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PART B

Part. B

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PO -CH /NL/0239
PART B

Chancellor's (Lawson) Papers:

SPEECH TO THE LOMBARD ASSOCIATION

DD's: 25 Years

20/12/95.

PO -CH /NL/0239
PART B

LR1.59 CONFIDENTIAL

FROM: MRS R LOMAX
DATE: 11 April 1986

MR CASSELL

cc PS/Economic Secretary
Sir P Middleton (or)
Sir T Burns (or)
Mr Peretz
Mr Scholar
Mr Sedgwick
Miss O'Mara
Mr C Kelly
Mr Walsh
Mr Ross Goobey

LOMBARD ASSOCIATION SPEECH

With time hanging heavy on my hands, I have taken it upon myself to tinker substantially with the draft I circulated yesterday. In particular, I have re-ordered to try and avoid repetition. I have also tried to anticipate the Chancellor's comments, based on what he said to me before he left for Washington. In the time available I have not taken account of all the comments on the earlier draft, but I shall try to do so this afternoon.

2. I would be most grateful for any further comments by close tonight - in particular could Mr Walsh kindly supply the missing figures on page 8.

RL

RACHEL LOMAX

Rachel

I've marked a few comments (pages turned down). A vast improvement on the last version.

David. 11/4

LOMBARD ASSOCIATION SPEECH

April is the season of international meetings. My appearance here tonight is sandwiched between the Spring meetings of the IMF in Washington and the OECD in Paris.

Meeting other Finance Ministers, I am always struck by the extent to which we share a common approach to economic management.

[This year was no different. Our discussions were dominated by the dramatic fall in the price of oil, which certainly poses some unfamiliar problems for the world economy as well as the UK.

But there is nothing new about the framework within which those problems will be tackled.]

The need for firm financial discipline: the importance of reducing fiscal deficits: improving the working of markets and promoting greater competition. These priorities are taken for granted by all major countries today.

It is easy to forget how much has changed since we first took office 7 years ago.

An approach to economic policy that is now commonplace was then radical, even revolutionary. Especially in the UK.

Shortly before the 1979 Election I wrote "The time has come for a wholly new approach to economic policy in Britain. The overriding need is for a long term stabilisation programme to defeat inflation, recreate business confidence, and provide a favourable climate for economic growth".

Putting those brave words into practice has been one of this Government's major achievements. That is an important reason why foreign opinion is in no doubt that Britain is indeed on the right track.

It would be idle to pretent that everything turned out as we expected. I want to spend my time tonight talking about one particular area where practice is considerably more complicated than some theor~~y~~ists suggest - monetary policy.

The policy we are pursuing today is identifiably the same as the one we embarked on 7 years ago. But it has clearly evolved - both in terms of presentation and substance. I shall try to explain what has not changed - as well as what has, and why.

The Medium Term Financial Strategy

Our main priority in 1979 was to achieve a lasting reduction in the rate of inflation. So our first task was to replace the shifts and strategems of the 1960s and 1970s by a clear and unequivocal commitment to financial discipline. That was the role of the Medium Term Financial Strategy.

It had two features, both novel at the time. First it provided a medium term framework for monetary and fiscal policy. It symbolised the Government's break with policies of fine tuning and crisis management that had dominated British life for most of the post War period.

Second, it was a strategy about finance. Partly because inflation is a financial problem, and has to be controlled by financial means. And partly because the only levers at the Government's command are financial levers.

This approach to reducing inflation depended in the first instance on scaling down the growth of nominal demand in the economy - that is, the growth of money GDP. Nominal demand is an amalgam of two things: the real rate of growth and the rate of inflation.

The crucial mistake that earlier Governments made was to equate money demand and real demand. Expansionary policies boost money demand. But it was a dangerous illusion to suppose that this was automatically translated into a higher rate of growth of real output.

Experience shows just the opposite. During the 1970s GDP in money terms more than quadrupled: but of that increase only 1/20th represented an increase in real output, the other 19/20ths was reflected in sharply higher prices.

Alas there is no magic short cut to boosting the rate of growth of real output; in anything other than the very short term, the growth of output depends on the supply performance of the economy. And that can only be raised by a determined effort to remove restrictions, improve incentives and generally develop a dynamic and enterprising economy.

By contrast it is all too easy to raise the rate of inflation by allowing money GDP to grow in excess of the supply potential of the economy. The bigger the gap the greater the inflation.

But conversely the way to squeeze inflation out of the system is to reduce the rate of growth of money GDP. Which is exactly what the MTFS was - and is - designed to do.

The validity of this approach has been amply borne out by the record of the last 7 years. The growth of money GDP has been halved from over 15 per cent to under 8 per cent. Inflation has been reduced from 13 per cent to 5 per cent. And after an initial setback, we have seen a steady growth in output, of an average rate of 3 per cent a year since 1981.

The monetary and fiscal framework

Reducing the growth of money GDP requires above all an appropriately restrictive monetary policy. And as in most other countries with a serious commitment to financial discipline, this aim has been encapsulated in published targets for monetary growth.

Some commentators have argued that monetary targets are otiose. That we should simply publish targets for money GDP - or even inflation - and set policy in the light of the best available forecasts. That has not been our approach. ~~For one thing we simply do not have a sufficiently detailed knowledge of the working of the economy to operate such a policy. And secondly, monetary policy is above all about markets, and one function of monetary targets is to provide an anchor for the market's expectations.~~

Cassell comment

insert Cassell version (minute of earlier today)

But we must never forget that targets are a means to an end. Their use depends on the robustness of a relationship between a particular measure of money on the one hand, and money GDP and inflation on the other. In the real world, no economic relationship is perfect. So monetary targetry was not and never can be a substitute for making an intelligent assessment of monetary conditions, based on all the evidence.

That is why the MTFS has always been more than a row of numbers. What it has been - and remains - is a commitment to maintain monetary conditions that will keep steady downward pressure on money GDP, and so on inflation.

I shall have more to say later about what this means in practice. But a discussion of the Medium Term Financial Strategy cannot be complete without a word on fiscal policy.

The classical framework for financial discipline - the gold standard and the balanced budget - had both a monetary and a fiscal component. So does the MTFS. From the start we recognised that a firm monetary policy has to be buttressed by setting public sector borrowing at a level that can be comfortably financed in a non-inflationary way. In theory of course there is no precise relationship between the PSBR and any given rate of monetary growth. But in practice the only way to be sure of financing the public sector soundly is to plan for a low PSBR.

Experience has shown the wisdom of leaving a margin of safety. The 1984-85 PSBR at 3 per cent of GDP was still the lowest for over a decade even though the £3 billion cost of the coal strike was met entirely by higher borrowing. The latest figures suggest that the PSBR was below 2 per cent of GDP last year. And it is planned to be below 2 per cent again in the current financial year - a level that will put us in a strong position to cope with unexpected developments, for example in the oil market.

It is worth recalling that little more than ten years ago - in 1975-76 - borrowing reached 9¼ per cent of GDP; and the last time the PSBR was below 2 per cent of GDP was in 1971-72.

This emphasis on low public sector borrowing has become part of the accepted wisdom in other major countries. It is a long time since OECD Ministers failed to refer to the need to reduce structural deficits over the medium term as an agreed tenet of fiscal policy.

Monetary policy

To recapitulate. While fiscal policy has an important supporting role, monetary policy lies at the heart of the MTFS. The central task of monetary policy is to create monetary conditions that will bring steady downward pressure on the rate of growth of money GDP, and hence on inflation.

