but also some national savings instruments, are more liquid now than when PSL2 was originally defined.

The size of the broad monetary aggregates (seasonally adjusted) at the end of the first quarter of 1985 was:

	£ billions
£M3	116.4
M3	135.9
PSL1	120.9
PSL2	202.1
PSL2A	221.4
Wider Liquidity	239.8
Wider Sterling Aggregate	136.7*

*Average of level at end of banking March and banking April.

Data Sources

All the tables in the paper except Table 2 use calendar quarter data everywhere. Calendar quarterly M0 is constructed by summing notes and coin and bankers' balances on the last day of the quarter. It is not constructed using weekly averaged data for M0. The calendar quarter data is available over a long period and is more suitable for comparison with variables such as GDP.

The money supply figures in Table 2 use banking month data:

- (i) The 1976-77, 1977-78 and 1978-79 (I) figures are 12 month growth rates to end-banking March.
- (ii) The 1978-79 (II & III) and 1979-80 figures are 12 month growth rates to end-banking October.
- (iii) The remaining figures (1980-81 on) are annualised growth rates from the end of banking February to the end of banking April the following year. (The 14 month period is used for targets because February data are the latest available when the financial year begins).

In table 3, in the column of data for 1975, the second figure gives the actual percentage shares of the interest bearing and non-interest bearing components. Prior to 1975, data do not exist for the interest bearing/non-interest bearing split. This has been approximated by counting all current accounts as non-interest bearing and all other accounts as interest bearing. The first set of figures under 1975 are also based on this approximation to indicate the probable size of the error.

The source of the historical data for Chart 1 is 'A Monetary History of the United Kingdom 1870-1982' by Forrest Capie and Alan Webber, Volume 1, (Allen & Unwin 1985).

In Charts 2-4 the nominal GDP data is *smoothed* for the effects of the three day week (1974Q1) and for the road haulage strike (1979Q1).

Most of the other data used in the paper is published in Financial Statistics and Economic Trends. The exceptions are data on the composition of M3 and on total national savings (Bank of England Statistical Abstract 1975), on PSL2A, building society SAYE deposits and all data for Table 2 (Bank of England).

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NOTE FOR THE RECORDDINNER WITH THE CHANCELLOR AND OTHERSON SUNDAY 15 DECEMBER 1985

The Prime Minister yesterday gave dinner to the Chancellor of the Exchequer, Chief Secretary, Sir Peter Middleton, and Sir Terence Burns. Nigel Wicks and Professor Brian Griffiths were also present.

The Prime Minister opened the discussion by expressing serious concern about the stance of policy at present. She believed it to be too loose, citing the growth of broad money, unit labour costs, house prices, retail sales and the behaviour of the stock market. There was evidence of excessive demand which risked higher inflation. The Treasury sought to reassure arguing that there had been a tightening of policy over last winter after a period during the Autumn of 1984 in which - with hindsight - policy had been a little loose. The indicators were not clear cut (see below) but on balance they supported the view that policy was not loose, and there was probably some effect of the tightening still to come. The Prime Minister appeared to take some reassurance from this, though she was ~~perhaps~~ not completely convinced.

Looking ahead, the Treasury pointed to the generally acceptable reception given to the Autumn Statement and argued that it was in any case premature to say that fiscal policy next year appeared to run risks of being on the loose side: no decision about the PSBR had yet been taken, and, when it was, the effect of the sizeable receipts from privatisation would need to be given proper weight - receipts from privatisation had in the past helped to hold borrowing below what it would otherwise have been. The Prime Minister concluded by emphasising the need for a prudent Budget, and indeed that there was a case for not making it too imaginative.

Generally, the theme of the evening was the Prime Minister urging prudence and caution. The Treasury whilst

agreeing, also pointed to the need for balance: UK industry was the only industry we had, and the pressures brought to bear on it had to take account of their ability to adapt, otherwise the result might be further increases in unemployment.

In greater detail, the main areas discussed were as follows:

- money and particularly £M3;
- labour costs;
- progress on inflation;
- stock market and mergers;
- consumer spending;
- house prices;
- interest rates.

Money

The Prime Minister was concerned about the high rate of growth of £M3 and its downgrading in the assessment of monetary conditions. After a period when its rate of growth seemed to be coming under control, it had now been rising for two years at an increasingly rapid rate. This could itself be seen as an indicator of loosening conditions and the build-up of liquidity could lead at some stage to excessive spending. It was important to have some measure of broad currency in the MTFs. The Treasury pointed to the slow growth of narrow money and argued that high real interest rates, falling inflation and increasing competition in the banking system were contributing to the rate of growth of £M3 and causing it to become a misleading indicator. They did not ignore it, or other indicators of broad money, though they themselves were mystified by the high level of bank lending. The changes to capital allowances were perhaps causing companies to borrow to finance higher investment in advance of the reductions in capital allowances. (The final stage would be reached next April.) Another possible explanation was that increasing use of financial swaps was leading banks to expand both sides of

their balance sheets. Nevertheless, the Treasury accepted that there was a build-up of potential spending power. What could trigger its use would be expectations of a rapid fall in the exchange rate and/or a rapid increase in house prices. These were threats to be watched, but on balance the Treasury did not feel that the behaviour of £M3 at present was a cause for major concern. Interest rates however had to remain high to keep downward pressure on inflation.

Labour Costs

The Prime Minister and the Treasury agreed readily that the rapid growth in unit labour costs was of course of concern. The broad stability of the exchange rate in the past few months (in effective terms) was increasingly coming into conflict with this growth, and employers needed to understand that depreciation of the exchange rate would not be accepted as a mechanism to bail them out. Rising costs, primarily reflected management. In this context it was noted that depreciation against the DM tended to help the competitiveness of exports, whilst appreciation against the Dollar tended to help import costs. But that was not a reason to look for continuing movement of the respective parities in those directions. There had already been recently a substantial depreciation against the DM.

Inflation

The Prime Minister expressed concern about the slow progress being made on inflation, particularly against a background where inflation had fallen fast in other countries and had been as low as 3.7 per cent in the UK May 1983. The Treasury argued that the figure of 3.7 per cent had been to some extent artificial, since nationalised industry price increases that year had been low, and there had possibly also been some help from a lower mortgage rate. Most other countries excluded the mortgage rate from their price indices. If the mortgage rate was taken out of the RPI it seemed likely that underlying inflation would have been

running at 4.5 - 5 per cent for two years or more. Inflation next year should fall to 3.5 - 4 per cent by the summer, but again this was likely to be artificially helped by a lower mortgage rate. The underlying rate of inflation next year might still be more than 4 per cent. The Prime Minister urged the need to keep inflation from the middle of next year down to the "artificial" level it would reach in the middle of the year.

Stock Market

It was agreed that the present level of the Stock Market and the wave of take-over activity was "frothy".

The Chancellor pointed to the benefits which could sometimes be secured by take-over activity of the kind now going on, which led to de-mergers in some cases. The Treasury argued further that there was no real cause for concern: stock markets were high around the world and in real terms the UK Stock Market was not much higher than in 1973 even though corporate profits were much higher.

Consumer Spending

The Prime Minister pointed to the rebound of retail sales and to the expected rapid growth of consumer spending (4 per cent next year) as indicators of excessive demand. There was no substantive discussion of this point.

House Prices

Terry Burns argued that house prices were probably rising at about 8 - 9 per cent a year, on average, though there were wide regional variations. House prices tended to rise broadly in line with earnings. Their behaviour would become a case for concern if they were to rise much more rapidly than earnings.

Interest Rates

The Prime Minister pointed to the high level of real interest rates in the United Kingdom, and also to the way in which the markets had reacted quickly and adversely to the fall in oil prices as if they did not fully accept the rectitude of the Government's economic policies. The Treasury argued that market confidence had been substantially restored by, among other things, only two or three speeches from the Prime Minister and the Chancellor. This was encouraging. But in any case the United Kingdom did not have the long successful track record of Germany and Switzerland in running prudent economic policies. It therefore had to pay a premium in higher interest rates, and the Chancellor argued that this premium was linked in particular to the inducement needed to maintain the exchange rate at its present level.

The evening also included some discussion of mortgage interest relief, where the Prime Minister argued the need for an increase to help particularly younger people in London; and teachers' pay, where the Prime Minister showed some inclination to share the doubts expressed by the Chancellor and the Chief Secretary about the wisdom of an inquiry, though without committing herself: she continued to see some merit in an inquiry which focussed on teachers' contracts and conditions of service.

(Dictated from memory 16/1)

DNS

DAVID NORGROVE

16 December 1985

POLICY
BACK-
GROUND
TO
THE
1986
MTFS

CONFIDENTIAL

From: T Burns
20th December 1985

CHANCELLOR OF THE EXCHEQUER

*The by question m/r
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policy" (It has had a bit of
m?)*

- cc Mrs Lomax
- Chief Secretary
- Financial Secretary
- Economic Secretary
- Minister of State
- Sir Peter Middleton
- Sir Geoffrey Littler
- Mr F E R Butler
- Mr A Wilson
- Mr Anson
- Mr Byatt
- Mr Cassell
- Mr Monck
- Mr Scholar
- Mr Evans
- Mr Monger
- Mr Odling-Smee
- Mr Turnbull
- Mr Sedgwick
- Mr Cropper
- Mr H J Davies
- Mr Lord
- Mr Riley
- Sir Lawrence Airey - IR
- Mr A Fraser - C&E

POLICY BACKGROUND TO THE 1986 MTFS

I attach our analysis of the policy background to the 1986 MTFS. The rest of this minute summaries the main conclusions.

2. The overall aim of the MTFS of reducing inflation and money GDP growth has been achieved. The growth of money GDP has fallen from nearly 20 per cent in 1979-80 to an estimated 7¹/₂ per cent this year. The split between output growth and inflation has improved, to a greater extent than was foreseen in successive MTFSs.

3. Although output growth has been no faster in the six years since 1979 than in the previous six years, average inflation and money GDP growth have been slower. This contrasts with other major countries where output has grown more slowly and the improvement in inflation has not been so marked. But unemployment remains a greater problem here than elsewhere, because of inflexibility of pay and the labour market.

4. The medium-term prospects for productive potential growth have improved since the 1985 MTFS. This is partly because of a prospective slower rundown in North Sea production, and partly because of faster growth in

labour supply and productivity in the rest of the economy than was expected a year ago. We continue to expect actual output to grow a little further than productive potential, in part because the output/inflation split will benefit from the terms of trade improvement.

5. The paper suggests that productive potential might grow at about 2 per cent a year over the medium term, and that output could grow at 2¹/₂ per cent consistent with the inflation profile shown in the 1985 MTF. This would leave room for some reduction in unemployment, although not much more than was expected a year ago.

6. There is little case for departing from the existing MTF inflation path. Anything lower would be unhelpful to unemployment and would stretch credibility, and anything higher would damage credibility.

7. We have recently been giving more emphasis in the MTF to the path for money GDP. There is no case for giving it a more formal position. But we should continue to use it to provide an indication of medium-term objectives and a way of checking whether financial policy has been broadly on track.

8. Little if any progress on reducing inflation has been made since 1983-84. An examination of the overall stance of policy over the last few years suggests it was not sufficiently tight to exert downward pressure on inflation. There was a temporary acceleration in money GDP in 1984-85 which showed up initially as a rapid growth of real GDP and in some reversal of the decline in inflation. Both monetary and fiscal policy were tightened last winter, and money GDP growth is now adjusting downwards. I doubt whether any further overall tightening of policy is required.

9. Within the overall stance of policy, the following factors point towards a different mix, with a tighter monetary and easier fiscal policy:

- the need to avoid sterling weakness
- its effects on pay through pressure on companies and additional tax cuts
- the end of overfunding and the rapid growth of £M3

*The MTF
implies
less & for
choice*

- the high level of world interest rates
- the decline in North Sea revenues
- a temporarily better split of money GDP between output and prices.

10. On the other hand there are factors pointing towards a tighter fiscal and easier monetary policy:

- the balance of payments current account and the effects of a high real exchange rate on the future current account
- the effects of high real interest rates on investment
- higher real interest rates than in other major industrial countries
- the sectoral impact on manufacturing and services, and the implications for unemployment
- the charge of "selling the silver"
- the present favourable prospects for the share of consumption
- greater debt interest burden in future years
- the room for manoeuvre, especially if confidence in the Government's policy weakens.

11. Most of the arguments for a tighter monetary and easier fiscal policy are short term in nature. The longer-term arguments suggest that imbalances between fiscal and monetary policy should be avoided. They point towards a tighter fiscal and easier monetary policy, with a continuation of the policy of reducing the PSBR over the medium term. The short-term arguments suggest caution about the speed at which this is done. There are, of course, risks in both directions.

12. Compared to the 1985 MTFS we have increased our estimate of privatisation receipts from next year. If the PSBR for 1986-87 is not also changed from £7¹/₂ billion, it will be virtually the same as that in 1981-82

when adjusted for privatisation receipts. In my judgement this marks the upper limit of the feasible range for the next MTFS, bearing in mind market expectations. However, projected North Sea revenues have been revised down since last year, which provides an argument for not fully adjusting the PSBR profile for higher privatisation receipts.

disagree

13. The paper examines four cases spanning a PSBR range of £6-£7¹/₂ billion. My own preference is for a figure in the lower half of the range. And to continue a very gradual downward adjustment in subsequent years, in line with the implications of the long-term arguments.

14. The underlying calculations may be revised over the forthcoming weeks as the forecast proceeds. And there could be significant changes in the oil price. If it falls sharply consideration should be given to an increase in fuel taxes or other non-North Sea taxes. But it may not be necessary to fully offset the loss of oil revenues. Some rise in interest rates would also be appropriate to ensure that the overall policy stance was kept unchanged.

15. Macro-economic considerations do not give any decisive pointers to the use of the fiscal adjustment next year. Neither companies nor persons are short of income. The arguments against raising indirect taxes are weaker this year because of the fall in commodity prices. The case for income tax reductions depends on the weight attached to the long-term aim of a lower tax burden and an improvement in incentives.

T BURNS

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John's note.*

CONFIDENTIAL

POLICY BACKGROUND TO THE 1986 MTFS

		<u>Page</u>
I	INTRODUCTION	1 - 8
II	QUESTIONS	9
III	INFLATION AND MONEY GDP	10-14
IV	THE OVERALL STANCE OF POLICY	15-19
V	BALANCE OF FISCAL AND MONETARY POLICY	20-31
ANNEX I - Comparisons of MTFS figures with Outturn		

20th December 1985

CONFIDENTIAL

POLICY BACKGROUND TO THE 1986 MTF5

I. INTRODUCTIONRecent Economic Developments

The MTF5 has now been in place for nearly six years. It was introduced in 1980 and set out targets for monetary growth and an illustrative path for the PSBR, with the aim of bringing about a progressive fall in the rate of inflation and establishing the conditions for a sustained growth in output.

2. Although the monetary targets and the PSBR path have changed significantly, the overall thrust of policy as measured by money GDP has been achieved*. The growth in money GDP during the first two years of the MTF5, declined sharply, from nearly 20 per cent in 1979-80 to 10 per cent and has since declined further. Adjusting for the coal dispute, money GDP is expected to grow by 7¹/₂ per cent during the current financial year. The rate of inflation, as measured by the GDP deflator fell from nearly 17 per cent in 1979-80 to 4¹/₂ per cent in 1984-85 and after rising slightly over the past year, is now expected to resume its downward course. The recent behaviour of money GDP, output and inflation is set out in Table 1 below.