In practice this involves a combination of economic analysis and market judgement. Policy must be continuously informed by a careful assessment of what monetary conditions are - and need to be - to meet the Government's objective. But implementing interest rate decisions in today's fast moving financial markets also requires a degree of tactical skill.

Let me be quite clear. Short term interest rates are above all ~~an~~ the essential instrument of monetary policy. That is not to say that the market does not exercise an influence, certainly on the structure and also, at times, on the level of short term interest rates. But we have never suggested that the market could, entirely independently, set the level of interest rates.

The relationship between official influence and market factors was clearly set out in the 1980 Green Paper on Monetary Control.

> "The level of short term interest rates at any time is determined by the interaction of the markets and the authorities. The short term interest rates generated by the market are not necessarily those needed to achieve the monetary targets".

Put bluntly, even though the authorities are not the only players in the field, no Government that is interested in controlling the quantity of money can afford to ignore its price.

Let me give some examples. There are times when the structure of money market rates indicates very clearly the direction in which the market believes that interest rates should move. It is obviously right to validate a movement, if we believe it is justified by monetary conditions. Last week was such a time.

Less frequently, there can be times when it is dangerous for the authorities to resist a market led move in interest rates, if to do so would cast doubt on the Government's resolve to control inflation. So, for tactical reasons, it may sometimes be right to acquiesce in a change in interest rates, even when we are not convinced that it is justified by the fundamentals. The best example of this sort of situation is perhaps July 1984.

But there are certainly occasions when it is right to resist. This was the case earlier in the year. Interest rates were raised promptly early in January to prevent a downward movement in the exchange rate acquiring an unhealthy momentum. Subsequently, however, I took the view that the pressure for a further rise beyond 12½ per cent was not justified on monetary grounds, and was based on an exaggerated view of sterling's vulnerability to movements in the oil price. And interest rates were not allowed to rise.

<u>Assessing monetary conditions</u>

I have said enough to show that the <u>timing</u> of interest rate changes can often involve a delicate assessment of market tactics. Looking beyond day to day market management, however, the guiding principle is to maintain, on average, a level of short term interest rates that will deliver the monetary conditions needed to reduce inflation.

There is no mechanical formula for taking this crucial judgement. Assessing monetary conditions very often involves weighing movements in one indicator against movements in another.

That is not to deny the special status of the monetary targets. Movements in the aggregates outside their target ranges always establish a presumption in favour of changing short term interest rates.

But that presumption is not overriding. For two reasons:-

- First, we can never be completely confident that the target ranges have been set correctly: that is, that they have been based on a correct understanding of the relationship between the aggregate in question and money GDP.

- Second, in differing degrees all the monetary aggregates respond to changes in short term interest rates with a lag: so it takes time for policy action to bring them back within their target range.

For example, it was clear by last autumn that the target range for £M3 had been set too low. Indeed, with the benefit of hindsight, it is clear that there has been a change in the relationship between £M3 and money GDP in recent years.

Between 1970 and 1980, £M3 grew on average by 2 per cent less than money GDP. Since 1980 it has grown between 2 and 6 per cent more.

Put another way, while £M3 has grown by [ ] per cent over the past five years, money GDP has grown by only [ ] per cent, and prices by [ ] per cent. Over the previous five years, £M3 grew by [ ], but money GDP rose by [ ] per cent, and prices increased by [ ] per cent.

It is still not absolutely clear why this has happened, or how well established the new trend is. A combination of a freer banking system, institutional change, greater international competition and new technology is certainly part of the story. So is the level of real interest rates. But what it means in practice is that the business of setting targets for £M3 is particularly hazardous.

In view of all the uncertainties, I set a target range for £M3 in 1986-87 that reflects the most recent trend in velocity~~, the end of overfunding and the high level of real interest rates~~.

The new range also allows for the possibility that heavy overfunding in some recent years had the effect of artificially depressing £M3 growth relative to the growth in money GDP. And it allows for ~~the high~~ level of real interest rates somewhat higher than the average of ~~the last few years~~ recent years.

These judgements will need to be assessed in the light of experience. That was why I decided not to publish illustrative ranges for later years.

Faced with difficulties with their main target aggregate, M1, the United States authorities have from time to time adopted a similarly cautious approach, ~~relating~~ relegating it to what they call "monitoring status", during periods when there have been particular uncertainties about its velocity trend ~~of M1~~.

Indeed, other major countries rarely if ever publish monetary targets for more than the year immediately ahead.

There are also considerable uncertainties about the relationship between £M3 and short term interest rates. Experience suggests that a change in short term rates is unlikely to alter the growth of £M3 significantly within the target period: and the very short term response to £M3 to a rise in interest rates is unpredictable, and may even be perverse.

The position with MO is more straightforward. Its relationship with money GDP appears to be relatively well established and stable. Money GDP seems to grow between 2 and 5 per cent more than MO in the previous year - very much the same sort of relationship as in the 1970s.

The growth of MO responds fairly rapidly and predictably to changes in the short term interest rates. So a rise in interest rates can be expected to bring MO growth back within its target range over the target period.

The messages coming from the different monetary aggregates need to be continuously tested against the evidence of other indicators, especially when, as sometimes happens, the various measures of money give conflicting signals. At such times, the exchange rate has often played an important role as umpire.

In an economy as open as the UK's there is a presumption that persistent exchange rate movements reflect, to some degree, underlying monetary conditions. And as I have frequently observed, significant movements in the exchange rate, whatever their cause, can have a short term impact on the general price level and on inflationary expectations which make sound internal policies harder to implement.

The <u>timing</u> of short term interest rate changes has often been strongly influenced by exchange rate movements. This has led some commentators to argue that the exchange rate is in practice the dominant influence on monetary policy, and even that we are operating some kind of informal exchange rate target.

Neither is true.

It is not entirely surprising that the exchange rate sometimes acts as a <u>trigger</u> for interest rate changes. The exchange rate is a sensitive barometer, responding rapidly to changes in short term interest rates and changes in market expectations. But it is patently untrue that every fluctuation in the exchange rate - or even every persistent movement - has produced an interest rate response.

Equally the fact that MO has rarely been the trigger for interest rate action is not evidence that it carries little weight in interest rate decisions. Its role has been less visible, but nonetheless important.

Arguments for higher interest rates - based on the behaviour of broad money, or over-pessimistic forecasts of inflation - have often been resisted, because of the more reassuring - and in the event more accurate - signals coming from MO.

But to return to the role of the exchange rate. I accept of course that membership of a fixed exchange rate regime can in ~~principle~~ the right circumstances ~~be~~ be a useful complement to - possibly ~~a~~ a substitute for ~~-~~ monetary targets. The exchange rate can be a tough discipline: forcing the authorities to recognise when domestic policies are out of line with other countries.

X

But, whatever the circumstances, it is both risky and dangerous to try and operate a unilateral exchange rate objective, outside a formal fixed exchange rate system, shared by other countries, and supported by a co-ordinated approach to economic management and intervention.

We have not attempted to set a target exchange rate zone for ourselves. And I don't believe the circumstances are yet right for us to ~~target~~ do so within the EMS.

Our interpretation of exchange rate movements does reflect a bias against sharp exchange rate changes; and a bias towards a firm rate, that will support the Government's general objectives on inflation.

But, in essence, the exchange rate is one input - and only one - to an overall assessment of financial conditions. Our aim is to strike a balance between domestic monetary growth and the exchange rate that will deliver conditions that keep downward pressure on inflation.

Evolution of the medium term financial strategy

Almost all my fellow Finance Ministers - and the Governors of their respective Central Banks - would recognise this description of how monetary policy is conducted in practice. Most well conducted countries operate policy in a very similar way. Those who are members of a fixed exchange rate system typically have domestic monetary targets; and those outside such systems still recognise the need to take account of the exchange rate.

But how different is it from the original conception of the MTFS?

It would have been surprising if there had not been some changes. There have been profound changes in the UK economy in the past 7 years; and nowhere has those changes been more pronounced than financial markets.

And, quite rightly, both the presentation and the substance of the MTFS have evolved in response to them.

To start with presentation.

At the time of the first MTFS almost everything remained to be done. Inflation, monetary growth and the public sector deficit were all high. The long process of containing public expenditure and dismantling the controls that were stifling the economy's natural growth potential had only just begun. I have explained how we had embarked on a policy very far from the accepted wisdom of the 1960s and the 1970s. Those who understood what we were about - and not everyone did - doubted our resolve.

In the circumstances of the time, the overriding need was for simplicity and clarity in getting across the central message. This Government - unlike its predecessors - was

determined to pursue a sustained programme of scaling down the growth in money GDP and squeezing inflation out of the system.

In a word, financial discipline was to be restored.

So we kept it simple. Monetary policy was expressed in terms of a target for a single aggregate: and that aggregate was one with which UK markets were already familiar - £M3.

Policy making in the real world is never that simple. But in presenting policy there is always a balance to be struck between clarity and ~~openness.~~ over-simplification

Suggests we've not been open (even though we haven't, better not to say so).

Even in 1980, we made it clear that no one aggregate could be a sufficient measure of monetary conditions; and that the definition and choice of target aggregates might have to change in response to circumstances. But the commitment to a target for £M3 was a useful shorthand for our resolve to reduce inflation and pursue prudent fiscal and monetary policies.

£M3 had been blessed by the IMF; it was well understood in the markets; and it was thought to indicate links with other policies - including most notably fiscal policy. So, in the words of the 1980 Green Paper, targeting of £M3 was widely understood to give "a general assurance that macroeconomic policies available to the Government will be used in a way which mutually support each other in the reduction of inflation".

This was an oversimplification. But in the early days of the MTFS, I am sure we were right to err on the side of clarity. Unlike Germany, the UK had no proven track record of prudent consistent and credible financial management. History was on the side of the sceptics.

Happily times have changed. Over the past 7 years the UK has had a Government that has pursued a consistent and responsible financial strategy. We are providing a model for others and not a cautionary tale.

It will take time before we build up a reputation equal to Germany's. But we are acquiring the right sort of track record. The evidence is there to show that we mean what we say.

We have not hesitated to raise interest rates as and when necessary; we have halved the rate of growth of money GDP; and the result over the past three years has been the best combination of output growth and low inflation for a generation.

As far as the presentation of policy goes, the delicate balance between clarity and ~~openness~~ over-simplification has shifted. Because the basic framework of our policies are not in doubt, we can now afford to be franker about the difficulties and complexities of putting them into effect.

There have been changes of substance too. In recent years we have moved further and faster than most of our competitors in freeing up financial markets. A range of outdated controls have been abolished, starting with the abolition of exchange controls only six months after we took office.

In the longer term, I have no doubt that these changes are in the interest of the British economy. But their immediate effect has been to blur long standing distinctions between different financial assets, and between the activities of various financial institutions.

This has inevitably affected the significance of the various measures of money. Policy has had to respond,

and in the process, it has certainly become more complicated.

Broad money, including £M3 has been most profoundly affected. As a result it has come to pay a progressively smaller part in monetary policy decisions.

Problems started to emerge at a fairly early stage. As far back as the autumn of 1980, interest rates were reduced by 2 per cent, even though £M3 was way outside its target range, on the view that it was giving a misleading impression of the tightness of the monetary conditions.

The 1981 MTFS listed the factors that had underpinned this judgement: they included the behaviour of other narrower measures of money, and the exchange rate.

With the benefit of hindsight, this was clearly the right decision, as was the subsequent decision to raise the £M3 target substantially in the 1982 MTFS. Few would now dispute that the growth of £M3 ~~has~~ in relation to the target set for it has proved a relatively poor guide to monetary conditions for much of the 1980s. Indeed some would argue that the real question is why we have persisted with it for so long, and in particular why I did not drop it altogether at the time of the last Budget.

Difficulties of interpretation there have certainly been. But it would be quite wrong to conclude from recent experience that we can safely tolerate any build up of liquidity.

The risk in dropping ~~the~~ £M3 is that markets would do just that. The £M3 target is evidence of our continuing concern with liquidity.

We have taken the view that the growth of £M3 in recent years reflects a genuine desire on the part of the

We have also taken the view ~~that that process will continue~~; In setting this years target That, in retrospect, ~~we have~~ it is clear we ~~in recent years~~ have been setting the target for £M3 too low in recent years

private sector to build up its liquidity on a lasting basis. I believe that judgement to be correct. But it must be continuously tested against other evidence. A similar judgement proved disastrously wrong in the early 1970s.

One reason why we have come to put increasing weight on the exchange rate and narrow measures of money is because we would expect these indicators to give early warning were the rapid growth of broad money to start to make its way into higher spending. What went wrong in the early 1970s was that the clear signals from these indicators were ignored.

The reduced emphasis on broad money has also been reflected in funding policy. For many years the principal aim of funding policy was to control the growth of broad money and liquidity. From time to time this involved overfunding - that is, selling more debt than needed to fund the PSBR.

In recent years, the attempt to contain a strong growth in liquidity, the reasons for which were only partially understood, came to make overfunding almost a way of life.

This led to distortions - to £M3 itself, and not least the rapidly growing bill mountain~~s~~ - which were undesirable in themselves, and made policy harder to operate.

I reached the view that this excessive reliance on funding policy was neither sensible nor desirable. Accordingly, I made it clear in my Mansion House Speech last year that the objective of funding policy was to fund the PSBR over the year as a whole: no more no less.

X I have already explained ~~why~~ how the problems of £M3 gave more prominence to the role of narrow money and the exchange rate. In particular, MO has been given target status for the last two years.

It is sometimes suggested that MO cannot be taken seriously because it covers only a narrow range of transaction balances. I accept that it is not ideal: but it has demonstrated a relatively stable velocity trend over a long period, and it shows a reliable and unambiguous relationship with short term interest rates.

It is important that the best should not be the enemy of the good. The fact is that MO is the best narrow aggregate we have. As in the United States, the more familiar narrow aggregate, M1, has been seriously distorted by a rapid growth of interest bearing sight deposits, some of which were previously held in the form of term deposits. And the same developments have distorted its non-interest bearing component.

The truth is that it has become increasingly difficult to draw a line between money balances held for transactions and those held for savings. MO is only a proxy for transactions balances: but for as long as it continues to bear a reliable relationship with money GDP, we shall continue to give it a significant weight in our assessment of monetary conditions.

Conclusions

These are significant technical changes and much ink has been spilt in describing and explaining them. Rightly so. Neither the authorities nor the markets have anything to gain from deliberate obfuscation.

But it is important not to miss the wood for the trees. The essence of the policy is the commitment to reduce inflation.

That has not, and will not, change.

And after 7 years, we have the track record to prove it.