Table 1Money GDP and the Inflation/Output Split

(per cent per annum)

	<u>1979-80</u>	<u>1980-81</u>	<u>1981-82</u>	<u>1982-83</u>	<u>1983-84¹</u>	<u>1984-85¹</u>	<u>1985-86¹</u>
Money GDP growth	19.8	14.0	10.1	9.4	7.9	8.7	7.5
Output growth	2.7	-3.8	-0.1	2.3	3.3	3.7	2.5
Inflation							
GDP deflator	16.8	18.6	10.2	7.1	4.4	4.7	5.1
RPI	15.8	16.3	11.5	7.1	4.7	5.1	6.0

¹Adjusted for the coal strike

*Tables in the Annex compare the projections in successive MTF5s with the outcome.

? Annex a abstract
 that if oil price
 falls below 100 per
 barrel, [something] can be
 achieved, but less can
 be done for the
 rest of the world.

3. The decline in the rate of inflation has been larger than that in money GDP growth, leaving room for an increase in output growth and resulting in a marked improvement in the split of money GDP between output and inflation. Output fell during the first two years of the MTFs, but has been growing at almost 3 per cent since the spring of 1981. Adjusted for the coal dispute, it grew by $3\frac{1}{2}$ per cent during 1984-85 and a growth rate of $2\frac{1}{2}$ per cent is expected during the current financial year. These output gains make up nearly two-fifths of the growth in money GDP over this period.

4. The split of money GDP over the last six years has been generally more favourable than over the previous six, with a similar growth of output and a much lower rate of inflation. This is shown by the table below which compares the UK's performance following the oil price shocks of 1973 and 1979. The rate of money GDP growth has been sharply reduced. This has been entirely reflected in lower inflation. The annualised growth in output has been similar; non-oil output and, in particular, services have tended to do better while manufacturing has done a bit worse (Table 2). The composition of demand between expenditure categories has also been more evenly balanced (Table 3).

Table 2

Output Growth by Sector

(per cent per annum)

	<u>1973-1979</u>	<u>1979-85*</u>
Total	1.3	1.3
- non-oil	0.6	0.9
- manufacturing	4.3 -0.7	5.7 -0.9
- non-manufacturing	1.2	1.8

*Adjusted for the coal strike

Table 3**The Components of Final Demand**

(per cent per annum)

	<u>1973-1979</u>	<u>1979-85*</u>
Private Consumption	1.3	1.4
Government Consumption	1.9	0.9
Fixed Investment	0.2	1.3
Stockbuilding**	-1.4 -0.4	-1.0 -0.1
Domestic Demand	1.0	1.1
Net Trade**	0.5	0
Statistical Discrepancy	-0.2	+0.2
GDP at factor cost	1.3	1.3

*Adjusted for the coal strike

**Change as % of GDP

5. By way of comparison Table 4 also shows the performance of the major six OECD countries over these two cycles. Like the UK these countries have been following strongly counter-inflationary policies since 1979, reflecting the lessons learned following the first oil price shock. This has resulted in lower rates of money GDP growth and inflation, though the difference between the two cycles is less marked than in the case of the UK. Output has grown less strongly than following the first oil price shock. Consequently, the gap between the performance of the UK and that of other countries has been much reduced during the present cycle (although it should be noted that the recovery outside the UK is still at a relatively early stage).

Table 4**The Two Cycles in the UK and Elsewhere**

(per cent per annum)

	UK		OECD Major 6	
	<u>1973-79</u>	<u>1979-85*</u>	<u>1973-79</u>	<u>1979-85</u>
Money GDP growth	17.6	10.1	11.2	8.4
Inflation	16.0	8.8	8.0	6.0
Output growth	1.3	1.3	2.9	2.2

*Adjusted for the coal strike

6. In the major six OECD countries the better inflation/output trade-off owes much to a better labour cost performance. The increase in real earnings since the 1979 oil price rise has been rather less than would have been expected on the basis of earlier experience. As a result these countries have been able to contain the inflationary impact of rising oil prices without the excessive squeeze on profits that characterised the years after the first oil shock, and their unemployment has risen less in the second cycle than that in the UK.

Table 5 **Earnings and Productivity Growth**
(per cent per annum)

	UK		OECD Major 6	
	1973-79	1979-85*	1973-79	1979-85
Nominal earnings growth	16.6	10.6	13.0	8.9
Real earnings growth	1.0	1.7	3.9	2.0
Productivity growth				
- whole economy	0.4	1.5	1.3	1.5
- manufacturing	0.7	3.9	2.9	3.5
Unemployment (%) - first year	2.6	5.0	3.8	5.1
- final year	5.0	12.8	5.1	7.4

*Adjusted for the coal strike

7. In the UK the behaviour of the labour market was not the same after the two oil price shocks (Table 5). Between 1973 and 1979 real earnings increased slowly. Following a sharp reduction in 1975 and 1976 employment in manufacturing was broadly maintained; total unemployment fell slightly in response to the growth in service employment. The climate of incomes policy, exchange rate depreciation and industrial policies and the expectation of a cyclical recovery contributed to the maintenance of overmanning and the pressure to avoid closing factories. The resulting low rate of productivity increase left companies with considerable scope for improvement, especially in manufacturing industry.

8. Real earnings rose faster in the second cycle than in the first. This, together with the stronger exchange rate, tighter financial policy, the initial overmanning and the climate of deregulation provided the trigger for a major shake-out of labour. The result was a faster rise in productivity than in the first cycle. This contrasts with the experience of

other major countries where productivity growth was similar in the two cycles. Indeed, between 1979 and 1985 UK manufacturing productivity grew more rapidly than the average of the major six.

9. This largely explains the bigger rise in unemployment in the UK in the second cycle than in the first, despite a similar growth in output. So far it seems that the improved bargaining power of employers has led to increased productivity and better working practices rather than lower pay settlements. Indeed during the period of rapid demanning employees have been well compensated, no doubt partly as an incentive to accept the changes in working practices.

Table 6 Employment and Unemployment

	Total change between:	
	<u>1973-79</u>	<u>1979-85</u>
a. in thousands		
- manufacturing employment	-680	-1,779
- other employment	573	473
- claimant unemployment	631	1,920
b. in %		
- population of working age	3.0	3.6
- activity rate	0.3	-1.3
- total labour supply	3.5	2.3

10. Since the spring of 1983 we have had a substantial growth in employment but this has largely taken the form of an increased demand for part-time female workers by the service industries. Many of these women were previously outside the labour force and so did not reduce the unemployment count.

The Medium-Term Prospect

11. We next consider the appropriate assumptions for output growth and inflation in the next MTFS. Further details are set out in a separate submission*. The approach adopted is to consider the output growth that seems to be compatible with the inflation path in the 1985 MTFS. This enables us to consider whether the inflation assumption should be changed.

*"Macro-economic Assumptions for the MTFS", 18 December 1985

12. The assumptions in the 1985 MTFS are shown in Table 7.

Table 7 **Inflation and Output Growth Assumptions, 1985 MTFS**

	(per cent per annum)				
	<u>1984-85</u>	<u>1985-86</u>	<u>1986-87</u>	<u>1987-88</u>	<u>1988-89</u>
<u>Real GDP</u>					
- Onshore	2	3 ¹ / ₂	2 ¹ / ₂	2 ¹ / ₂	2 ¹ / ₂
Total	2 ¹ / ₄	3 ¹ / ₂	2	2	2
<u>Inflation</u>					
- GDP Deflator	4 ¹ / ₂	5	4 ¹ / ₂	3 ¹ / ₂	3
Money GDP	6.9	8.3	6.5	5.8	5.0

13. In the past successive versions of the MTFS have made assumptions for the growth in money GDP that have turned out to be close to the mark; it is hard to detect systematic errors one way or the other. But the projections have been consistently pessimistic about the split of money GDP between inflation and output; growth has tended to be faster than assumed and there has been greater success in reducing inflation. The main reason for this has been the persistent tendency to underestimate the rapid growth of productivity. In addition since 1983 world conditions have also been favourable; world trade growth has been strong and world inflation has been reduced further than expected.

14. These favourable world trends now look more likely to persist into the future than they did a year ago. In particular, industrial countries may continue to benefit from improved terms of trade. Demand/supply conditions in world markets suggest that commodity prices, particularly for oil, will continue to fall relative to manufactured prices; this may set the stage for better output and better inflation performance in the industrial countries. The UK stands to benefit as we outline below.

15. In reviewing the prospect for output growth we follow a two-stage process. First we attempt to estimate the growth of productive potential. Then we try to evaluate the extent to which output growth may be faster or slower than potential.

16. Three factors are relevant to the growth of productive potential: the trend growth in on-shore productivity; the prospective change in the labour supply; and the path for North Sea output.

17. As productivity has continued to rise briskly it has become increasingly clear that there has been an improvement in trend growth as well as a one-off shake-out of labour. Our latest estimates suggest that the trend increase may be $1\frac{1}{2}$ - $1\frac{3}{4}$ per cent a year, fractionally higher than that assumed last year. Labour supply may contribute more to the growth of supply potential than seemed likely a year ago. On present demographic and activity projections, the labour supply could be growing by an average of 200,000 per year over the MTFS period, contributing about $\frac{3}{4}$ per cent average annual growth in productive potential. The outlook for North Sea production also looks better. Geological evidence since the Budget suggests that the decline in output will be slower over the next few years than the 1985 MTFS assumes.

18. These revisions mean that supply potential may grow faster over the MTFS period than we assumed last year (Table 8).

Table 8 Components of Productive Potential Growth

	(per cent per annum)	
	Current	1985 MTFS
	Estimate	(1985-86 to 1988-89)
	(1985-86 to 1989-90)	
Labour supply	$\frac{3}{4}$	$\frac{1}{2}$
Productivity	$1\frac{1}{2}$ - $1\frac{3}{4}$	$1\frac{1}{2}$
Total On-shore	$2\frac{1}{4}$ - $2\frac{1}{2}$	2
North Sea Production	- $\frac{1}{4}$	- $\frac{1}{2}$
TOTAL	2 - $2\frac{1}{4}$	$1\frac{1}{2}$

The help in much agreed to be assumed lower than

19. And our estimate of the gap between the growth for the onshore economy and the whole economy is reduced. Last year, it was assumed that the decline in North Sea production would reduce whole economy growth by $\frac{1}{2}$ percentage point relative to that in the onshore sector. Better prospects for the North Sea reduces the difference to $\frac{1}{4}$ per cent a year.

20. Judging the likely growth of actual output relative to potential is always difficult. Last year we assumed that actual growth at 2 per cent would be above the growth of productive potential of $1\frac{1}{2}$ per cent, implying some labour market adjustment. In reconsidering this, two factors are relevant: the extent of labour market adjustment, and the help that may come from beneficial movements in world commodity prices and activity.

21. The absence of labour market adjustment has been one of the striking features of recent years. Rising oil and material prices in the 1970s meant a shift in command over real resources away from labour in the industrial countries in favour of primary material producers. There should have been a fall in real wage rates but in Europe this did not take place. The resulting squeeze on profits was very damaging for employment and raised the unemployment path consistent with stable inflation. The damage was less in the US where wages did not fully respond to higher inflation.

22. To some extent, we are now seeing a reversal of the commodity price trends of the 1970s. Industrial countries' export prices are rising relative to oil and other primary product prices and this helpful development looks set to continue for some time yet. The effect is to raise real national disposable income and thus to increase the real wage which market conditions justify. If real wage growth does not rise to absorb this extra margin, a significant part of the required adjustment could be accomplished in this way.

23. If the UK, and Europe as a whole, do benefit in this way, there should be a fall in the rate of unemployment consistent with any given inflation path. As long as actual unemployment remains some way above the level compatible with stable inflation, there is no reason why our inflation objectives cannot be met with some reduction in unemployment. Output growth could then be greater than the growth rate in productive potential.

24. Of course, if higher real national disposable income is merely reflected in higher real wages, then no adjustment will take place. Unemployment would then be likely to remain close to present levels; and output growth would be no higher than the growth in productive potential.

25. My own judgement is that some small correction of the labour market will occur in any case, allowing some fall in the inflation rate to be combined with a gradual reduction of unemployment. A significant terms of trade gain of the kind mentioned above would give added impetus to that adjustment. If we assume the same gap between output and productive potential growth as last year - about $\frac{1}{2}$ per cent a year - this would point to growth in the whole economy of $2\frac{1}{2}$ per cent a year over the MTF5 period.

II. QUESTIONS

26. The broad objectives for the next MTFS might be as follows:

- continue to bring down inflation gradually
- provide scope for some reduction in unemployment insofar as it depends on the macro-economic policy stance
- present a coherent account of how we interpret monetary indicators, including money GDP, so that monetary conditions develop in line with the strategy
- give due weight to both short-term and long-term consequences of fiscal policy, including the implications of privatisation receipts and the prospective fall in North Sea revenues.

27. To help the discussion of how to achieve these objectives, the remainder of the paper is concerned with the following policy issues:

- medium-term objectives for inflation taking account of their implications for output growth
- the role of money GDP in the MTFS and the implications for monetary policy
- the overall pressure from fiscal and monetary policy that is necessary to achieve the objectives for money GDP
- the appropriate mix of fiscal and monetary policies and the implications for fiscal policy and the use of the fiscal adjustment.

III. INFLATION AND MONEY GDP

Inflation Objectives

28. The discussion above suggested that the medium-term prospects for the economy are somewhat better than appeared to be the case a year ago. There are improved prospects for labour supply, productivity and North Sea oil. And there may also be favourable world developments that will improve the output-inflation split. On the other hand, without some external help there are few grounds for expecting faster adjustment of real wages and employment -if anything the reverse.

29. In the 1985 MTF5 inflation was assumed to fall gradually to 3 per cent in 1988-89. If we were to adopt the same assumption this year with a continued fall to 2 $\frac{1}{2}$ per cent in 1989-90, this could be combined with slightly higher output growth than was assumed last year. However, as productive potential growth is also expected to be higher, the prospect for unemployment would be little different from that expected last year.

30. In designing the MTF5 we have to accept that the main policy instruments for influencing unemployment are micro-economic measures. But at the same time macro-economic policy needs to create the most favourable environment for labour market adjustment. This implies that it should be non-accommodating, consistent and credible so that employers and employees fully realise the need to adjust. Inflation needs to be kept under control and gradually reduced.

31. In practice there is probably some trade-off in the short term between output growth and the speed of reduction of inflation. For example, there is a choice between a medium-term path in which inflation declines as in the 1985 MTF5, and one in which inflation stays at around the 5 per cent level and unemployment falls somewhat more because of the room for faster output growth. But it is very difficult to quantify how much lower unemployment might be in this case. It depends on various factors, especially the relative emphasis on monetary and fiscal policies within the overall easier stance and the impact on expectations.

32. The best that could be hoped for from an easier overall stance of policy would be 1-1 $\frac{1}{2}$ per cent higher output by the end of the MTF5 period. This might imply a level of unemployment in 1989-90 that was 150,000-200,000

lower. But the outcome could be less favourable and there would be a distinct risk that inflation might turn out even higher than it is at present. As it is widely believed that the Government's aim is 3 per cent inflation by 1988-89 that could be very damaging for confidence in financial markets.

33. On the other hand, even with favourable world commodity prices it would be very difficult to bring inflation below 3 per cent over the MTFS period without considerable pressure from fiscal and monetary policy. In turn that would have the effect of making it more difficult for output to grow faster than potential.

34. My own view is that we should stick to the profile for inflation shown in the last MTFS. There seems to be little case for departing from it. Anything lower would be unhelpful to unemployment and would stretch credibility, and anything higher would damage confidence.