BACKGROUND PAPERS

PRESS ARRANGEMENTS

FROM: S J PICKFORD
DATE: 11 APRIL 1986

PS/CHANCELLOR 12/2

cc Mr Cassell
Mr Culpin

LOMBARD ASSOCIATION SPEECH

I spoke to Mr Frost (Secretary of the Lombard Association) to clarify the press arrangements at their end.

2. He told me (as I believe he told you) that as far as they are concerned their meetings are private affairs to which members and guests only are invited, and at which any speeches or comments are off-the-record. They have no intention of either inviting the press directly or allowing the press to gain access as guests of members.

3. As far as Mr Frost is concerned, whether or not we release the text of the speech to the press is a matter entirely for ourselves. There are apparently good precedents for speakers releasing their speeches to the media, including Dr Henry Kaufman.

4. There is one further aspect that could raise complications. It is apparently usual for speakers to be prepared to answer questions at the end of the speech. If the Chancellor were to do so, this might raise complications. The first (and minor) complication is that the press would no doubt complain bitterly. A much more important consideration is that if the Chancellor were to be called upon to expand on his comments on monetary policy, he could be accused of giving out information to those present at the dinner which was not equally available to all market participants.

5. Mr Frost seemed to think that it would not matter too much to them whether or not the Chancellor agreed to take questions. But you will no doubt wish to consider the wider implications.

Stephen Pickford

S J PICKFORD

2931/038

CONFIDENTIAL

Michael

Comments on B-M below. Not essential reading.

RL 11/4

FROM: M NEILSON
DATE: 11 April 1986

PPS

cc: Sir P Middleton or
Sir T Burns or
Mr Cassell
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr C Kelly
Miss O'Mara
Mr Walsh
Mr Ross Goobey

LOMBARD ASSOCIATION SPEECH

The Economic Secretary has the following comments on the draft Lombard Association speech attached to your minute of 10 April which he thought was in good shape. (Also enclosed - top copy only - a copy of the draft with the Economic Secretary's minor textual amendments).

Paragraph 15 is too condensed; it needs to make clear that targetting money GDP would be ineffective because there are no instruments to act directly on money GDP, and information available about GDP is so late.

Paragraph 27: the first sentence should indicate that it is clear what factors have caused the change in the relationship between M3 and money GDP, but that their relative weight is unclear. It might be worth mentioning the corset in the second sentence, and the paragraph should make clear that there has been a change in the type of facilities available to bank customers, partly in response to competition.

Second indent on page 2 of the exchange rate section; better to avoid talking about "a bias towards a firm exchange rate". The real point to be made is that the exchange rate should not be used as a means of easing competitive pressures on British Industry.

Last paragraph page 2 of exchange rate section; the appreciation of the exchange rate was not particularly unexpected in Government.

Third full paragraph on page 5, development of the MTFS; the reference to "giving priority to real growth at the expense of inflation" should be accompanied by an explanation that the concept of a choice between the two is mistaken anyway.

Anti-penultimate paragaraph is too telescoped, and at the minimum the last sentence should end, "will lead through higher interest rates to a higher exchange rate".

MN

M NEILSON

21P

DRAFT 2 Date: 9 April 1986

LOMBARD

The publication of the Medium Term Financial Strategy set the framework for macro-economic policy making in this country. It was also a major influence on economic thinking throughout the world. Indeed, the best tribute to the MTFS is that its approach and language have become the common currency of economic management.

2. The ethos of the MTFS was realism. To direct economic policy towards objectives which could be achieved and to eschew those which could not. ~~And~~ To design policies which would improve the economy in the medium term. And to discard those which sacrificed long term objectives for transitory short term considerations. Thus it was that macro-economic policies focussed on the defeat of inflation and micro-economic policies on improving the output performance~~s~~ of the economy - the supply side.

3. This may seem commonsense - even commonplace, today, but in 1979 it was far from that. Remember, we still had not got rid of the belief that Government spending would produce output, that more spending would produce more output. All you needed to do was decide on the output required and spend to achieve it. If only the Chancellor's job was that easy.

4. The MTFS not only brought monetary and fiscal policy together within a single framework, it also did this far more explicitly than had been attempted before. There were good reasons for this. No one, either at home or abroad, really believed that British Governments would resist the fool's option - to spend excessively, to get into financial difficulties, and then try to get out of the difficulties by inflation, that most evil of taxes. We had no track record of the sort that the Japanese, the Germans, the Americans - indeed practically anyone among our main competitors - had. If we were to live in the same financial world as them such a record had to be established.

5. Simply writing down a set of numbers in the MTFS was not enough. It had to be seen to succeed in its objectives. But it was a radical new start. The Government's role was set out clearly and simply - even starkly - so that the private sector would be in no doubt and could base its own decisions against a clear statement by a committed government accordingly. Government policy henceforth would provide direction and sound financial discipline - it would not simply react in order to try to compensate for inefficiencies and rigidities in the private sector. There were now some rules for the public sector, rules which could not possibly be mistaken or misunderstood.

6. Other countries have not of course gone about things in exactly the same way. But they all have a counter-inflationary framework in which downward pressure is exerted on monetary variables, and structural defects are being reduced over the medium term. On an international level these policies have been outstandingly successful. The inflation rate has come down decisively; output is going steadily, and the same policies will consolidate and improve on this performance.

7. But my main objective today is to demonstrate ~~explain~~ how the MTFS has succeeded in this country, and explain the way it has evolved as we have gained experience and how we operate policy at present.

8. An essential first stage was to get our accounting on to a cash basis. Getting rid of all the astonishing number of dodges which went under the name of "funny money" was a major undertaking. But we were able to commence the MTFS with three essential cash concepts: public expenditure which is now planned and controlled in cash terms, the public sector borrowing requirement and, of course, the supply of money in the economy.

9. These could all be related to each other by considering their effect on national output in current price or money terms - commonly known as money GDP. This is the only framework which makes any sense if the object is to reduce inflation.

10. Money GDP is an amalgam of two things. The real rate of growth and the rate of inflation. Real growth is primarily the

responsibility of the private sector. The Government can do a lot to help. But not with its macro-economic policies. This is where micro-economic policies count. They enable markets to work better, remove restrictions, improve incentives and generally develop a dynamic and enterprising economy. These policies are an essential part of the Government's economic programme. The fact that I am not dwelling on them tonight does not diminish their essential part in the Government's medium term strategy. Real output can of course be affected in the short term by changes in financial policy. But there is no lasting effect. In the medium term these effects are ironed out and output returns to the level determined by the supply performance of the economy.

11. Inflation is quite different. Though changes in output resulting from financial policy are transitory, changes in the rate of price increases are long lasting and cumulative. Governments can easily get inflation into the system. But because of these long term dynamics, it is desperately difficult to get out.

12. The only way to do it is to accept the medium term nature of inflation, and pursue policies to bring down the growth of money GDP over the medium term. Once money GDP has been reduced to the trend growth of output, inflation will be eliminated. If you follow the alternative of allowing money GDP to grow in excess of the supply potential of the economy, all you can get in the medium term is more inflation. The bigger the gap, the greater the inflation. Output remains unaffected in the medium term.

13. Some still argue that money GDP is an unhelpful concept - because it combines two different things: real output which is a good thing and inflation which is bad. But this misses the point. Inflation is eliminated if money GDP can be brought down to the appropriate level. The question is can it? The answer is that it can by appropriate monetary and fiscal policies. And it follows that the movement in money GDP is the best possible indicator of the success of these policies. And the path of money GDP is therefore an essential element underlying the MTFS.