The Role of Money GDP and Monetary Policy

35. The MTFS has gradually evolved. Originally it was expressed mainly in terms of a path for money supply. More recently we have given greater emphasis to the growth of money GDP and inflation. This evolution has been in response to a number of factors including:

- the difficulties of predicting the velocity of broad money. We have attempted to identify a number of factors - financial liberalisation and deregulation, new technology, higher real interest rates - but they are almost impossible to quantify or project.
- the desirability of being more precise about the expected path for inflation now that it has been brought down from its initially very high level.
- the ability to show more clearly that wage and price moderation would lead to more activity when explained in the context of unchanged money GDP compared to that of unchanged money supply. This culminated in the NEDC pledge and the 1985 Budget speech

Why?
(if other well-governed countries)

- the helpful framework it provides for the analysis of the interactions between fiscal and monetary policies. At one stage we attempted to do this via £M3 and its counterparts but the problems with £M3 have made this impossible.

36. So far the main role of money GDP has been in the context of medium-term assumptions, which have acted as strategic objectives, and in the presentation of policy. The path for money GDP growth set out in the MTFS is an important statement about the way in which the Government sees the economy developing. The NEDC pledge has made it a little more than just an illustrative assumption. It now has an element of ambition about it, in the sense that there is an expectation that sustained deviations away from it will be corrected. On the other hand, the Government has also indicated that there are circumstances in which it would be appropriate to change the path of money GDP. For example, the May EPR said that:

"If, as a result of an improvement in the performance of the economy, underlying real growth of output were faster than assumed, with the downward trend of inflation maintained, the money GDP assumptions for the medium term could be revised upwards."

37. The problems with monetary aggregates raise the question whether money GDP could also play more of a role in assessing monetary conditions and in interest rate policy. The line we have taken so far is that it has only limited value in this role. This is primarily because information on money GDP is out-of-date and subject to revision. What we have had to accept more recently is that this is only a decisive factor if there are other indicators that are both quickly available and provide helpful information about the evolution of money GDP and prices in the present or the future. In practice, problems have emerged with other indicators as well.

38. The approach that we have been developing for the short term has been to take into account a number of indicators - monetary aggregates, exchange rate, asset prices - all of which are related to past and prospective growth of money GDP. We remain persuaded that it would be unwise to rely too heavily on money GDP, because the inevitable lags in responding to money GDP deviations could introduce unnecessary fluctuations.

39. Moreover there are circumstances in which money GDP may give misleading signals, possibly even to the extent of indicating a perverse response. The most obvious example is a cut in indirect - or direct - taxes, which would tend to reduce money GDP while clearly raising underlying inflationary pressure although in practice there should be no difficulty in allowing for this.

40. Perhaps more worrying are cases where money GDP fails to indicate an underlying inflationary change. Examples include an expansion of output leading to higher inflationary pressures which may have little effect on money GDP in the short term because productivity improvements put downward pressure on prices; and a sustained supply side improvement which raises output but puts downward pressure on prices, again leaving money GDP little changed.

41. In spite of these difficulties it is possible to look backwards at money GDP to see whether things are broadly on track, given the other factors which we know are operating. This enables us to recalibrate our judgement about the information from the other financial indicators and their implications for monetary conditions, though considerable care is needed in view of the difficulties involved.

42. One possibility that emerges from time to time is the argument for monitoring inflation itself for the purpose of calibration. After all, inflation is a final objective of policy, and some indicators of inflation (eg the RPI and the Producer Price Index) are available more quickly and reliably than money GDP data. But direct indicators of inflation often conceal underlying trends in inflationary pressures because they ignore movements in output which may give advance warning of inflationary pressures. And they are affected by changes in interest rates, indirect taxes and temporary fluctuations in the exchange rate. The GDP deflator suffers less than the RPI and some other indicators from temporary distortions and fluctuations but it is no more up-to-date or reliable than money GDP itself. And following changes in policy instruments or cyclical developments, output changes often precede inflationary pressures.

43. We are therefore persuaded that on balance it is better to use money GDP rather than any of the usual inflation measures as an indicator of underlying inflationary pressures. The inflation indices can provide

supplementary information, and the growth of earnings, perhaps adjusted for trend productivity increases, might also prove helpful on a longer-term basis.

44. Despite the higher profile for money GDP, the case for giving it a more formal position is not strong. It was given an enhanced status in the last MTF, and a further move in this direction might be interpreted as being more significant than is desirable. But there is one change that might be considered.

45. The money GDP path in the MTF, and the inflation and output growth assumptions that are consistent with it, gives a clear indication of the Government's medium-term objectives. The paths for the monetary ranges - particularly for broad money - do not add significantly to this, because it is clear that the government would change them if velocity trends changed substantially. There is a case for discontinuing the publication of monetary ranges in the MTF, other than for the year immediately ahead. The role of the monetary targets would be confined to an operational one, namely assessing monetary conditions in the short term. This would be especially convenient this year, in view of the presentational difficulty of publishing a series of £M3 ranges which are significantly higher than those in the 1985 MTF.

✓ Worth considering for MTF:

Part case for 5 yr. horizon for M3 is as sharp now as it was last year. Dropping all forward monetary ranges would inevitably be seen as a significant change in approach.

And, rightly setting ranges for more than year ahead does involve an increasing manoeuvre, despite all the caveats about "the ranges being merely "indicative" in the MTF Text.

IV. THE OVERALL STANCE OF POLICY

46. The aim of this section is to review the overall stance of policy and its impact upon the growth of money GDP. We describe briefly the evolution of policy over the last few years as an introduction to a judgement about next year. The official forecast attempts to examine rigorously the influence of the various policy instruments and the channels through which they work. This presentation seeks to describe this in a more intuitive way. The basic data are shown in Table 9.

47. The main instruments of macro policy are fiscal policy and interest rates. For fiscal policy the table shows the PSBR as a percent of GDP including and excluding receipts from privatisation. This is inevitably a very limited measure when it comes to examining the short run movements in the economy. Expenditure and revenue components vary in their impact on demand, which depends on, for example, their effects on the savings ratio and interest rates and the leakage into imports. Nevertheless it is a useful starting point and is the focus of the fiscal dimension of the MTFs.

48. The growth of £M3 and M0, the present two target aggregates, are shown as indicators of monetary policy. The three-month interbank rate is shown in both nominal and real terms, with the latter defined in relation to growth in the GDP deflator. One of the important channels through which monetary policy operates is the movement of the exchange rate. The table shows the movement of the sterling index in nominal and in real terms, the latter based on relative GDP deflators. To complete the list of monetary indicators the growth of house prices is also shown.

49. In examining the pressures upon money GDP it is also interesting to look at the behaviour of the rest of the world. The table shows for the major 6 industrial countries, the growth of GDP, the inflation rate and the three-month interest rate.

50. It is clear from the basic data for the UK that, after making considerable progress in reducing inflation up to 1983-84, little if any further progress has been made since then. The behaviour of money GDP and inflation suggests that the overall stance of policy after 1981-82 was not sufficiently tight to exert downward pressure. In subsequent paragraphs we outline some of the changes in fiscal and monetary policy since 1983-84.

Table 9

Monetary and Fiscal Stance

(percentages, except exchange rate which is 1980 = 100)

	Money GDP growth	Output growth	Inflation ¹	Short-term interest rates		OECD Major 6			<i>Real</i>
				Nominal	Real ³	Output growth	Inflation ¹	Short-term interest rates	
1980-81	14.0	-3.8	18.6	15.5	-3.1	0.8	8.8	12.5	3.7
1981-82	10.1	-0.1	10.2	14.2	4.0	1.7	8.2	13.9	5.7
1982-83	9.4	2.3	7.1	11.5	4.3	-0.3	6.2	10.8	4.6
1983-84	7.9 ²	3.3 ²	4.4	9.7	5.2	4.0	4.7	9.2	4.5
1984-85	8.7 ²	3.7 ²	4.7	10.9	6.2	4.4	3.9	9.5	5.6
1985-86	7.5 ²	2.5 ²	5.1	11.7	6.6	3.0	4.0	8.0	4

1986-87	7.3 ²	2.7 ²	4.3	10.4	6.1	2.9	3.8	7.3	3.5

*not stable
not
not*

	<u>Monetary growth</u>		<u>Exchange rate</u>		House price inflation ⁵	<u>PSBR/GDP ratio</u> excluding receipts		North Sea revenues as % of GDP
	M0	£M3	Nominal	Real ⁴		Actual	privatisation	
1980-81	7.1	17.1	98.2	103.5	22.3	5.4	5.5	1.7
1981-82	3.8	16.4	92.3	97.6	5.9	3.3	3.3	2.4
1982-83	1.6	12.4	88.0	93.6	0.5	3.1	3.3	2.8
1983-84	6.0	12.3	83.5	89.8	9.3	3.2	3.6	2.9
1984-85	5.5	9.5	76.2	82.2	9.6	3.1 ⁶	3.8 ⁶	3.7
1985-86	4.3	13.5	80.7	87.9	9.2	2.2	2.9	3.2

1986-87	4.2	11.9	81.0	88.7	6.2	2.0	3.2	2.4

¹Increase in GDP deflator

²Adjusted for coal strike

³Nominal interest rate minus increase in GDP deflator

⁴Relative GDP deflators in a common currency

⁵RPI component index

⁶These figures would be 2.3 (actual PSBR) and 3.0 (PSBR excluding privatisation receipts) if they were adjusted for the coal strike.

basis?

51. 1983-84. Examination of the data for 1983-84 suggests some slight easing of the overall policy stance:

- the growth of M0 increased significantly whilst £M3 growth was little changed
- nominal interest rates fell by almost 2 per cent; in real terms there seems to have been a small increase
- house price inflation rose sharply
- the PSBR adjusted for asset sales shows a small increase on the previous year
- the exchange rate in both nominal and real terms was lower than in the previous year
- the world environment was also much better with a significant recovery in output following a year of stagnation.

The acceleration of money GDP in 1984-85 (after adjusting for the coal strike) probably owed something to this slight easing of the policy stance and the pick-up of world activity which continued into that year.

52. 1984-85. There is no unambiguous answer to the question of the development of the overall policy stance in 1984-85 taking the year as a whole. The various indicators point in different directions.

- both M0 and £M3 grew less rapidly than in 1983-84
- nominal and real interest rates were both higher
- house price inflation was unchanged
- the PSBR adjusted for privatisation receipts was a shade higher than in the previous year although this was significantly affected by the coal strike. If we adjusted for the effects of the coal strike it would show a sharp reduction. On the other

hand, 1984-85 was a year in which oil revenues rose sharply. And £1.2 billion was raised by introducing VAT on imports. The demand effects of this change were probably very small

- the exchange rate in 1984-85 fell in both real and nominal terms quite decisively.

The following year we returned to the pattern of a declining growth rate for money GDP (strike corrected).

53. 1985-86. The various indicators, with the exception of £M3, show a distinct tightening of the overall policy stance this year.

- MU grew less rapidly
- both nominal and real interest rates are higher than in the previous year
- the PSBR adjusted for privatisation receipts is lower than in the previous year; if we adjust for the effects of the coal strike then it is broadly flat
- the exchange rate in both nominal and real terms is higher than in the previous year
- at the same time there was some easing of the growth rate in the major industrial countries.

54. Our expectation is that the growth of money GDP in 1986-87 will be much the same as in 1985-86 (adjusted for the effects of the coal strike);

- the forecast assumes a slight easing in real interest rates and a more noticeable fall in nominal rates
- the PSBR adjusted for privatisation receipts is a shade higher than in 1985-86
- the exchange rate is at about the same level.

Without some easing of interest rates it is possible that we will see greater downward pressure on money GDP.

55. The general conclusion I reach from this examination is that the overall policy stance was probably eased in 1983-84 and 1984-85. There was a temporary acceleration in money GDP which showed up initially as a rapid growth of real GDP and in some reversal of the inflation decline as measured by the GDP deflator. The events of last winter caused us to tighten both fiscal and monetary policy - monetary and fiscal policy had been relatively easy earlier in 1984-85, although the coal strike confuses the picture. This seems to be delivering a further downward adjustment to money GDP growth. It has been reflected in both some easing of the growth rate and the underlying inflation rate.

56. As far as the year ahead is concerned I doubt if any overall tightening in policy is required. The recent tightening of policy appears to have exerted the steady downward pressure on money GDP and inflation envisaged in successive versions of the MTFIS. In addition the improvements in commodity prices and the terms of trade are likely to impart a favourable impact to inflation over the next year. Insofar as we felt it necessary to tighten the fiscal stance there would probably be some room for easing monetary policy; and vice versa if we felt it necessary to tighten monetary policy further. There were signs during the middle of this year that the tightening of policy last winter may have had a more decisive impact. But survey information and financial indicators this autumn suggest that this may have only been a pause, coinciding with the particularly high interest rates and exchange rate last spring.

V. BALANCE OF FISCAL AND MONETARY POLICY

57. If we are content that the overall stance of policy is satisfactory, the key Budget decision becomes that of the balance of fiscal and monetary policy. We have had a number of discussions about this in recent months. The Budget Speech last year explained that there was nothing sacrosanct about any particular balance of monetary and fiscal policy. It is therefore useful to explore those factors that might lead us to tighten monetary policy relative to fiscal policy and those factors that would lead us to take the opposite action.

Case for Tight Money/Easier Fiscal Stance

58. A number of factors have come together which point to the need to maintain generally high levels of interest rates.

59. **The Need to Avoid Sterling Weakness.** Over the past year the tightening of policy has been concentrated on the monetary side. There has been a clear shift of emphasis in our presentation of policy. For a good part of the lifetime of the MTFs we have emphasised the need to reduce interest rates and the requirement that this imposes upon the need to reduce the fiscal deficit. The events of last winter played a significant role in a shift of emphasis from this view. Sterling had been declining by about 4-6 per cent per annum since the peak in early 1981. Last autumn that steady decline turned into a sharp correction. Interest rates had been reduced to the same level as US rates and there was a widespread feeling that significant tax cuts were on the way. This combined with weakened oil prices and a sharply rising dollar were, we thought, the main reasons for sterling weakness. At the time we reached the conclusion that interest rate reductions had been pushed too far; and if we were to maintain downward pressure upon inflation we would have to hold interest rates at the level needed to avoid such a rapid exchange rate depreciation in the future.

60. **The Problem of Earnings Growth.** The dangers of exchange rate depreciation coincide with worries about the growth of earnings. Despite an easy labour market wage settlements if anything, grew faster over the past year. The faster inflation rate and relatively healthy profit level probably were contributing factors. This has emphasised the need to avoid upward pressure upon import prices from depreciation and made us wary of easing the pressure upon companies too rapidly.

61. **The Growth of £M3.** The behaviour of liquidity in general and £M3 in particular has been another cause for concern. During 1985 we have seen a further sharp increase in the growth of £M3. Our interpretation is that people are willing at present to hold increased amounts of liquidity partly because of high real interest rates; and partly because of increased competition and technological change in the banking system. But there is not universal acceptance of our interpretation. And we recognise that if there was an adverse shift of confidence some of this growth of liquidity could find its way into spending. We hope to avoid this by monitoring the growth of M0 and the exchange rate, but inevitably it has meant a more cautious approach towards setting interest rates. We need to prevent the circumstances whereby the exchange rate and property prices might move rapidly. If there was a problem of confidence there is a great deal of liquidity in existence which may try to move into alternative assets.

*slowly
caution
from 1984*

62. **The End of Overfunding.** The rapid growth of broad money has been further increased by the short-term effects of the decision to cease over-funding. In the 1983 Mansion House speech the Chancellor said that it was not the intention to over-fund the PSBR systematically. But the continued rapid growth of £M3 tempted us into further over-funding last year. Increasingly this meant technical difficulties for money market operations and we decided to cease over-funding. But we were aware when making this decision that this would also imply some bias towards caution on interest rates.

the rate ✓

(directly, has implications for the yield curve - we've put the curve weights on ST rates, & less on LT rates)

short term

63. **World Interest Rates.** The high level of world real interest rates is a further factor pointing in the direction of a tighter monetary policy. If other countries have high real interest rates and we share relatively open capital markets we are bound to accept relatively high rates ourselves. If we attempt to follow a different line we run the risk of periodic bouts of exchange rate pressure.

v. m.p.

(see para 59)

64. **Implications of High Interest Rates.** These arguments all point towards a cautious approach to monetary policy. But if we wish to maintain the same degree of overall pressure then it would point towards taking a slightly more relaxed view about fiscal policy. Such an approach would offer more room for tax cuts which would probably have advantages in terms of supply behaviour. In turn they might serve to moderate the growth of earnings. Out of this temporary period of a high exchange rate and a

falling tax burden might come a rather better pattern of wage behaviour. This is a long-term objective and its achievement would have long-term benefits.

65. **North Sea Revenue Decline.** The unexpectedly sharp decline in North Sea oil revenues is another reason for not being over-concerned about a further reduction of the PSBR as a percent of GDP this year. In the years of particularly high oil revenues we argued that there should be a marked reduction in the PSBR. It would be consistent now to conclude that in the years when oil revenues are falling there is less need for a reduced PSBR. Although it is difficult to argue that we have saved the whole of the transitory component of North Sea oil, we have taken it into account. And to the extent that we have, this is a factor to bear in mind as the oil revenues decline.

66. **Short-term Output and Inflation Effects.** These reasons are given added impetus by our analysis of the effects on GDP and inflation of some switch towards a tighter monetary and easier fiscal policy. Model simulations show that, for a given money GDP, there would be a tendency for inflation to fall temporarily and output to rise. Therefore the short-term effects of the switch tend to look favourable. It needs emphasising that these are only the short-term effects and that they are uncertain and unlikely to be large; but even so they should not be ignored.

(have given a pretty low wage at the same)

Case for Tight Fiscal/Easier Monetary Policy

67. Most of these arguments are short-term in nature and it seems reasonably clear that the short-term arguments point in the direction of an easier fiscal stance. However, the longer-term considerations tend to point in the opposite direction. It is these longer-term considerations that we have been seeking to bring out in the various notes on balance sheets and net worth considerations.

With no exception of 76, down some wage has for another, the system is patchy

68. **Balance of Payments.** The most striking way in which longer-term problems of fiscal relaxation show up is in the behaviour of the balance of payments. The potential adverse effects of a tight money/easy fiscal mix on the balance of payments are apparent from the US example. We have only a modest current account surplus in the UK at a time of high North Sea oil receipts. If we were to have an easier fiscal policy that problem would be accentuated. There is a widespread perception that at a time of peak

North Sea revenue we should be running a sizeable balance of payments surplus, accumulating overseas assets and minimising the extent to which the non-oil account has to improve as the oil runs down.

69. **High Real Exchange Rate.** The real exchange rate has moved sharply upwards and is back to its 1982-83 level. There is a clear danger that we will go into a period of declining North Sea revenues with a rather high real exchange rate. Although we want to avoid excessive depreciation which is likely to lead to higher inflation, we also want to avoid an unnecessarily high exchange rate that in time will create extra problems for the balance of payments.

70. **High Real Interest Rates.** The level of real rates, measured relative to the GDP deflator, has risen in each of the past five years. Based upon our estimate of inflation they now stand at between 6 and 7 per cent. This seems inappropriate for an economy which requires increased investment if it is to increase productive potential and utilise the labour force fully. In order to reduce unemployment significantly we are likely to need a larger capital stock. That is likely to be damaged by a regime of high real interest rates. We also need to consider that these high real interest rates coincide with the end of the old high capital allowances. This in itself has the effect of raising the required rate of return.

71. **International Comparisons.** Interest rates in the United Kingdom are well above the international average. In part this is because our inflation rate is higher than in the average of the major industrial countries. But real interest rates in the UK are also distinctly higher. If the comparison is made with an inflation rate measured by the GDP deflator the tables show that the gap in 1985-86 is about 2 1/2 per cent. This is a disappointing comparison for an economy with a temporarily high level of North Sea oil revenues and the longer-term requirement for higher levels of capital expenditure.

72. **Industrial Composition.** A higher interest rate, higher exchange rate policy is relatively disadvantageous to manufacturing and construction and relatively beneficial to services. Even if the short-term effects of an easier fiscal and tighter monetary policy are to give a better price/output split, the impact on unemployment may not be so favourable. Manufacturing industry and construction are labour-intensive and make use of skilled and

Who of course will have the low level of jobs

ms. 1 build up of overseas assets with some measures of the income from the N Sea that we expect in principle

(Lindsey's compare the have several to state)

all v. low; but lower int. rates w/ bigger problems - an understated XR divt with all the w/ future

Specious

(Mr) arguments discuss this compare with what we were saying pre-Br (Budget)

That was the sign of the end

Show long rates; measures expected inflation; details of other countries table in the table

leads into discussion of main point analysis

Will

the j. employing a lot of money; they were very inefficient. How is this now - in other countries - in the future will be technologies?

unskilled male labour that has a high registration rate. To the extent that jobs are created in manufacturing and construction it is more likely that they will have an effect on the level of unemployment.

Ridiculous expansion

to have nearly a good economic argument

not even in the crisis, good politics

73. Selling the Silver. A further reason for fiscal caution is the misunderstanding that has emerged about the use of privatised receipts to finance tax cuts. There is now a widespread view that this is being planned, combined with a natural worry about the wisdom of such an approach.

The only way of dealing with this is to treat privatisation receipts as higher quality funding rather than expenditure reductions. If we take the bulk of the privatisation receipts into account in this way, it would point to a much lower PSBR next year than planned in the last MTF5.

Wet

74. The Share of Consumption. An easier fiscal and tighter monetary policy will tend to lead to faster growth of personal disposal income and a faster growth of consumer spending because of the terms of trade gain. This will be greatly amplified if the fiscal adjustment is in the form of personal tax reductions. But because of the failure of wages to adjust to the lower inflation rate we are likely to experience a rapid increase in consumer spending in any case. This year does not seem to be the ideal time to give a large boost to consumer expenditure, possibly at the expense of investment and exports. An additional reason for rapid personal disposable income growth is weak commodity prices. We are obtaining an important transitional benefit to the rate of inflation. This is a time when some exchange rate depreciation would do less damage to the inflation rate than it might at other times.

MAKING

but what he said is the TCSC

Why?

but it

74. Curb it!

? and earnings?

75. Debt Interest. An easier fiscal and tighter monetary policy raises a larger debt interest burden to be borne in later years. This is then added to the problems of declining oil revenues and finiteness of privatisation receipts.

anything else has a once off effect on prices eg increases in

depends how much, what is the market expecting?

76. Confidence. Any move to ease fiscal policy would inevitably be described as a U-turn. Considerable political capital has been invested in the idea that we should bring down the PSBR as a proportion of GDP. To change this policy at the same time that we were having trouble with £M3 - the other key component of the original MTF5 - runs the risk of undermining confidence. Confidence would also be adversely affected if the current account went into deficit at a time of high oil revenues.

under a taxation / higher interest rates - except these would not also boost company income (to some extent)

v. gradually at high interest

Is this a real risk?

not to be done! we should expect a surplus even years

77. **Freedom of Manoeuvre.** After the experience of last winter it is evidently risky to reduce interest rates rapidly. Even if the exchange rate did not respond immediately, eventually we would be vulnerable to a sharp reduction. This would require a step up in interest rates with all the accompanying problems with the inflation rate. A high interest rate, high PSBR policy is also risky but in another way. It means that there is less room for manoeuvre if problems do emerge. If we find ourselves with a high interest rate, problems with the current account, worries about sustainability of policy, and fears of the implications of an alternative government it is easy to imagine exchange rate pressure. But then it becomes very difficult to take avoiding action and raise interest rates even further. Because markets would appreciate the limited room for manoeuvre their unease would be increased.

Balance of Arguments

78. Many of the longer-term arguments suggest that imbalances between fiscal and monetary policy should be avoided. There are risks in trying to combine easy monetary policy with tight fiscal policy. But there are also risks in trying to combine tight money and easy fiscal policy. The long-term arguments point towards continuing the policy of reducing the PSBR as a percentage of GDP over the medium term. The short-term arguments suggest caution about the speed with which this is done.

79. Some historical perspective may be helpful even if a comparison of periods that are very different in respect of factors such as asset sales (or purchases), initial debt levels and North Sea revenues is bound to be imprecise. Table 10 shows average figures for the PSBR, money GDP, inflation and output for the seven business cycles since 1951. In the years up to 1968 when inflation averaged between 3 per cent and 4 per cent the growth of money GDP was of the same order of magnitude as we are expecting over the MTFS period. Then the PSBR ratio averaged between $2\frac{1}{2}$ per cent and $3\frac{1}{2}$ per cent of GDP.

Table 10

GDP Growth and PSBR/GDP Ratio

(per cent)

	<u>Money GDP</u>	<u>Inflation</u>	<u>Output</u>	<u>PSBR/GDP Ratio</u>
	(annual growth rates)			
1951-55	7.3	4.0	3.3	3.2
1955-60	6.0	3.4	2.5	2.4
1960-64	6.5	3.0	3.5	2.5
1964-68	6.9	4.2	2.7	3.4
1968-73	11.1	7.6	3.5	2.1
1973-79	17.6	16.0	1.3	6.4
1979-85	10.1	8.8	1.3	3.4

80. It may also be helpful to recall the approach to the PSBR path we followed last year and consider the extent to which those judgements need revision in the light of changed circumstances. The basic information is set out in Table 11.

81. The PSBR profile in the 1985 MTF5 was designed to show a sharp step down in 1985-86 followed by a gradual fall in the later years. A similar profile was published the previous year but the planned sharp step down did not occur because of the effects of the coal strike. Among the reasons for attempting to bring about this downward step were the increase in privatisation proceeds in 1984-85 and the profile of oil revenues, which were expected to peak in 1984-85 and 1985-86.

Table 11

PSBR, North Sea Revenues and Fiscal Adjustment

% of Money GDP

	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89
PSBR									
(1985 MTFS)	5.4	3.3	3.1	3.2	3.2	2.0	2.0	1.7	1.7
Privatisation proceeds:									
1985 MTFS	0.1	-	0.2	0.4	0.6	0.7	0.6	0.6	0.5
1985 AS	0.1	-	0.2	0.4	0.7	0.7	1.2	1.2	1.1
						$\Delta + 0.6$			
PSBR excluding privatisation proceeds:						<i>est.</i>			
1985 MTFS	5.5	3.3	3.3	3.6	3.8	2.7	2.6	2.3	2.2
1985 AS	5.5	3.3	3.3	3.6	3.8	2.9	3.2	3.0	2.9
North Sea Revenues:									
1985 MTFS	1.7	2.4	2.8	2.9	3.7	3.8	3.0	2.4	2.0
1985 AS	1.7	2.4	2.8	2.9	3.7	3.2	2.4	1.9	1.7
						$\Delta - 0.6$			
Fiscal Adjustment:									
1985 MTFS	-	-	-	-	-	-	1.0	1.7	2.4
1985 AS	-	-	-	-	-	-	0.8	1.7	2.5
Money GDP (£ bn)									
(1985 AS)	236	260	284	306	328	357	383		

82. Between the MTFS and the Autumn Statement there have been some important revisions:

- the level of privatisation receipts has been revised up for next year and the later years and the projected North Sea oil revenues have been revised down for this year and later years

- and for this year the PSBR has been revised upwards. *(but may still be more adverse than in the AS)*

83. If we stick to the existing MTFS path the PSBR adjusted for privatisation proceeds will be a larger share of GDP after this year than it has been this year. It will be virtually the same in 1986-87 as in 1981-82. In my judgement this marks the upper limit of the feasible range

PSBR up v. lower

for the next MTFS. And there might be difficulties in selling that to markets for the reasons outlined above. On the other hand, the lower projected North Sea revenue is an argument for not fully adjusting the PSBR profile for the higher privatisation receipts.

Table 12

PSBR Arithmetic for 1986-87

	1985-86	1986-87			
		A	B	C	D
PSBR - £ bn	8	6	6 ¹ / ₂	7	7 ¹ / ₂
- per cent of GDP	2.2	1.6	1.7	1.8	2.0
PSBR excluding privatisation proceeds (per cent of GDP)	2.9	2.8	2.9	3.1	3.2
PSBR excluding 80 per cent of privatisation proceeds (per cent of GDP)	2.8	2.6	2.7	2.8	3.0
Fiscal adjustment (£ bn)		1 ¹ / ₂	2	2 ¹ / ₂	3

as % GDP

0.4 0.5 0.7 0.8

84. Some alternative ways of looking at the PSBR in 1986-87 are set out in Table 12. It is designed to show the change from this year in the PSBR as a percentage of GDP. Four cases are shown spanning a cash range of £6 to £7¹/₂ billion. In addition to the actual PSBR the table includes the PSBR excluding privatisation proceeds. It also shows the PSBR adjusted for 80 per cent of the privatisation receipts.

85. The calculations show that a PSBR of £6 billion would mean a slight reduction, compared to this year, in the ratio of the PSBR excluding privatisation receipts. A figure of £6¹/₂ billion would imply an unchanged ratio if privatisation receipts were excluded, and a small fall if only 80 per cent of receipts were excluded. A figure of £7 billion could be presented as 3 per cent of GDP excluding privatisation receipts - broadly the same as this year - and would represent the same ratio as this year if only 80 per cent of the receipts were counted.

86. The table also shows the implications for the fiscal adjustment based upon the Autumn Statement arithmetic (but unpublished). They range from £1¹/₂ billion with a £6 billion PSBR to £3 billion with a £7¹/₂ billion PSBR. For interest Table 13 shows the fiscal adjustment, in both cash and as a share of GDP, that have been assumed in the past four budgets.

Table 13 Budget Measures: Direct Effect on Public Sector

(compared to indexed base)

	<u>£</u>	<u>% GDP</u>
1982-83	1,205	0.4
1983-84	1,670	0.6
1984-85	40	-
1985-86	730	0.2

*Impressively -
but a
bit of a
fact*

87. My preference is for a figure for the PSBR in 1986-87 in the lower half of the £6 billion-£7¹/₂ billion range. And to continue a very gradual downward adjustment in subsequent years, in line with the implications of the long-term arguments.

88. There are two complications to bear in mind:

- the PSBR figure for 1985-86 could be significantly revised before we have to finalise the Budget judgement. This could well affect these rather precise calculations of the smoothness of the path from one year to another;
- oil prices could change by significant amounts before we finalise the figures.

89. If oil prices were to fall sharply from the levels we envisage (Table 14), it would be necessary to re-assess the stance and mix of policy. For example a 10 per cent fall in dollar oil prices, allowing for the effects of some decline in the exchange rate, would reduce revenues by about £1 billion a year in the first two years. To keep monetary growth on track and limit the fall in the exchange rate interest rates would have to rise.

Table 14

Oil Price and Revenues

	Oil Price ¹ \$	Oil Price ¹ £	North Sea Revenues (£ billion)
1980-81	34.7	14.9	3.7
1981-82	37.3	18.4	6.5
1982-83	33.1	18.9	7.8
1983-84	30.0	19.8	8.8
1984-85	29.4	22.0	12.0
1985-86	27.6	21.3	11.5

1986-87	25.0	17.2	9.2

¹Calendar year.

90. The question then arises of whether to raise non-North Sea taxes to offset some of the loss of oil revenue and limit the rise in interest rates. One way of doing this would be to raise fuel taxes to offset some of the change in relative prices.

91. On longer-term grounds, we should be prepared to allow some rise in the PSBR. But the rise should be less than the total change in oil revenues, partly because the permanent income from the North Sea would have been reduced. If the whole of the excess of actual over permanent oil revenues had been saved in the past this might point to allowing a PSBR increase of perhaps £ $\frac{3}{4}$ billion for each £1 billion cut in revenues. As probably only a part of the transitory income has been saved in the past the adjustment in the face of lower oil revenues needs to be scaled down -possibly by 50 per cent.