14. Look at the record over the last 7 years. The growth of money GDP has been halved from over 15% to under 8 %. Inflation has been reduced from 13% to 5%. Further progress in reducing money GDP will bring further progress in lower price increases. The MTFS path I set in the Budget sees money GDP coming down to 5½% by the end of the decade. Growth can confidently be assumed at an underlying 2½%. So inflation of 3% is within our grasp.

15. The way we deliver that path of money GDP is by the pursuit of an appropriate monetary policy. Some commentators have suggested a target for money GDP with policy instruments adjusted to meet that target in the light of the best available forecast. That is a useful check and an essential part of the analysis we perform. But it is not enough. It is essential to have in place a suitable monetary discipline that is visible and produces the correct responses. It is not enough to rely on forecasts. The record suggests that during inflationary periods they understate the pressure on inflation. We need more of an anchor.

[16. It is the role of monetary policy to deliver that path for money GDP. Fiscal policy and public borrowing, can make this easier. The more that structural budget deficits are reduced the less the risk they will be monetised and the less the strain on monetary policy and interest rates.]

17. The classical framework for financial discipline - the gold standard and the balanced budget - had both a monetary and fiscal component. So does the MTFS. From the start we recognised that a firm monetary policy has to be buttressed by setting public sector borrowing at a level that can be comfortably financed in a non-inflationary way. In theory, of course, there is no precise relationship between the PSBR and any given rate of monetary growth. But in practice the only way to be sure of financing the public sector soundly is to plan for a low PSBR. Experience has shown the wisdom of leaving a margin of safety. The 1984-85 PSBR, at 3% of GDP, was still the lowest for over a decade, even though the £3 billion cost of the coal strike was met entirely by higher borrowing. In fact, the PSBR has been less than 3½% of GDP in every year since 1981-82; and the latest estimates suggest that it was below 2% of GDP last year. It is planned to be below 2%

again in the current financial year. It is worth recalling that little more than 10 years ago - in 1975-76 - borrowing reached 9¼% of GDP; and the last time the PSBR was below 2% of GDP was 1971-72.

18. This approach to fiscal policy has become part of the accepted wisdom in other major countries. It is now a long time since the OECD Ministers have not referred to the need to reduce structural deficits over the medium term as an agreed tenet of financial policy.

19. But it is monetary policy which at the end of the day delivers the money GDP path.

20. What do I mean by monetary policy? Let me give you the answer and then elaborate. I mean the combination of indicators that we use to assess the monetary health of the economy and which guide decisions on interest rates. They are the measures of money supply which experience shows are related to money GDP. The exchange rate which tells us both about money conditions in this country compared with our competitors overseas, and serves as a valuable check on domestic conditions at times of uncertainty. And a variety of other indicators - house prices are one - which give an early indication that monetary conditions may be becoming lax.

21. Since 1976 almost all the major countries have found monetary targets to be an effective element in the control of monetary conditions. They have to be applied with good sense and judgement. And above all they have to be read with an eye to the effect of other policies and the development of technology. It would be difficult to find any country which is not keenly aware of the need to continually update its monetary strategy to keep its essential objectives intact.

22. We are no exception to this general rule. Initially the main focus of the MTFS was on £M3. This was a broad measure of money which came into being in its present form as a result of the IMF discussions in 1976. But it had been around in different manifestations much earlier, and the rapid growth of M3 in the early 1970s had preceded the rapid inflation of 1974-75.

23. It had one other great advantage in those early days. The counterparts to M3 were the PSBR, bank lending and the balance of payments. It thus provided the first, early constraint on the PSBR. It did what the MTFS itself now does. It gave some assurance that public borrowing would not be expanded to such an extent as to make the control of £M3, by funding and interest rates, impossible. In other words the Government could not dodge its own role in increasing the supply of money.

24. Not surprisingly therefore, having a definition of money which was accepted in the markets, with an IMF pedigree and with a good track record, the first version of the MTFS was explained predominently in terms of £M3.

25. At the same time, the possibility was recognised that £M3 would not remain a reliable guide as controls - especially those on the banking system and foreign exchange - were removed. We did not quite realise then the the full extent of coming impact of technology, but deregulation was Government policy and very much in our minds. So from the outset we developed and monitored other measures of money. We discussed them and the attendant methods of control widely. Remember the 1981 Green Paper on Monetary Control and the public debate which it provoked.

26. This was just as well as the relationship between £M3 and money GDP in the 1980s has been very different from that in the 1970s. Between 1970 and 1980, M3 grew on average by 2% less than money GDP. Since 1980 it has grown on average by about 4% more.

27. It is not absolutely clear why this has happened. A combination of a freer banking system, greater international competition and new technology is certainly part of the story. So is the level of interest rates - high in real terms after allowing for inflation. This means that people can use interest bearing bank accounts as a savings medium and earn a healthy rate of interest. The banks have been very successful financial institutions over this period. Their deposits have grown. And these deposits are £M3.

28. Whatever the reason, £M3 has given progressively less information about money GDP. So it has also played a progressively smaller part in monetary policy decisions. We have not felt compelled to meet £M3 targets because other indicators have convinced us, rightly, that £M3 was giving the wrong signals. It no longer has a role in funding decisions, and it has a relatively small weight in our thinking about short term interest rates.

29. I did consider very carefully before the Budget whether the time had come to drop £M3 as a target altogether. We would then have monitored it and nurtured it against the day when the factors causing its present unreliable behaviour ceased. But in the end I decided to try a target for 1986-87 with a range which reflects its recent trend velocity, but not to hazard any figures for later years. The reason was that an excessive build up of liquidity could threaten our inflation objectives. And to drop £M3 would make it appear that we were completely unconcerned. So I retained the target, recognising that the role of £M3 in interest rate decisions would be rather atmospheric. Other indications would be giving more certain information.

30. There are of course different measures of broad money. We have tried several of these over the years and rejected them. Some have performed a bit better than £M3 for a while. But all exhibit the same sort of characteristics. So it would have been completely misleading to put one of these in the place of £M3 as a target aggregate, because it would have implied a degree of confidence in the new figure which we simply did not feel. Outside Germany, which is exceptional in the relatively slow pace of financial innovation, there is not a country in the world which is not experiencing these sort of difficulties in interpreting the wide aggregates.

31. That is why, over the years, we have also paid attention to the narrower definitions of money. M1 the traditional narrow aggregate has however been affected by the same forces which have affected £M3. As current accounts have increased their interest bearing elements, the nature of M1 has changed. And it is now no more reliable than £M3.

32. M0 on the other hand has proved a reliable indicator of movements in money GDP in the year ahead. We can expect money

GDP to grow between 2 and 5% more than M0 in the previous year. This is a narrow range. And our confidence is increased by the fact that its average velocity is very much what it was in the 1970s.

33. It has been suggested that M0 cannot be taken seriously because of the narrow range of transactions which it covers. And that it, too, has potential for distortion as a result of technological change. The fact is however that there are no signs of it giving misleading signals, and its lack of any interest bearing component is a source of comfort. So we shall continue to give significant weight to its movement in our assessment of monetary conditions.

34. M0 has therefore been given target status for the last two years. It has the right characteristics for a target aggregate. I have explained its relevance. It moves unambiguously in the opposite direction to changes in interest rates. And it has an appropriate sensitivity to these changes - not so great that the change is meaningless and not so little that it is of no significance.

35. Other critics have looked for a black box mechanism relating M0 to money GDP of a sort which I have never claimed. My judgement is that M0 is influenced by many of the factors that influence money GDP - especially changes in interest rates and disposable incomes. But that influence shows up in M0 more immediately than it does in money GDP. So it is a useful indicator of when interest rate changes may be necessary. We do not, of course, rely on it exclusively. But it is undoubtedly an important factor in decision-making. It provides stability in our assessment of monetary conditionsfrom month to month. It may not trigger many change~~d~~s, but it is an essential guide post as to where we are going.

36. It is sometimes asked why interest rates are never changed in response to news about M0. This is largely because M0 growth only tends to change slowly and we would not expect sharp interest rate changes to follow. But whereas it has not usually been the trigger for interest rate action it has often persuaded us against changes that might otherwise have taken place. Let me be more

precise. Most forecasts of inflation have been too pessimistic in recent years - particularly those generated outside the Treasury. In general they have been pointing to a need for higher interest rates to deliver our inflation objection. And those who have given a high weight to £M3 have also tended to argue for higher interest rates than proved necessary. We have often resisted these blandishments because of the more reassuring - and in the event more accurate - signals coming from MO.

The Exchange Rate

By contrast the timing of short term interest rate changes has often been strongly influenced by exchange rate movements. As a result it is often wrongly concluded that we must be operating an exchange rate target. Let me try once again to set out our views about the role of the exchange rate in the operation of monetary policy.

My remarks apply to the present environment. In some circumstances, a fixed exchange rate regime can be a very effective monetary discipline. It forces the authorities to recognise when policies are too expansionary or too restrictive for inflation to continue coming down at the same rate as in other countries. It leaves little room for variation and it is indeed a tough discipline.

Unless we are part of a formal fixed exchange rate system, shared by other countries as well, it is both risky and dangerous to try and set up a unilateral exchange rate objective. There is no systematic expectational benefit and markets are continuously tempted to test the authorities' resolve. Large changes in interest rates may be needed which can have profound effects on the real economy.

So we do not attempt to set a target exchange rate zone for ourselves. Interest rates are not changed with such a target range in mind. But we are influenced by other considerations:-

- a bias against sharp exchange rate changes. Whatever their cause they can be self-fulfilling and lead to sharp changes in inflation. So it is often necessary to act to limit the speed of change and enforce some stability.

- a bias towards ~~a firm~~ exchange rate. Exchange rates should support the Government's general objective to bring down inflation. That will mean a bracing - but not excessively - competitive environment.

The exchange rate can fulfil another role. That of being umpire when the various monetary aggregates are giving different messages. There must be a presumption that persistent exchange rate movements reflect, to some degree, underlying monetary conditions - unless they can obviously be explained by developments in other countries or by special factors. So if there is a conflict in the messages coming from the monetary aggregates, the exchange rate can help to resolve it.

There is nothing new in this approach to the exchange rate, though it has devolved over time. The first — many people used it in the '70s to judge conditions.
in policy
occasion when the exchange rate played such a role was in the autumn of 1980. Following the abolition of the corset £M3 was growing rapidly whilst most of the narrow measures of money were slowing down. Somewhat
to some / to many
unexpectedly, the exchange rate appreciated steadily. Other asset prices, particularly for land and houses, were rising slowly.

to whom?

We had to choose between two interpretations of monetary conditions. We reached the conclusion that monetary conditions were tight - rightly as it turned out. Interest rates were reduced by 2 per cent in November 1980 and a further 2 per cent in March 1981.

Some have argued that we failed to appreciate fully the tightness of monetary conditions. That is clearly wrong. Others have argued that we responded too late and by too little. That has to be judged against the circumstances of the time - rising inflation, a very rapid growth in earnings, greater than expected public borrowing and a very rapid growth in liquidity and bank lending. An MTFS that had recently been launched and had not yet had time to build up the credibility it now has. Given the rapid build up of liquidity, a risk of a very sharp reversal in the exchange rate would give added impetus to the inflationary spiral which could not be ignored.

The determination of interest rates

Our approach to interest rates is based on an interpretation of monetary conditions which in turn reflects an overall assessment of the behaviour of the monetary aggregates together with other relevant evidence, especially the exchange rate.

Let me be quite clear. Short term interest rates are above all an instrument of monetary policy. In the final analysis they must be set by the monetary authorities in the UK as elsewhere. This is not to say that the market does not exercise an influence on rates. But we have never suggested the market could, entirely independently, set the level of interest rates. Of course there are times when the yield curve indicates very clearly the direction in which the market believes that interest rates should move. And there are times when we choose to validate a movement if we believe it is justified by monetary conditions. There can also be -

rarer - occasions when it is right to move, even when we are not convinced that a move is justified. It can be dangerous to resist a market led move, where to do so would cast doubt on the authorities' resolve to control inflation.

But there are other occasions where it is right to resist. This was so earlier this year. I decided on an early move in response to the falling oil price, but took the view that the pressure for a further rise beyond 12½ per cent was not justified on monetary grounds and was based on the exaggerated view of sterling's vulnerability to movements in the oil price.

So the timing of interest rate changes can often involve a delicate assessment of market tactics. It also involves an assessment of monetary conditions which itself is rarely straightforward. There is no mechanical formula for taking the various factors into account. It is very often the case of weighing movements in one indicator against movements in another. That is not to deny the special status of the monetary targets. If the underlying growth of MO or £M3 were to move significantly outside their target ranges, there is always a presumption of action, unless the evidence of other indicators is conclusive.

In the case of MO this is relatively straightforward. Short term interest rates tend to have a fairly fast acting effect on the growth of narrow money. So a rise in interest rates can be expected to bring MO growth back within its target range within the target period. It is also be likely to show up fairly promptly in the behaviour of the exchange rate.

In the case of £M3 the position is more complicated. Experience suggest that a change in short term rates is unlikely to alter the growth of £M3 significantly within the target period. But such action clearly affects the tightness of monetary conditions, which is what matters.

This is why I said in my Budget Speech that the target for broad money does not have the same operational significance as that for narrow money.

The development of the MTFS

omission ?

I am often urged to provide a brief succinct summary of the operation of monetary policy, and I am aware that what I have just said is a far cry from that. Unfortunately the operation of monetary policy is difficult: that is an unhappy fact of life. It is sometimes suggested that quite different from the original MTFS and that it was a mistake to begin with a relatively uncomplicated version. It is argued that both models cannot be right. Either the 1980 model was too simple or the 1986 model is too obscure.

I recognise of course that there have been changes. They fall into two categories: changes of presentation and changes of substance.

First the question of presentation. At the outset the Government had no track record. The MTFS represented a new approach. Many people doubted if we would ever see a single digit inflation again. At that point it was important to err on the side of rigidity and rules, rather than flexibility and discretion. In the past discretion had generally been exercised in favour of financial relaxation; it erred on the side of giving priority to real growth at the expense of inflation.

Our first task was to convince markets both at home and abroad, that we were serious about defeating inflation.

We have now built a track record. The inflation rate has been decisively reduced and it is much closer to the average of other major industrial countries. We have demonstrated that inflation can be reduced by monetary control; and that we are not afraid to respond by tightening monetary policy if that success is threatened.

At the same time we have seen clearly that output recovery can be combined with low inflation. Steady output growth does not require persistent fiscal and monetary stimulus.