92. Macro-economic considerations do not give any decisive pointers to the use of the fiscal adjustment next year. There is not much of a case on income grounds for preferring to ease the tax burden on either persons or companies: personal disposable incomes are anyway expected to grow rapidly, and the need to keep pressure on companies to encourage them to agree lower wage settlements is as great as ever.

93. Another factor to take into account is the short-term impact of different tax changes on the economy. Our estimates vary according to their effects on prices, although over the medium term the differences diminish.

Conventional simulations suggest that a reduction in indirect tax has the biggest impact on prices, and a reduction in income tax the smallest, with employers' NIC in between. As a result we normally urge moderation in raising indirect taxes. This year with sharply lower commodity prices those arguments are weaker. Even so the case for income tax cuts must rest on incentive grounds. Similarly within income tax, the choice between higher allowances and a lower basic rate depends on micro-economic and distributional rather than macro-economic issues.

94. It is appropriate to base decisions about the use of the fiscal adjustment on structural rather than macro-economic criteria. As between tax reductions and increases in expenditure on special employment measures, the issue is one of the relative weights to be attached to the long-term aim of a lower tax burden and short-term job creation (which perhaps carries some supply-side benefits too).

the fated
the Green
Paper

As no matter if
date/memo what the yr -
because that would make
a higher P/B!

ECONOMIC EFFECTS
OF BUILDING SOCIETY
LEGISLATION

LOMAX
→ EST
311



FROM: MRS R LOMAX

Rachael

DATE: 3 JANUARY 1986

10

ECONOMIC SECRETARY

- cc Sir P Middleton
- Sir T Burns
- Mr Cassell
- Mr Odling-Smee
- Mr Peretz
- Mr Sedgwick
- Mr Hall
- Mr Walsh
- Mr Ridlington

Jan

ECONOMIC EFFECTS OF BUILDING SOCIETY LEGISLATION

The Chancellor has seen Mr Ridlington's paper of 13 December. He has commented that this analysis needs to be considered in the context of the meeting on broad and narrow money in the 1986 MTFS (on 10 January).

RL

RACHAEL LOMAX



Meeting 10 Jan

LO MAX
→ Sir P
MIDDLETON
3/1

FROM: MRS R LOMAX
DATE: 3 January 1986

SIR PETER MIDDLETON

cc: Sir T Burns
Mr Cassell
Mr Peretz
Mr Sedgwick

MONETARY POLICY IN THE 1986 MTFS

The Chancellor has read Mr Sedgwick's paper attached to your minute of 13 December, which we are to discuss on 10 January. You also agreed to provide a further paper on narrow money for that meeting, together with an annotated agenda. The Chancellor's marginal comments on the broad money paper suggest that he might find it useful to have a brief note on practice in other countries - notably the US and Germany.

The Chancellor has indicated that he wants to discuss two questions which are only raised obliquely in Mr Sedgwick's paper: -

- (i) the value of the wider aggregates as predictors of inflation - and the role of broad money as an early warning system.
- (ii) the implications of different definitions of broad money for funding policy (para 19 (iii) notes that all the changes to the definition to broad money considered involve redefining funding; the Chancellor has commented that this fundamental issue is only touched on briefly in Annex 2).

On the suggestion that we might move to an aggregate broader than sterling M3 the Chancellor has raised the following questions:-

- (i) how would it be controlled



- (ii) what evidence is there that the total demand of all deposits with banks and building societies is relatively stable (para 16)

- (iii) on a related point, what evidence is there for the view (recorded in the final sentence of para 25) that a monetary aggregate that includes building societies deposits would be a different animal ~~for~~ one that excludes them. (Incidentally the Chancellor thinks there is a good chance that a new aggregate called £M3a or £M4 would indeed provoke mirth).

The Chancellor has noted the ranges suggested for different broad money aggregates in para 31. He has asked whether these take account of the implications of the end of over funding. He takes it that the new assumptions for money GDP growth for 1986/87 would warrant slightly higher figures (eg 10-14%).

The Chancellor is not convinced by the final sentence of para 33 which asserts "that it would be difficult presentationally to introduce and justify a subtle distinction between the commitment to broad and narrow money targets".

The Chancellor has also read Mr Ridlington's paper on the economic effects of the new building societies legislation, and noted that it is relevant to some of the issues raised in the broad money paper.

RL.

RACHEL LOMAX

POLICY BACKGROUND
TO THE 1986 MTFS

SP/069

CONFIDENTIAL AND PERSONAL



FROM: MRS R LOMAX
DATE: 7 JANUARY 1986

PROP
1. To ✓
2. PROP

RL
To
S.R.T.
BURNS
7/1

SIR T BURNS

cc Sir P Middleton

POLICY BACKGROUND TO THE 1986 MTFS

The Chancellor has made a number of comments on your paper for Chevening. None, I think, require further action; however you might like to know that in the context of the monetary framework, he said that he hoped you would do some more thinking about how we could give money GDP a slightly more prominent role in this year's MTFS and general Budget presentation.

2. The Chancellor's general reaction to your cover note was that it failed to answer one key question - namely, to what extent is an easier monetary policy (ie lower real interest rates) on. In particular, he commented that paragraph 9 is based on the implicit assumption that we have a free choice. He has expressed general scepticism about the conclusion in the third sentence of paragraph 11 - that longer term arguments point towards a tighter fiscal and easier monetary policy, with a continuation of the policy of reducing the PSBR over the medium term. He agrees with the argument at the end of paragraph 12 - that the downward revision to expected North Sea revenues provides an argument for not fully adjusting the PSBR profile for higher privatisation receipts.

3. He has noted that he disagrees with your general preference for a PSBR figure in the lower half of the range £6-7½ billion, and asked what the market is expecting (his impression is that the market expectation is certainly not less than £7½ billion and probably more).

4. The main paper prompted the Chancellor to suggest that there might be attractions in planning (and possibly announcing in the Budget Speech) that if the oil price were to fall below the level assumed in the forecast, leading to a loss of revenue, such a loss would be made good by increasing petrol and derv duties, either during the course of the Finance Bill or subsequently using the regulator.



5. He had the following more detailed comments:-

- (i) Paragraph 35 second indent: The Chancellor would like to discuss the desirability of being more precise about the expected path for inflation with reference to practice in other well-governed countries.
- (ii) Paragraph 43: He agrees with the judgement in the first sentence - that on balance it is better to use money GDP rather than any of the usual inflation measures as an indicator of underlying inflationary pressures.
- (iii) Paragraph 45: The Chancellor thinks the suggestion that monetary ranges should only be published in the year immediately ahead is well worth considering for sterling M3.
- (iv) Paragraph 62: The Chancellor has added the comment that the decision to cease over-funding had implications for the yield curve.
- (v) Paragraph 63: He attaches considerable importance to the point in the final sentence (attempting to move our real interest rates against the world trend runs the risk of periodic bouts of exchange rate pressure).
- (vi) Paragraph 67 to 77: The Chancellor has commented extensively on this section which he evidently found very unconvincing, with the exception of paragraph 76 to which he would attach some weight. He has noted that we are in fact running sizeable balance of payments surplusses, and accumulating overseas assets against the time when North Sea oil will run out (indeed he would find it interesting to compare the build up of overseas assets in recent years with some measure of the income from North Sea that we might in



principle have saved). He has commented that the argument about a high real exchange rate is all very well - but lower interest rates could well lead to much bigger problems including an unsustainable exchange rate dive with all that would ensue. He was quite unconvinced by paragraph 70 and the points about industrial composition in paragraph 72; and clearly sceptical about the arguments in paragraph 74. On paragraph 77, he agrees that it is evidently risky to reduce interest rates rapidly - but finds it difficult to understand the proposition that a high interest rate, high PSBR policy is also risky but in another way.

6. On a general point, he has noted that there is no mention of the debt income ratio in this year's paper.

6. The Chancellor also read Mr Grice's paper on macro-economic assumptions for the MTFs. He shares your preference for option B in paragraph 36 and agrees with your comment that there is a clear case for revising the growth of productive potential upwards; and that we should continue to assume actual growth a little faster than potential. He has noted that he wants to discuss the presentational issues briefly outlined in paragraph 35.

A handwritten signature in dark ink, appearing to be 'RL' with a small flourish at the end.

RACHEL LOMAX



Ch.

You now have a structured
agenda, supplementary notes
arising from your comments on
the broad money paper, and an
extremely perceptive note on
narrow money.

The ordering of the agenda
is not what I would have chosen.
There is much to be said for
trying to separate the issues of
substance from presentation,
starting with the former. Again
we to be paying more attention
to under measures of money/
ignoring broad money to the agenda.

Subject to the obvious
constraints of constraints,
consistency & credibility, the
preservation should be rooted
in what we do. These constraints
may be important. Target
bopping is generally a bad idea;
even worse is inventing new
aggregates to target. So is
~~pro~~ setting the targets for
aggregates that you have no
visible means of controlling.

It's important to have some
understanding of the real world
in the universe presentation,
as seen by the market &
commercials (not necessarily
the same thing). What do outsiders
know about broad money? and
specifically LHM3. How would



dropping the alternative
leaves for later years to
be received? (The fact that the
major amounts don't appear
then doesn't necessarily mean
that we could get away with it,
without damage).

Robert may be able to
contribute on some of this.
Judging by these papers, I think
you will have very many others.

It is true that Crutcher is
making his first appearance
at one of your meetings (though
he may be a little late).

The next step is a discussion
with the Bank. Perhaps we ought

to get her to
produce a paper. The papers
for this meeting are so poor
that it scarcely seems worth
the assumption; if we do a paper,
someone needs to start after
her work.

Re.

9/1/86.

PERETZ
→ CH/EX
811

From: D L C PERETZ
Date: 8 January 1986

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Mr F E R Butler
Sir G Littler
Mr Cassell
Mr Fitchew
Mr Odling-Smee
Mr Sedgwick o/r
Mr Scholar
Mr Walsh

Prof Griffiths - No 10

Monetary Policy in the 1986 MTFS

As requested in Mrs Lomax's minute of 3 January to Sir Peter Middleton, I attach an annotated agenda for Friday's meeting. I have discussed this with Sir Peter.

2. I also attach a note on narrow money, to supplement the longer paper submitted with Sir Peter Middleton's minute of 13 December. This has been agreed with the Bank.

3. Lastly, I attach three short Treasury notes which address questions you asked, as recorded in Mrs Lomax's minute of 3 January:

(i) A note by Harry Walsh on other countries' experience with monetary targetting in recent years.

(ii) A note by Penelope Rowlatt, giving a very brief summary of the econometric and other evidence about the information content, and stability of demand and velocity of the various wider aggregates. (This draws on material prepared for the September FEU paper on broad money. A key point is the recent evidence of the extent to which bank and building society deposits are becoming increasingly close substitutes, with

Wash
reading

document add
check

movements in relative interest rates leading to flows between them, while leaving the aggregate of both on a relatively steady trend).

(iii) A note by Steve Hannah saying a bit more about the possible implications for funding policy of different broad money definitions. - to which (have added) a short

*mostly
letter
occasionally quote of my own.
command*

DL

D L C PERETZ

Monetary Policy in the 1986 MTFPSAnnotated Agenda

Reference Papers

- MP "Monetary Policy in the MTFPS", submitted with Sir P Middleton's minute of 13 December.
- NMA Addendum on Narrow money, submitted herewith.
- SD Note on Stability of Demand for Wider Aggregates, submitted herewith.
- OC Note on Monetary Targets in Other Countries, submitted herewith.
- FP Note on implications for funding policy of different broad money definitions, submitted herewith.

Points for decision

1. What aggregate to target for narrow money?

*Labour
critique?*

M2 still suffering from teething troubles, and affected by building society innovation. M1 and NIB-M1 both still greatly affected by move to interest bearing sight deposits, and growth and heavy marketing of interest bearing chequing accounts. M0 still looks the best bet.

Ref: NMA - paragraphs 2-7

2. Do we still need a target for broad money (and if so should we retain illustrative ranges for later MTFS years)?

There are 5 subsidiary questions:

(a) Do we think growth of broad money carries information about future inflation. (Answer: yes, probably, about potential risk for future inflation; but do we know enough about behaviour of broad money to interpret meaning of any particular growth rate?)

(b) If so do we know enough about its behaviour to set a target?

(c) Market has lived with no target since Mansion House: but could it live with no target for 1986-87? (Other countries' experience is also relevant.) Would this be seen (ie target only for MO) as abandoning the policy?

(d) Do we have any means of controlling broad money within target period? (Answer: probably no. See 6 below)

(e) If we do retain a target, do we want also to retain ranges for MTFS years? (See 7 below).

Refs: MP - para 11; SD; OC.

3. What broad aggregate to target/monitor?

(a) Is £M3 seriously flawed, with increasing bank/building society competition?

(b) Is the best option (the wider institutional aggregate) significantly better? (more stable demand function/more stable velocity trend)

(c) Market aspects: would market be happier with £M3; or is it now so discredited that a change would be helpful for the market?

(d) Implications of a change for funding policy? (if thought to be serious, consider redefining funding policy in terms of keeping MMA at constant level)

U don't exist! You Cen. & invent a new aggregate + target it all in one go.

Refs: MP - paragraphs 12-19; SD; FP.

4. What to call any new broad aggregate?

£M3; "broad money"; £M3A; £M4; PSL2 ?

Ref: MP - paragraphs 20 - 28

5. Do we propose any changes in how we operate monetary policy in practice? *(Rate easier!)*

(As set out in Mansion House Speech; funding related to PSBR (subject to any decisions on 3(d) above); interest rates set on judgement based on range of evidence, but balancing in particular evidence

from growth of narrow and broad money, and exchange rate - eg looking for lower growth of narrow money if broad money grows faster or exchange rate falls.)

6. What changes to make in the way we explain and present policy?

Options include:

- Explain that target ranges for broad money (or for broad and narrow money) may act as triggers for corrective action on short term interest rates, but that such action would not necessarily be expected to get aggregates in the ranges within the year.

Implication - if we explain it that way do how

- Explicitly demote broad money target to a "guideline".

don't see this option - we can publish numbers if we don't (1st time publishing numbers, but saying they aren't serious)

- Set target for narrow money, but **no target for broad money;** and say it will be treated in same way as the exchange rate (ie taken account of in setting interest rates, but with no predetermined guideline).

7. What ranges to set for narrow money and (if any) broad money):

- (a) as targets (or guidelines) for 1986-87?
- (b) as illustrative ranges for later years?

they've always been that

For 1986-87 options would seem to be:

(i) for narrow money (MO) either 2-6%, as in 1985 MTFS; or 1-5%.

we don't want to be under any - certainly we have to forecast

(ii) for broad money, either
9-13%; or 10-14%

*How do you
look at*

For later years, given uncertainty about velocity trend for broad money, would there be advantage in displaying illustrative ranges/assumptions for money GDP and narrow money only? (This would also serve to give broad money a different status ~~from~~ narrow).

Refs: MP - paragraphs 29-32; NMA - paragraphs 8-9.

SECRET

*This is very thin -
Even though I think
this is a foregone
conclusion.*

MONETARY POLICY IN THE MIFS : ADDENDUM ON NARROW MONEY

The FEU paper of December 1985 focussed on questions about the target for broad money in the 1986-87 MIFS. This note discusses briefly a few questions about the target for narrow money.

Choice of narrow aggregate

2. There are four possible candidates for target status:

- (i) M0
- (ii) Non-interest bearing M1 (NIB M1)
- (iii) M1
- (iv) M2

3. The following table summarises the main advantages and disadvantages of each as a target aggregate.

Advantages

- M0
- Current target aggregate.
 - Relatively stable velocity trend over a long period.
 - No interest bearing element, so unambiguous response to interest rates (though timing and scale uncertain).
 - Well established concept, defined in terms of the authorities' monetary liabilities.
 - data available quickly, and for a long run.