The task is now a different one. To make a further important dent in the inflation rate within a framework that leaves room for output to grow. We are now in a position to be more explicit about the complexities of policy without running the risk of creating worries that we are about to fall back into the bad old ways. Some countries - for example Germany and Switzerland - have not had to face this problem, thanks to the track record built up over many years.

Second, the problem of substance. Without doubt the problem of operating monetary policy has become more complicated. In part this is because of deregulation and more competition in financial markets. It is a classic example of the sort of trade off we have had to face. In the long run there can be little doubt that deregulation and competition must be good for the financial sector and for the efficient operation of the economy. But in the shorter term they undoubtedly complicate the monetary signals and make the technical problems of monetary control that much greater.

These changes have been an important explanation for the changed relationship between £M3 and money GDP. And for the structural changes that have affected M1 as an increasing proportion of sight deposits have become interest bearing. It has become increasingly difficult to draw a line between money balances held for transactions and those held as savings.

And greater freedom of capital movements has changed the relationship between monetary policy, fiscal policy and the exchange rate. In the days of low capital mobility the current account probably had a bigger influence on the exchange rate. There was a greater presumption that fiscal expansion would reduce the exchange rate. More recently capital flows have been a more dominant element. Combined with the regime of monetary targets this has created a stronger presumption that easier fiscal policy will lead to a higher exchange rate.

These changes inevitably change the balance between rules and discretion. There is a greater need to monitor information more carefully before coming to a judgement about the implications of the various indicators. In the process, it is important that the best should not be the enemy of the good. It is no use commentators urging me to ignore MO because it only shows a relatively short lead over money GDP if there is nothing more robust.

Conclusions

As I said at the Mansion House, "At the end of the day the position is clear and unambiguous. The inflation rate is judge and jury". In looking back at our past record we have to examine the outturn for inflation. Some commentators suggested this meant we would be basing monetary policy on forecasts of inflation. That is not at all what I said. Today's inflation rate tells us something about monetary policy in the past. The decline of inflation over the past 7 years tells me, that despite all the problems with the monetary aggregates, and the need to learn how to integrate exchange rate movements into that analysis, we have basically succeeded in deliver~~y~~ing the appropriate monetary policy.

CONFIDENTIAL

FROM: **P N SEDGWICK**
DATE: 11 APRIL 1986

Comment on B-M

MRS LOMAX

cc Sir P Middleton
Sir T Burns
Mr Cassell
Mr Peretz

LOMBARD SPEECH

My principal concern is with the way that the speech deals with high rates of growth of broad money. (The current draft hardly mentions credit.) I think that there is a widespread unease among commentators and market operators that the government might be prepared to allow both liquidity and credit to grow at rates that are inconsistent with its own aspirations for inflation. I suggest therefore a short passage to come <u>before</u> the detailed discussion of £M3 in paragraphs 22-31 to reiterate

(a) that the government is prepared to tighten policy if and when there are signs that current rates of growth of broad money and credit pose a threat to the government's aim of lower inflation,

and (b) that with broad money and credit growth close to the high rates of recent years there are no signs that inflation is likely to turn up.

I think that the detailed discussion of £M3 would be more effective if it followed a passage such as I have suggested.

<u>Detailed points</u>

<u>Paragraph 20</u>

The "combination of indicators" referred to in the third sentence measure monetary conditions. They do not define monetary policy, as the first sentence suggests.

<u>Paragraph 21</u>

Many would consider Germany to be an example of a country that has not had continually to update its monetary strategy (third sentence).

Paragraph 24

I think that it is stretching language to refer to £M3's "IMF pedigree". The 1976 Letter of Intent discussed £M3, but provided targets for DCE (as had been the case under Roy Jenkins). The IMF acquiesced in the subsequent move to targeting £M3, but surely it was the UK authorities rather than the IMF that pushed for this change.

Paragraph 25

The Green Paper was published in 1980. The famous footnote to table 5 of the first (1980) MTFS referred to it.

Paragraph 28

It is a little difficult to claim that £M3 has given "progressively less information about money GDP" and to talk in the next paragraph about the 1986-87 target range reflecting its recent trend velocity. The crucial point is that the relationship between £M3 and money GDP in the first half of the 1980's has been very different to that in the pre-1980 period. We still do not know whether the relationship with money GDP will turn out to be stronger or weaker than in earlier years.

Paragraph 32

It is the velocity trend that has been similar in recent years to that of the 1970's.

P.N.S

P N SEDGWICK

FROM: DAVID PERETZ
11 April 1986

MRS LOMAX

cc PS/Economic Secretary
Sir P Middleton o/r
Sir T Burns
Mr Cassell
Mr Walsh
Mr Ross-Goobey

LOMBARD ASSOCIATION SPEECH

I have passed most of my comments on the draft of 10 April to Mr Cassell, but said I would let you have direct a suggested redraft of paragraphs 28 and 29. There is a related change I would like to suggest to paragraph 26.

2. The following redraft of paragraphs 28 and 29 is designed to bring them more into line with the Budget presentation on £M3: that is that our conclusion is that in the past the target ranges have been set too high, rather than, necessarily, that £M3 has become more or less useless as an indicator.

> "28. Whatever the reason, £M3 has given progressively less reliable information about money GDP. It is also clear in retrospect that we have failed to take proper account of the change in its relationship with money GDP since 1980. So successive targets have been set too low. We have not, therefore, felt compelled to meet £M3 targets. Other indicators have convinced us, rightly, that the performance of £M3 in relation to its target range was giving the wrong single. It no longer has a role in funding decisions; and has come to play a smaller role in our thinking about short term interest rates.
>
> 29. I considered very carefully before the Budget whether the time had come to abandon a target for £M3 altogether: to reduce it to what the Americans would call monitoring status. But in the end I decided to set a target for 1986-87, but with a range that reflects its recent trend in velocity - taken together with the likely effects of last year's change in funding policy and a continued high level of real interest rates. But to indicate our continued uncertainty about its velocity trend by not giving any

EST does not like the implication that high real rates will continue
AWK

illustrative figures for later years. It remains important to monitor the growth of liquidity in the economy. An excessive build-up could threaten our inflation objectives, if it came to be spent. In those circumstances we would also expect to see an early warning in the behaviour of M0 and the exchange rate. Nevertheless, we do need to watch the growth of liquidity, and to have dropped £M3 would have made it appear that we were unconcerned about this potential risk. So I retained the target, recognising that the role of £M3 in interesst rate decisions was likely to remain limited in relation to other indicators.

29a. I also recognised, for reasons, I will come to later, that the target range for £M3 necessarily has a slightly different operational significance to that for M0."

3. I think, given the number of comments there have been about the looseness of an 11-15% range, that the additional points I have added in the second sentence of paragraph 29 above - to the velocity trend - are important. It would also help if the final sentence of paragraph 26 were expanded to read:

"Since 1980 it has grown on average by about 4% more, although the annual figure has ranged up to 6%."

B Woodall

pp D L C PERETZ

D

FROM: M C SCHOLAR
DATE: 11 April 1986

MRS LOMAX

cc: Economic Secretary
Sir P Middleton o/r
Sir T Burns o/r
Mr Cassell
Mr Peretz
Mr Sedgwick
Mr C Kelly
Miss O'Mara
Mr Walsh
Mr Pratt
Mr Ross Goobey

LOMBARD ASSOCIATION SPEECH

1. You asked for further comments on the revised (and, I believe, much improved) draft of the speech circulated under cover of your minute of today's date.