Disadvantages

- lacks credibility at present, because excludes the bulk of transactions balances; and because thought to be subject to unpredictable innovation.
- The small bankers' balances component fluctuates erratically. (But an aggregate consisting only of notes and coin would lose some of the other advantages of M0).

(unambiguous response to interest rates)

ADDENDUM
ON
NARROW
MONEY

AdvantagesDisadvantagesNIB M1

- A comprehensive measure of non-interest bearing transactions balances. Therefore should have more credibility than MO.

There is no series called NIB M1 in the FED's, maybe it is separately identified in the Board's press release.

M1

- A comprehensive measure of money realisable on demand [other than building society deposits].

- Previously used as a target aggregate (but dropped for reasons that remain valid).

M2

- Specifically designed as a measure of retail transactions balances at banks and building societies.

- growth distorted, downwards, because of continued rise in use of interest bearing current accounts, which is not a steady or predictable process. *has target; has much established as an aggregate base?*
- growth biased, upwards, by continued growth in interest bearing current accounts, through substitution out of time deposits. So ambiguous response to interest rates.

- Includes large amount of interest bearing wholesale deposits.

- Little known about long run characteristics, with only 3 years' data.

- Development of "instant access" facilities means M2 now contains a large portion of building society deposits almost certainly held for savings rather than transactions purposes.

- data unreliable at present, subject to serious mis-reporting and revision.

ADVANTAGES
AND
DISADVANTAGES

4. All four aggregates have been distorted by privatisation and large new issues, though M0 less than the others.
5. More importantly, all are subject to financial innovation. The underlying growth of M0 will in principle be affected by financial innovation affecting the use of notes and coin, and the spread of the banking habit. This might not continue to be a smooth process - there could for example be an impact (in ways hard to establish in advance) from recent changes in bank charges. But the other aggregates are also being affected, possibly to an even greater extent, by similar factors: in particular by the development of high interest chequing accounts.
6. Chart 1 and 2 show movements in the growth rate and velocity of each aggregate since the early 1970's (or over the longest period for which data are available). Tables 1, 2 and 3 give more details.
7. The balance of evidence and argument still points to M0 as the best choice for a narrow money target.

Choice of target range

8. Rolling forward the figures in the 1985-86 MTFs would give a 2-6% target range for M0 in 1986-87. The 12 month growth rate for M0 in mid-November 1985 was 3.4%, and it seems likely to remain below 4% for the rest of 1985-86. The earlier paper (paragraph 34) discussed the presentational case for reducing the 1986-87 M0 range to 1-5%, at the same time as setting a higher target range for broad money. Arguably that would also fit in with increased reliance on short term interest rates (and less on funding) as the instrument of monetary control; and be more consistent with aiming for a reduction from the current M0 growth rate.
9. Against that, the Budget forecast for Money GDP growth in 1986-87 might turn out to be higher than the 6½% assumed in last year's MTFs (it was over 7% in the Autumn forecast), and weighted towards consumer spending. Both factors would tend to increase demand for notes and coin. There is also some asymmetry

in the risks of missing targets by going above the range rather than below. The worst position of all would be to find ourselves above the ranges for both broad and narrow money because of unexpected financial innovation. And to stick to 2-6% for 1986-87 has the advantage of continuity in a year when we will be making a number of other changes.

Nature of the target range?

10. The earlier paper (paras 5-9) discussed the case for recognising more explicitly than hitherto that when the target aggregates move outside the ranges set for them, corrective action taken - on interest rates - may not bring them back within their ranges, at least within the financial year. This is most obviously relevant to broad money, where the effect of interest rate movements may be perverse in the short run. But it can also apply to narrow money. For example if broad money were overshooting (and/or the exchange rate falling), it might in some circumstances be right to raise interest rates, even if the effect in the short run were to drive the narrow aggregate through the floor of its target range. It is also of course the case that, as this year, unexpected financial innovation within a year can make it appropriate to miss a target range, and that could apply to narrow money as well as broad money.

11. So there are good grounds for applying any new language about the nature of the targets to the narrow as well as broad target aggregate.

HF

3 January 1986

TABLE 1 - GROWTH RATES OF NARROW MONEY AGGREGATES

	MO	NIBM1	M1	M2 ⁽¹⁾	
(a) Financial years (annual changes to banking April, %)					
1980-81	6.8	8.8	12.2	N/A	
1981-82	2.9 ⁽²⁾	-0.1	4.8	N/A	
1982-83	6.1	11.2	14.8	8.9	
1983-84	4.9	9.2	13.6	7.9	
1984-85	6.0	3.6	14.9	8.4	
(b) Change in 12 months to (%)					
1984	October	5.5	7.2	15.4	9.1
	November	5.6	9.1	18.5	9.8
	December	6.5	8.5	18.2	9.7
1985	January	5.4	6.7	14.8	9.4
	February	5.4	6.7	14.2	9.5
	March	5.3	4.7	13.1	9.3
	April	6.0	3.6	14.9	8.4
	May	5.4	4.0	15.8	8.1
	June	5.2	9.4	18.2	9.3
	July	5.1	2.8	16.3	7.3
	August	4.5	2.5	18.4	7.3
	September	4.2	2.1	16.9	7.5
	October	3.4	2.3	18.0	8.1
	November	3.4	1.5	17.1	8.8
(c) Change at an annual rate in 6 months to (%)					
1985	April	5.5	2.4	14.3	8.0
	May	4.1	0.1	12.3	6.1
	June	2.9	10.8	19.4	8.9
	July	5.0	-0.3	19.4	5.3
	August	3.3	2.8	27.9	6.4
	September	3.3	1.7	23.1	6.0
	October	1.4	2.1	21.8	8.2
	November	2.7	3.0	22.0	11.5
(d) Change at an annual rate in 3 months to (%)					
1985	July	4.4	-0.4	18.9	4.8
	August	2.4	2.4	22.8	7.8
	September	1.1	-22.2	4.9	1.1
	October	-1.5	4.7	24.7	11.6
	November	3.0	3.6	21.3	15.2
(e) Change in 1 month to (%)					
1985	July	0.4	-6.7	-1.9	-1.2
	August	-0.6	1.6	3.2	1.1
	September	0.4	-0.9	0.0	0.5
	October	-0.2	0.5	2.4	1.1
	November	0.6	1.3	2.5	1.9
(f) Stocks fbn					
1985	November	14,205	34,286	58,830	145,437

(1) Corrected for reclassifications

(2) Adjusted to remove effect of redefinition of bankers' balances

TABLE
1
GROWTH
RATES
ON
NARROW
MONEY
AGGREGATES

CONFIDENTIAL

TABLE 2 - VELOCITY OF NARROW MONEY AGGREGATES⁽¹⁾⁽²⁾

(Annual % change to last quarter of financial year i.e. Q1 of calendar year)

	M0 ⁽³⁾	nibM1	M1	M2 ⁽⁴⁾
1980-81	4 (4½)	4½	1½	N/A
1981-82	7 (6½)	7½	2½	N/A
1982-83	5½ (6)	½	-2	1
1983-84	1 (1)	-1	-4½	-1
1984-85	2½ (1½)	2½	-5	-½

- (1) Data for money aggregates based on cumulated, seasonally adjusted banking month changes to Q1 (defined as a weighted average of banking months).
- (2) These figures are to some extent affected by the volatility of quarterly data. Chart 2 gives a better overall impression of the stability of velocity trends.
- (3) Figures are derived in a slightly different way from those in earlier paper (which are shown in parentheses).
- (4) Corrected for reclassifications.

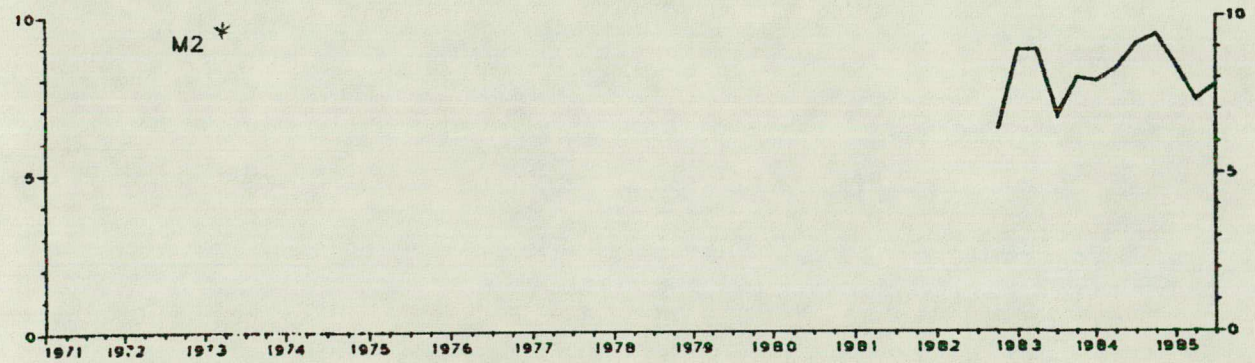
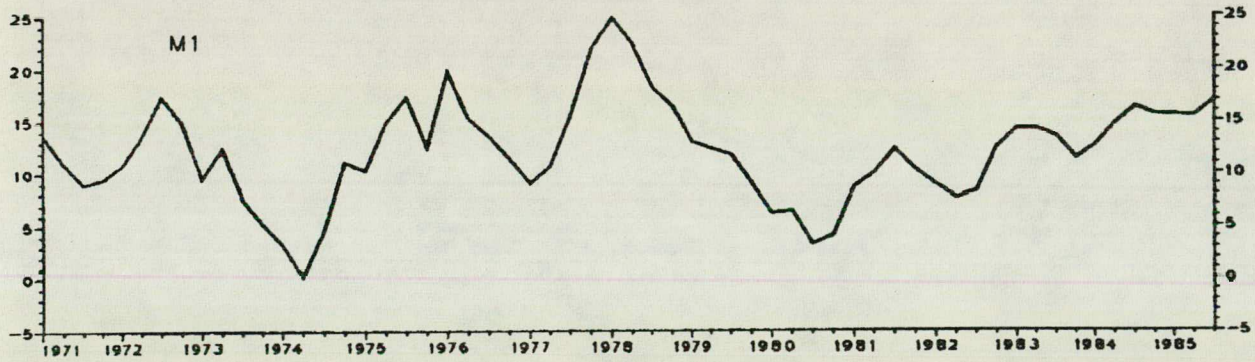
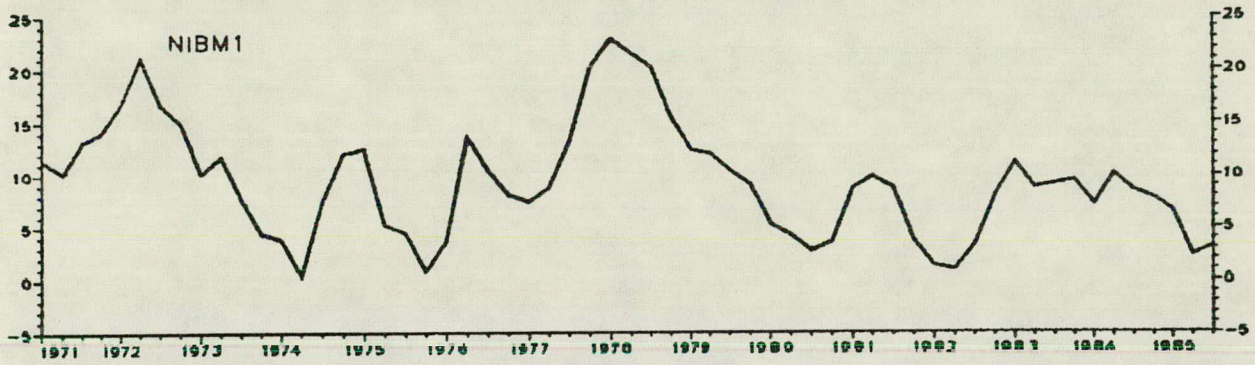
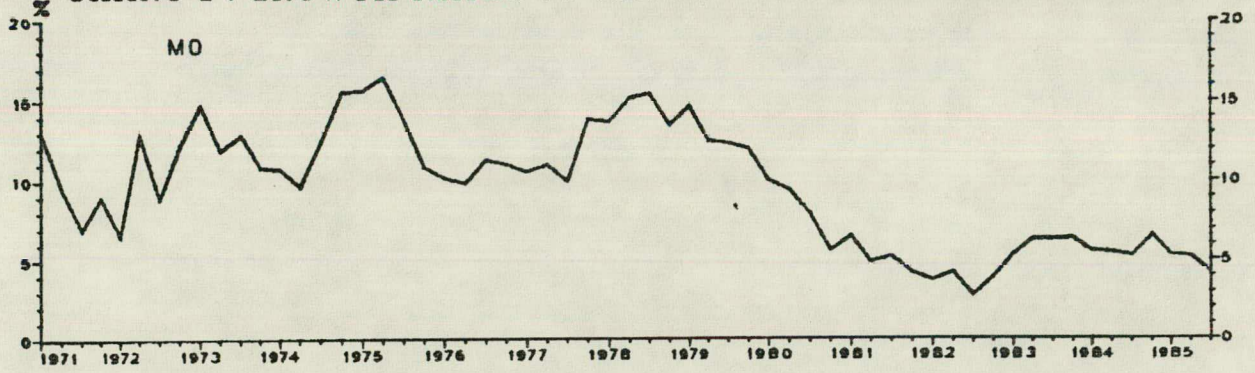
TABLE 3: COEFFICIENTS OF VARIATION FOR QUARTER TO QUARTER CHANGES IN NARROW MONEY (1)

	M0	nibM1	M1	M2
1963Q1 - 69Q4	N/A	2.52	1.70	N/A
1970Q1 - 74Q4	0.86	1.03	1.07	N/A
1975Q1 - 79Q4	0.35	2.58	0.59	N/A
1980Q1 - 84Q4	0.64	0.96	0.58	0.41 ⁽²⁾

- (1) The coefficient of variation is the standard deviation divided by the mean. It is thus a scale-free measure of variation.
- (2) 1981Q4 - 84Q4, M2 corrected for reclassifications.

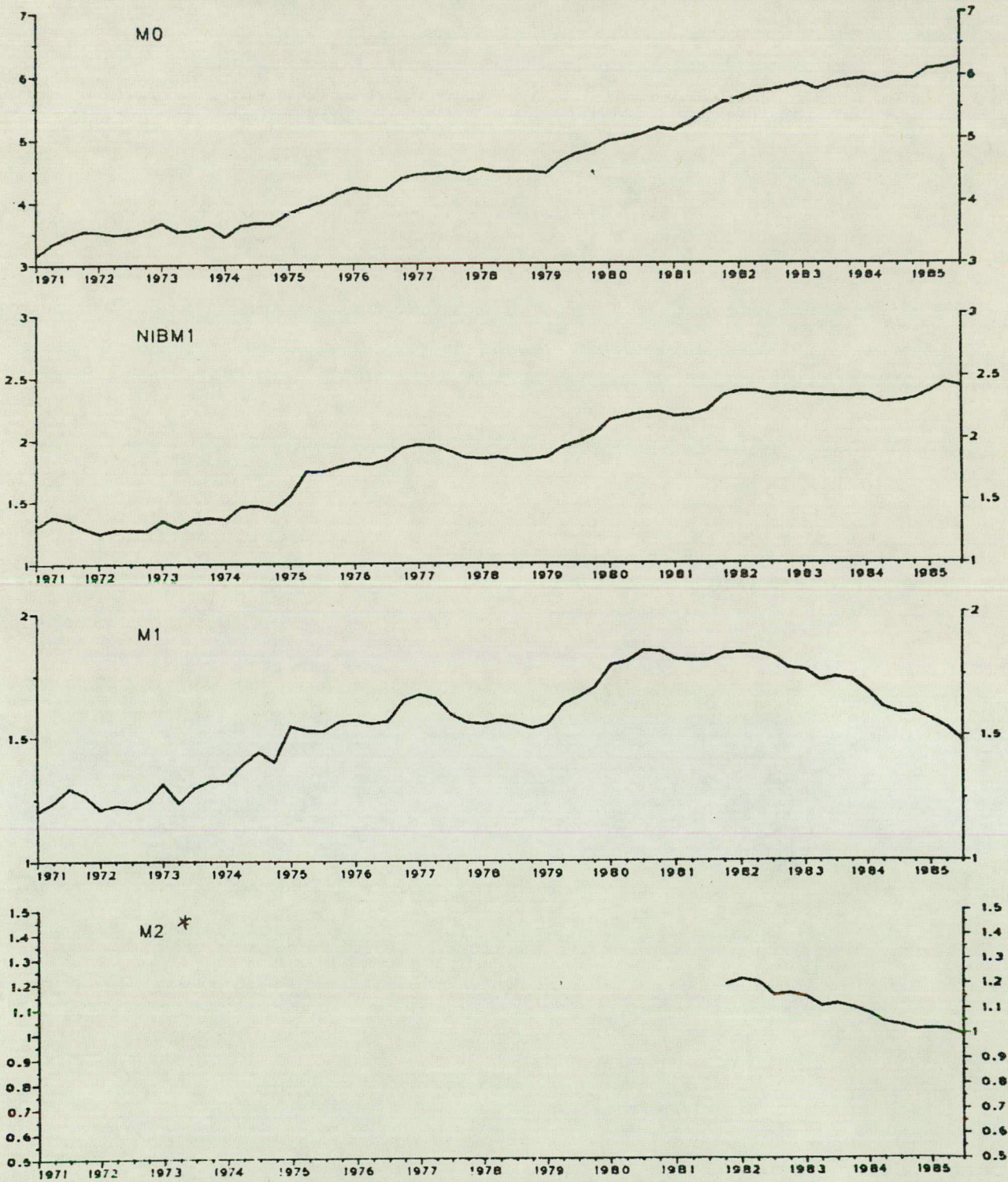
TABLE
2
VELOCITY
OF
NARROW
MONEY
AGGREGATES
(1)(2)

CHART 1 : GROWTH RATES OF NARROW MONETARY AGGREGATES



* Corrected for reclassifications

CHART 2 : VELOCITIES OF NARROW MONETARY AGGREGATES



* Corrected for reclassifications

CHART
2
VELOCITIES
OF
NARROW
MONETARY
AGGREGATES

MONETARY TARGETS IN THE US, GERMANY AND OTHER MAJOR COUNTRIES

MONETARY TARGETS IN THE US, GERMANY AND OTHER MAJOR COUNTRIES

United States

Definition of Aggregates

The Federal Reserve targets M1 (currency, demand deposits and chequable interest-bearing deposits) and also M2 (M1 + overnight repos + most types of savings and small denomination time deposit liabilities), M3 (M2 + large time deposits + term repos), and monitors Domestic Non-financial Debt (a broad credit aggregate). One year target ranges are set in February of each year and reassessed in July when a tentative target range is also set for the next year. The liabilities of Savings and Loans and Mutual Savings Banks - the equivalent of Buildings Societies - are included in the various US monetary aggregates according to the same criteria used for banks.

Experience

2. Table 1 below shows the target ranges set in each February since 1983, together with the actual outturn for the four targeted aggregates. In the ten years since 1975, the Fed has missed the M1 and M2 targets about half the time, with a strong tendency (including M1 recently) to overshoot. The three appended charts show the performance of M1 targeting since 1976.

TABLE 1

<u>Aggregate</u>	<u>ranges (%)</u>	<u>Actual (%)</u>	<u>Target Achieved</u>
<u>1983</u>			
M1 (1982Q4 to 1983Q2)	4 - 8	12.4	No
M2 (Feb/Mar to Q4)	7 -10	8.3	Yes
M3 (Q4 to Q4)	6½- 9½ ⁺	9.7	No
Debt (Dec 82 - Dec 83)	8½-11½	10.5	Yes
<u>1984</u> (Q4 to Q4)			
M1	4 - 8	5.2	Yes
M2	6 - 9	7.7	Yes
M3	6 - 9 ⁺	10.5	No
Debt	8 -11 ⁺	13.4	No
<u>1985</u> (Q4 to Q4)			
M1	4 - 7 ⁺⁺	13.2*	No
M2	6 - 9	8.6*	Yes
M3	6 - 9½ ⁺	7.8*	Yes
Debt	9 -12	13.0*	No

* Latest four weeks over target base.

+ Monitoring range.

++ Changed in July to 3-8 per cent for H2.

Explanation

3. The period since the late 1970s has been the greatest period of private financial innovation in US history, and there has also been major deregulation of the financial system. The deregulation of interest-bearing current accounts in the US has affected (in particular) M1. New operating procedures - involving controlling part of the reserves of the banking system - were adopted in October 1979, but had to be radically watered down in 1982. In trying to contain monetary growth, the Fed has faced an often hostile Administration and a critical Congress, and has needed to balance a large number of national and international factors. It has also suffered from internal divisions. Aside from financial innovation and the macroeconomic condition of the US economy at any particular point, the following main factors have been adduced (or at least referred to) by the Fed at various times and with varying weights as reasons for not bringing overshooting aggregates back into their target ranges:-

1. The effect on the US banking system, which is experiencing record numbers of failures and is overexposed in lending for LDCs and domestic agriculture, energy, and real estate.
2. The effect on US housing finance institutions, which have large books of low-interest, fixed rate mortgages.
3. The effect on debt repayments of LDCs.
4. The discriminatory effect on exceptionally interest-sensitive sectors such as cars and housing (during the recession).
5. The acceptable rate of inflation actually achieved.
6. The need to keep the dollar down and maintain US competitiveness (now has increased importance).

GermanyDefinition of Target Aggregate : CBM

4. Monetary targeting in Germany centres on the "central bank money stock", growth rate objectives for which are set by the Bundesbank. CBM is defined as currency held by non-banks and bank reserves on domestic liabilities, calculated at reserve ratios required in January 1974. As actual reserve ratios have been lowered since then, German CBM should be interpreted not as a version of the monetary base but as a composite monetary indicator which comprises: all currency held by non-banks, 16.6 per cent of residents' sight deposits, 12.4 per cent of residents' time deposits and 8.1 per cent of residents' savings deposits. M1, M2 and M3 are also calculated by the Bundesbank. The target ranges for CBM are set - for one year only - in relation to the forecast increase in productive potential and unavoidable inflation. The weights for the components of CBM are rather arbitrary, but there is a strong relationship between the growth of German productive potential at current prices and the growth of CBM.

ExperienceTABLE 1

	<u>Target Range for CBM (%)</u> (Q4 to Q4)	<u>Actual (%)</u>	<u>Target Met</u>
1979	6 - 9	6	Yes
1980	5 - 8	5	Yes
1981	4 - 7	4	Yes
1982	4 - 7	6	Yes
1983	4 - 7	7	Yes
1984	4 - 6	5	Yes
1985	3 - 5	4.7 ¹	Yes
1986	3.5 - 5.5		

¹ 12 months to November

?
to d
money
GDP

5. The period 1975-78 were years of target overshoot, but Table 2 shows that since 1979 the CBM targets have been met. Over one or two quarters, both CBM and the broad aggregate M3 have responded predictably to the use of the Bundesbank's policy instruments. Both have also tended to grow relatively steadily, whereas M1 and M2 have been subject to sharp fluctuations, often in opposite directions, as interest rate changes have affected the opportunity cost of holding non-interest bearing money in sight form and caused shifts of funds between various types of bank account. The authorities believe that, over a fairly long period, CBM and M3 expand at roughly the same pace. Although there have been recent suggestions within Germany that the Bundesbank should adopt medium-term targeting, these have not been taken up, including most recently when the 1986 target range for CBM was set by the Bundesbank Council in December.

Other Major Countries

6. Experience in other major countries is summarised in Table 3 below:-

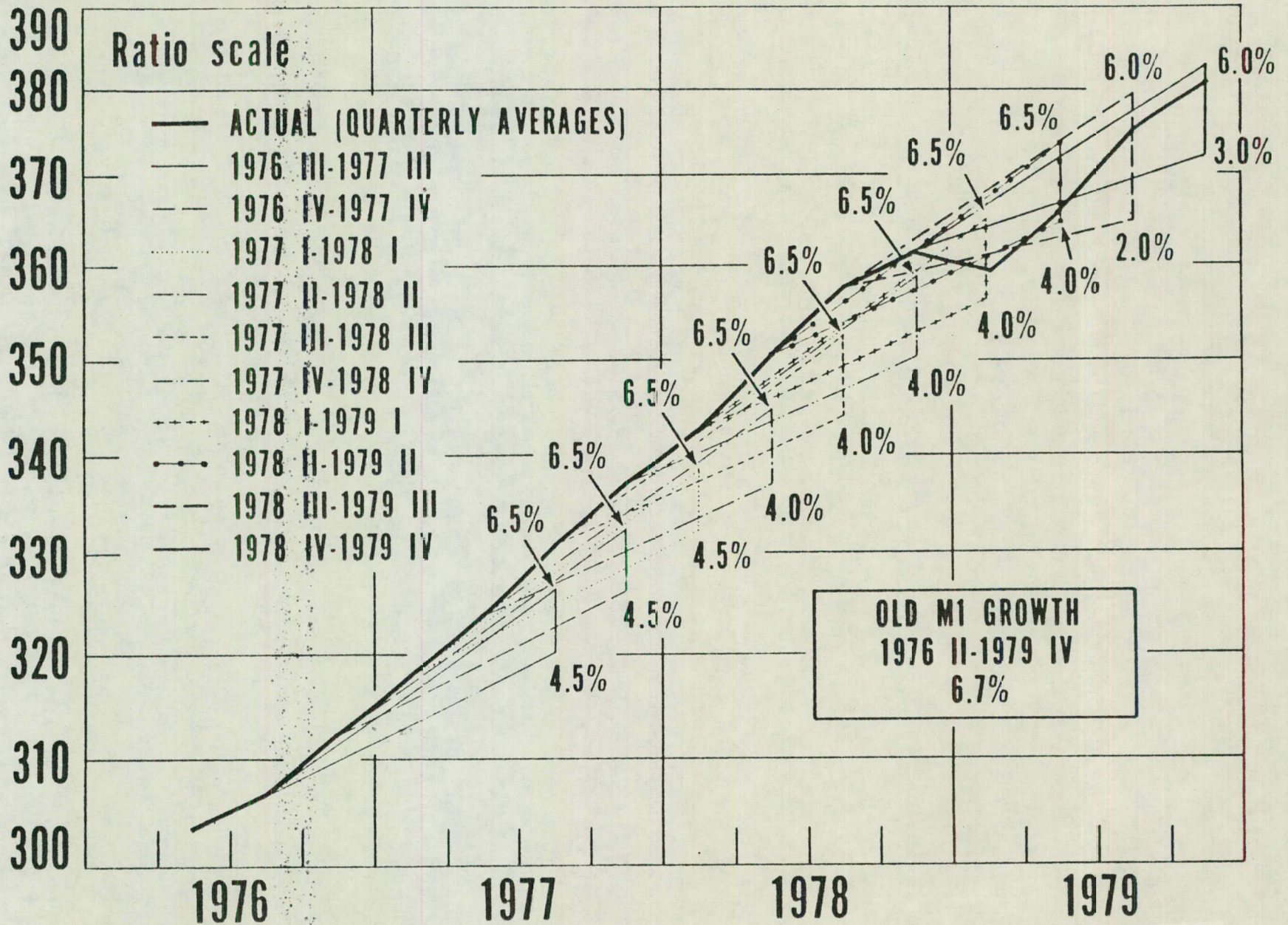
TABLE 3

Country	Main Aggregate Targeted	Forward Period	Generally meets Target?
Canada	Formally abolished targets in 1982		
France	M2R (changes to M3R in 1986)	1 year	Tends to overshoot
Italy	Project DCE ¹ (M2 also in 1986)	1 year	Tends to overshoot
Japan	Project M2 (including Certificates of Deposit)	One quarter	Yes
Netherlands	No monetary targets: Exchange Rate tied to DM		
Switzerland	Monetary Base	1 year	Yes

¹ Includes all of domestically-financed state sector deficit, not just that part financed by banks.

OLD M1 TARGETS AND "BASE DRIFT"

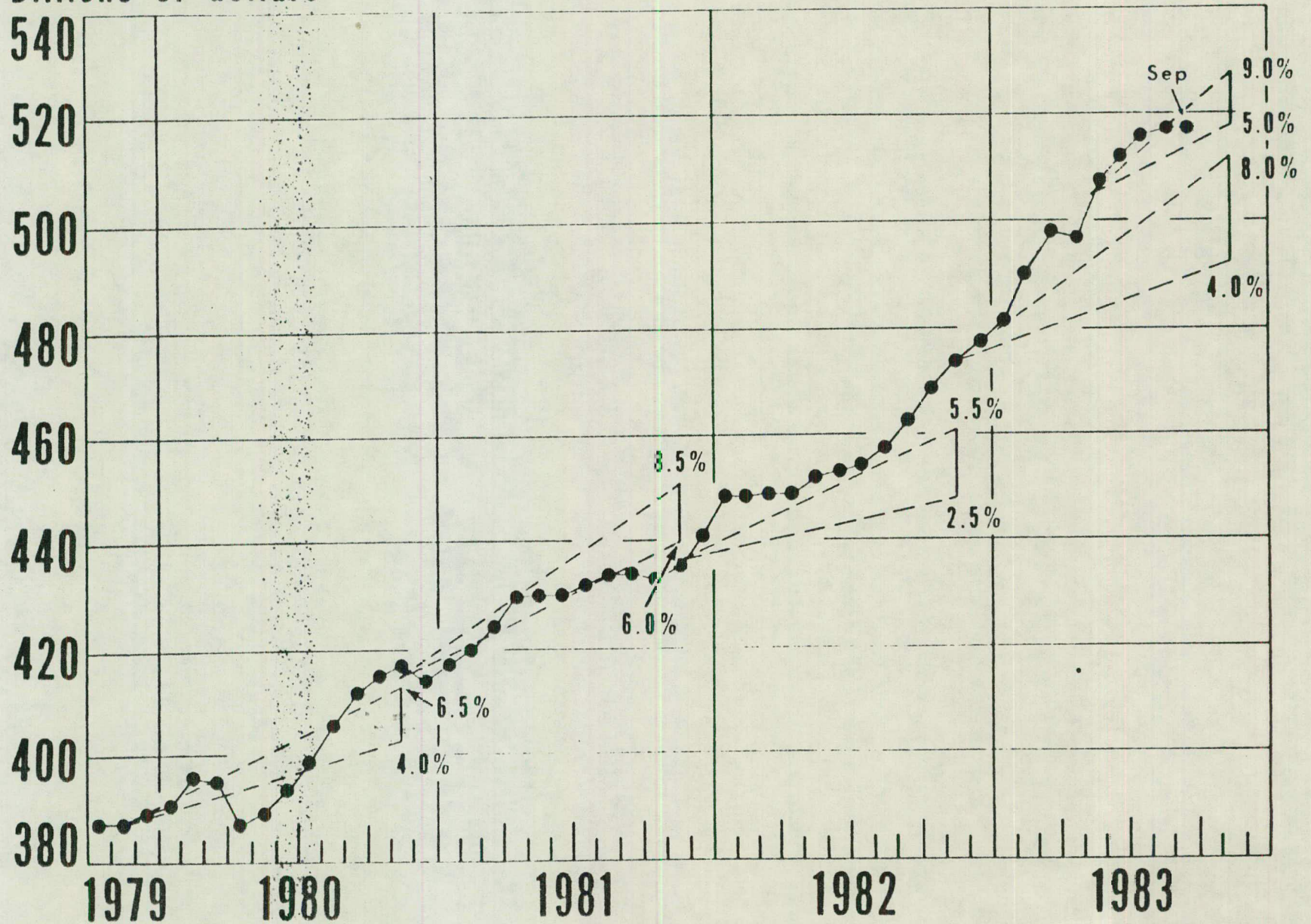
Billions of dollars



OLD M1
TARGETS
AND
BASE
DRIFT

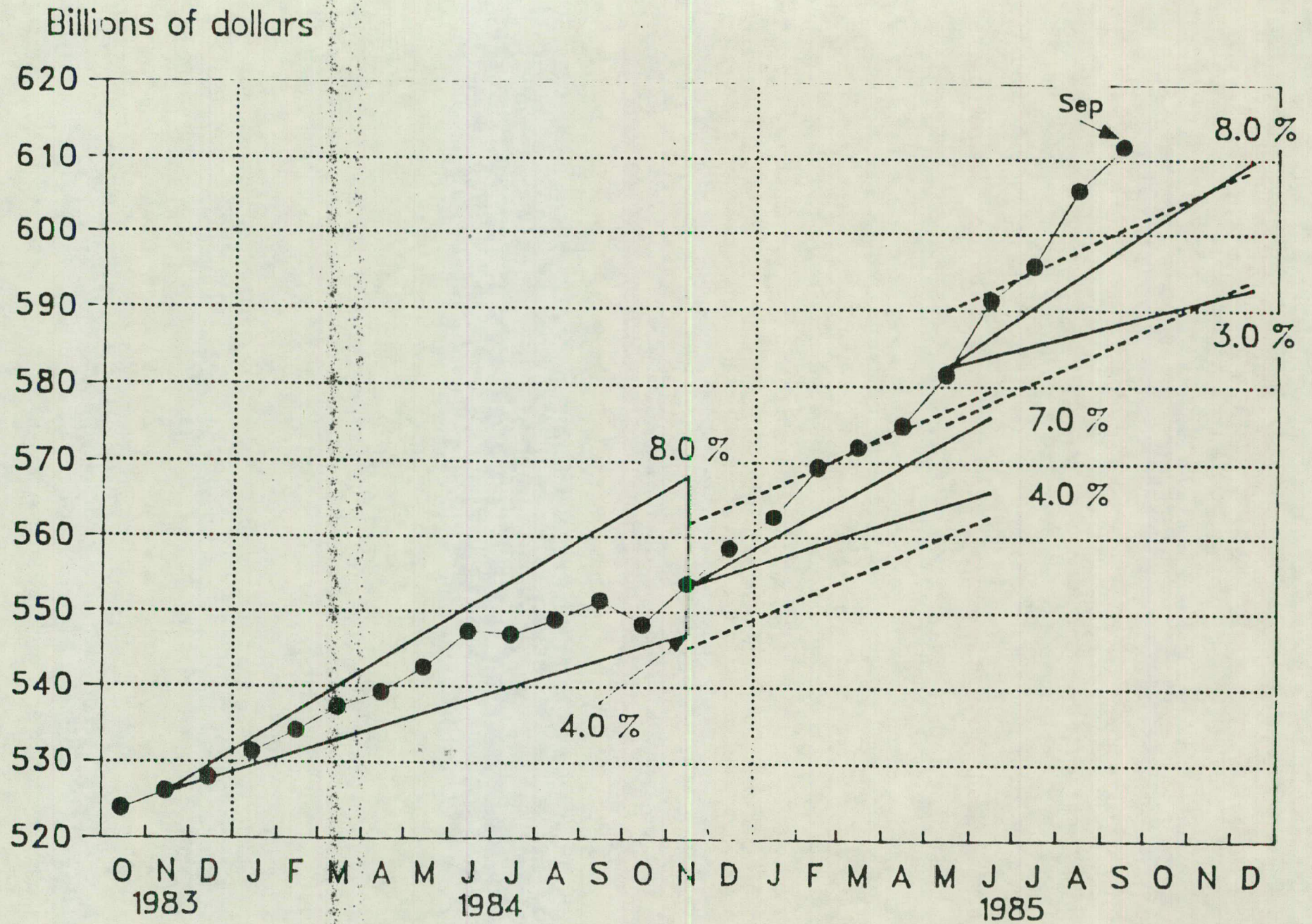
LONGER RUN PERFORMANCE OF M1

Billions of dollars



LONGER RUN PERFORMANCE OF M1

M1 : LEVELS AND TARGETS (CONES AND TUNNEL)



M1:
LEVELS
AND
TARGETS
(CONES
AND TUNNEL)

DIFFERENCES IN THE BEHAVIOUR OF £M3 AND AGGREGATES THAT INCLUDE BUILDING SOCIETY DEPOSITS

A. Information content

A considerable amount of work has been done in the past, both here and at the Bank, on the performance of the monetary aggregates as predictors of inflation. However no clear and unambiguous message can be gleaned from this about the aggregate that performs best. The rank ordering of the aggregates depends on the data period used, details of the methodology (lag length, order of differencing and so on) and the objective variable under investigation (the precise definition of price inflation, money GDP).

2. The main result that emerges from these studies is that broad aggregates such as £M3, PSL2 and PSL2A perform best as indicators of price inflation when the early 1970s is included in the period under investigation. As the estimation period is moved later, to start in the mid-1970s and extend into the 1980s, the predictive power of these aggregates diminishes. Little evidence has been found of information regarding the future growth of nominal GDP in any of the broad aggregates.

3. Viewed over longer periods the relationship between some of the narrower aggregates (notes and coin, M0) and money GDP seems to have been rather more stable. However the conventional econometric tests indicate that there is little information in them regarding short-term fluctuations in either price inflation or nominal GDP.

4. The most recent and comprehensive study of this is that of Barry Johnston, September 1984. It covers the period from 1966Q1 to 1983Q4. He found that £M3 had significant information content regarding the path of RPI inflation at lags of one to two years. When building society deposits were added to £M3 the information content of the aggregate increased. The

DIFFERENCES
IN THE
BEHAVIOUR
OF £M3
AND
AGGREGATES
THAT
INCLUDE
BUILDING
SOCIETY
DEPOSITS

further inclusion of national savings instruments reduced the information content. However these results do not appear to be particularly robust: other work suggests that they might be heavily dependent on the particular estimation period he used.

B. Stability of demand

5. Not unexpectedly, econometric evidence in work done here and elsewhere, in the past, relating to the stability of the demand for broad money gives no clear guidance on the relative merits of £M3 and the broader aggregates under consideration. For example, in the work done by Grice and Bennett (1981), although PSL2 is very different from £M3 (for a start it is nearly twice as big) the fit of the estimated equations for the two aggregates is very similar - each have standard errors of about 0.6 per cent. But there is some evidence that the dependence on wealth, income and relative interest rates may be rather different for the two aggregates. Further, the estimated equation for £M3 was more stable than that for PSL2 in the early 1970s when competition and credit control was affecting the data.

6. The more important point about the stability of demand for these aggregates, however, is that it is likely to have been influenced by the recent innovations in financial markets and is expected to be further affected by the proposed building society legislation. It is therefore likely to be different in the future from it has been in the past. The more similar the services provided by banks and building societies become, the less meaningful is the distinction between a bank deposit and a building society deposit. Small changes in the interest differential between the two are likely to lead to increasingly larger flows of deposits from the one sector to the other. These flows will not affect the demand for the wider aggregates, that include deposits with both types of institution, but they will be evident in an increased volatility in the deposits held with each individual sector. This problem is amply illustrated by the figures in Table 1 of the paper circulated on 13 December, copy attached.

TABLE 1 - GROWTH RATES OF BROAD MONEY AGGREGATES

	£M3	The Institutional measure ¹	PSL2A
(a) Financial Years (Annual changes to Q1, %)			
1980-81	17.9	16.5	14.5
1981-82	14.2	13.4	13.1
1982-83	11.2	13.8	13.9
1983-84	8.0	11.7	11.0
1984-85	11.8	14.0	13.9
(b) Changes in 12 months to (%)			
1984 September	8.8	12.7	12.4
October	8.1	12.5	12.4
November	10.5	14.0	13.6
December	9.3	13.0	12.7
1985 January	9.4	13.1	12.9
February	9.8	13.2	13.1
March	9.2	12.6	12.5
April	12.0	13.7	13.6
May	11.6	13.2	13.1
June	12.2	13.3	12.9
July	12.0	13.0	12.8
August	13.5	13.8	13.4
September	14.1	14.1	13.4
(c) Changes (at an annual rate) in 6 months to (%)			
1984 September	8.6	12.3	12.0
October	8.8	12.5	12.6
November	11.7	14.2	14.3
December	7.8	11.0	10.5
1985 January	11.3	13.4	13.3
February	10.5	13.1	13.2
March	9.8	13.0	13.1
April	15.4	14.9	14.6
May	11.5	12.2	11.8
June	16.7	15.6	15.3
July	12.7	12.5	12.3
August	16.4	14.4	13.5
September	18.5	15.2	13.7
(d) Changes (at an annual rate) in 3 months to (%)			
1985 March	9.1	13.1	13.5
April	17.7	14.9	15.1
May	18.4	15.0	14.3
June	24.7	18.1	17.0
July	8.0	10.2	9.5
August	14.4	13.9	12.8
September	12.6	12.3	10.6
(e) Changes in month to (%)			
1985 June	2.2	1.7	1.6
July	-0.7	0.0	0.1
August	1.9	1.5	1.3
September	1.8	1.3	1.1
(f) Stocks, £bn			
1985 March	111.0	202.4	216.1

¹Residents deposits with banks and building societies

SECRET

BROAD MONEY AND FUNDING DEFINITIONS

This note briefly considers the implications of adopting zero over-funding rules, on various definitions, if a broader aggregate than £M3 were to be targeted.

2. At the Prime Minister's monetary policy seminar last July it was agreed that funding should be set at the level required to cover the PSBR. The definition of funding adopted (and currently used) included the external finance of the public sector and the background was set out in the Chancellor's Mansion House speech in October.

3. As identified in Annex 2 of the monetary policy paper¹ a substantial amount of debt sales to the non-bank private sector would not count as funding under a PSL2A definition of broad money. Building societies purchases of public sector debt would be excluded as would all other non-bank private sector purchases of "liquid" National Savings, CTDs, local authority temporary debt and Treasury bills (these instruments are all included as components of PSL2A). In 1984-85 the stock of MMA would have been around £1¼ billion higher under a PSL2A zero over-funding rule than had the current rule been adhered to. *(other things being equal)*

4. Under the "institutional" definition of broad money the only change from the current definition would be that sales of debt to building societies would not count as funding. Prior to 1984-85 this would have led to a significantly different funding outturn since building societies were significant purchasers of gilts. In 1983-84, for example, societies purchased around £2 billion of public sector debt instruments.

¹ Attached to Sir P. Middleton's minute of 13 December 1985.

BROAD
MONEY
AND
FUNDING
DEFINITIONS

5. In 1984-85, however, following changes in the tax treatment of gilts, societies purchased less than £½ billion of gilts so that an "institutional" zero over-funding rule would have shown little difference, in terms of the impact on the stock of MMA, from the current rule. Indeed, in 1985-86 societies have been significant sellers of gilts and funding on this "institutional" basis has a closer correlation with MMA than on the present £M3 basis (the same is true for the PSL2A definition, which also excludes building society purchases of gilts from funding, but to a lesser extent)².

only by accident because the ss. were net sellers of gilts; over a period of years, the relationship will necessarily be less close

6. Whilst societies' sales of gilts cannot continue indefinitely it seems plausible to expect that, given the change in the tax treatment, societies are not likely to become heavy purchasers of gilts again on a systematic basis. The similarity of the MMA effect of the "institutional" definition and that for £M3 under the present zero over-funding rule could therefore be expected to continue.

7. The papers prepared for the PM's seminar last July included an annex on definitions of funding³ (attached). As that annex shows, it would in principle be possible to adopt a definition of funding which focussed more sharply on the level of MMA.

(but this would be derived from the central bank to Mo, or via under by aggregate)

8. At the extreme would be a definition under which zero over-funding delivered a constant stock of MMA. This would mean defining funding in terms of the CGBR. And all sales of central government debt, including those to the monetary sector, would count towards the funding target. An allowance would also have to be made for the targeted growth of MO.

The purpose of the definition of funding has been to include all CGBR sales & all sales to the monetary sector (including those to the CGBR) to ensure that the change in funding is equal to the change in the CGBR. This is the basis of the "Ending Overfunding" paper.

HF Group
January 1986

2 As indicated in Annex 2 of the monetary policy paper. *(not demonstrated - no figures for MMA provided)*

3 This was the annex to the "Ending Overfunding" paper attached to Mrs Lomax's letter of 12 July to Andrew Turnbull (No. 10).

Definition of overfunding

If the object is to eliminate overfunding altogether, we will have to decide which definition to use. The main possibilities are:-

(i) The "conventional" definition. That is to fund the PSBR with sales of public sector debt in the UK other than to banks.

(ii) The "wider" definition, illustrated in paragraph 1 of the paper. That would imply funding the PSBR by raising finance outside the banking system and from external flows.

(iii) A definition focussed on the growth of the monetary base. This would imply funding the PSBR in any way that did not involve an addition to the growth of MO greater than that allowed for in the target set for it. But it would allow additional gilt sales to offset the monetary effects of any local authority or nationalised industry borrowing from the banks.

(iv) A definition focussed on the level of money market assistance (MMA), ie. a level of funding that would not add to the stock of MMA. The difference between this and (iii) - assuming MO growth is on target - is that there would be no attempt to offset nationalised industry and local authority borrowing from the banks by additional gilts sales.

On the narrowest definition (i) we would have had no overfunding last year with £2.3bn lower sales of gilts. But the bill mountain would still have risen by £3.3bn. To have achieved no growth in MMA (definition (iv)) would have required debt sales £5.6bn less than we actually achieved. The table attached shows the degree of overfunding on each definition in 1984-85, and the relationship between them.

ANNEX
DEFINITION
OF
OVER
FUNDING

At present the prospects for this year and next look not dissimilar to the 1984-85 pattern. To remain in sight of meeting the £M3 target we may need to contemplate overfunding and a growth in the bill mountain similar to last year. So in relation to this prospect, a decision to end overfunding would represent a large step even on the narrowest definition: and we would not achieve the aim of preventing further growth in the bill mountain - let alone reduce its size - without going a good deal further than that.

Table: Different definitions of overfunding in 1984/85

£bn

		<u>Excess debt sales</u>
PSBR	10.6	
- Debt sales to UK non-bank private sector	- 12.9	
(i) Conventional definition of overfunding	- 2.3	2.3
- external finance of the public sector	- 2.2	
(ii) Wider definition of overfunding	- 4.4	4.4
- debt sales to banks and other sectors	0.6	
- allowance for target MO growth	- 0.7	
(iii) "Monetary base" definition	- 4.5	4.5
- local authority and nationalised industry contribution to above	- 1.5	
other finance	0.5	
(iv) Increase in money market assistance	- 5.6	5.6

These are rather peculiar concepts, which are hard to relate to the PSBR + Mo. If you are talking about the monetary base it is much more natural to start from the CA BR + deduct all CA debt sales - & this gives you a definition of overfunding that corresponds exactly with (iv) below, which derives from the MO counterpart, as published in the EPR.

TABLE: DIFFERENT DEFINITIONS OF OVERFUNDING IN 1984/85