2. I can see that it may be best not to mention ERM membership in this speech, and your draft, like the last one, does not in terms. But, as they stand, the third, fourth and fifth paragraphs of p 11 may read to some like a coded plea for membership:it is "risky and dangerous" to try to operate a unilateral exchange rate objective (an objective commended in the previous paragraph as imposing a tough discipline and being a substitute for monetary targets) outside a formal fixed exchange rate system shared by other countries etc; why, people may think we are suggesting, do we not do so multilaterally? If this passage is to be retained (as I think it should be) I think we will need a sentence or two reiterating why we are not joining the ERM now.

3. In the fifth paragraph on p 13 you say that we made it clear in 1980 that no one aggregate could be a sufficient measure of monetary conditions. Where? Not in the FSBR, which more or less equated £M3 and the money stock. I don't think the footnote to Table 5 of the 1980 FSBR ("...the way in which the money supply is defined for target purposes may need to be

adjusted from time to time as circumstances change") will bear this weight.

4. I am unhappy with the argument (fourth para of p 14) that we can now afford to be more frank about the complexities of operating monetary policy, whereas in 1980, without a track record, we had to be "clearer" in order to persuade the sceptics. The implication of this - that we were less than frank in 1980 - is unfortunate and, I think, disingenuous. This awkwardness comes out acutely in your sentence about the balance between clarity and openness. There is no antithesis between clarity and openness, and this sentence shows that by 'clarity' you mean obfuscation (which you rightly excoriate in your conclusion).

5. May I repeat a couple of further points from my earlier minute?

(i) Page 16, bottom. "Illustrative ranges", surely, not 'target status' for MO in the last two years?

(ii) Why not add, in the second para of p 5, my point about the 1985-86 PSBR being around or below the average for the 1960's etc?

(iii) In the antepenultimate line of p 3 "and after an initial setback" seems rather a provocative description of the 1979-81 recession. Omit?

MCS

M C SCHOLAR

FROM: F CASSELL
11 April 1986

MRS LOMAX cc Mr Peretz

LOMBARD ASSOCIATION SPEECH

Some suggestions:-

On your revised opening section (a great improvement!).

Page 3, at top. Having introduced "money GDP", keep it in the next sentence: "This is an amalgam of two things: the growth of output and the rate of inflation". [I can't see how "nominal demand" can be defined in that way - except by identity with something else.]

The penultimate paragraph on that page is pure Noddy-style. But if we wore it in the FSBR I suppose we must wear it here. [With real wage resistance, it is employment that gets squeezed out.]

Yesterday's Version

Paragraph 20. This is ghastly. At the very least it should say in the third sentence:

> "I mean keeping monetary conditions under control, as measured by the combination of indicators we use to guide decisions on interest rates. These are ..."

The last sentence might then give real interest rates as well as house prices as an example - and end: "... - which can give an early indication that monetary conditions are being lax or too tight."

Paragraph 21. The third sentence should refer to: "... the development of financial institutions and the technology they use".

Paragraph 25, fourth line. "...impact of institutional and technological change..."

Paragraphs 28 and 29. These need to say more about the shift in V, and our belatedness in reflecting it in the target for £M3. The point to get across is that the new target range is not a relaxation of previous policy. Mr Peretz will be letting you have a suggested redraft of these paragraphs.

Paragraph 36. Obviously by the author of 'A Doctor Writes' in the Eye. Do we need it? I think not. Probably, but not with this opening.

Page 2 of exchange rate section, first indent 'self-fulfilling' should be self-feeding.

Page 3. I'd omit the paragraph on failing to appreciate fully the tightness of monetary conditions in 1980.

In the final paragraph on that page, expand the fourth sentence:

"... the market, or movements in rates abroad, do not ..."

Page 5. Something missing from the sixth line of the paragraph under the cross-heading (presumably a reference to the present MTFS).

Pages 6/7. It's not clear why the last paragraph on page 6 (on capital movements) leads up to a paragraph beginning:

> "These sentences inevitably change the balance between rules and discretion."

pp J. E. Rigby

F CASSELL

23/4

FROM: H G WALSH
DATE: 11 APRIL 1986

PRINCIPAL PRIVATE SECRETARY

cc: Mr Cassell
Mr Peretz
Mr Sedgwick
Miss O'Mara
Mr Heath

LOMBARD ASSOCIATION SPEECH

We in HF3 have worked through the monetary numbers in the speech and two small matters have been pointed up:-

(i) In paragraph 26, the second sentence should refer to "£M3" and not "M3". The actual figure (shown in the attached table) is 1.8 per cent excess money GDP growth between 1970 and 1980, so that perhaps "<u>about</u> 2 per cent" might be better than "2 per cent";

(ii) The proposition in paragraph 32 about expecting money GDP to grow between 2-5 per cent more than one-year lagged M0 is generally confirmed from crude data for 1976 onwards if allowance is made for M0 redefinition in 1983 and the effect of the miners' strike in 1984. Even so, in 1979 and 1981 the lower end goes slightly below 2 per cent.

H.W.

H G WALSH

	~~£1932~~ growth GDP growth*	£M3 growth	Difference
19[illegible]	9.68	6.28	3.4
1971	12.30	12.29	.01
1972	10.74	24.15	-13.41
1973	15.54	25.54	-10.0
1974	13.65	16.92	-3.27
1975	26.36	7.33	19.03
1976	19.32	8.04	11.28
1977	15.03	7.73	7.3
1978	15.16	15.46	-0.3
1979	16.93	13.06	3.87
1980.	17.21	16.67	0.54
			1.845.

* gross domestic product (expenditure) at market prices.

	GDP growth*	M0 growth lagged one year	Difference	
1972	10.74	8.15	2.59	
1973	15.54	5.98	9.56	
1974	13.65	13.14	0.51	
1975	26.36	11.79	14.57	
1976	19.32	14.31	5.01	
1977	15.03	10.98	4.05	
1978	15.16	10.57	4.59	
1979	16.93	15.09	1.84	
1980	17.21	13.05	4.16	
1981	10.20	8.50	1.7	
1982	8.91	4.63	4.28	
1983	8.72	0.89	7.83	(M0 change in defintn
1984	5.99	5.72	0.27	(miners' strike)
1985	(8.8)	5.58	3.22	

* gross domestic product (expenditure) at market prices

FROM: C J RILEY

DATE: 11 April 1986

MRS LOMAX

Sir T Burns (o/r)
Mr Cassell
Mr Odling-Smee (o/r)
Mr Peretz
Mr Sedgwick
Mr Walsh

LOMBARD ASSOCIATION SPEECH

Although the draft you circulated on 10 April was not copied to MP, may I offer one or two detailed comments.

Paragraph 8

I think I am right in saying that the MTFS did not commence in 1980 with the three cash concepts set out in the final sentence of this paragraph. The public accounts, including the PSBR, were expressed either in constant prices or as a percentage of GDP. Only the monetary aggregates were given in nominal terms, and the move to a cash basis for public expenditure and the PSBR in the MTFS did not occur until 1982.

Paragraph 10

I found the argument in this paragraph too extreme. We surely do not wish to argue that moving to low and stable inflation as a result of a suitably restrictive macroeconomic policy has no effect on performance in the real economy. While we clearly wish to stress the role of microeconomic policies, we surely do not want to rule out the beneficial effects of low inflation on growth - via reduced uncertainty, variability of relative prices, etc -which were clearly implied in earlier versions of the MTFS. The penultimate sentence of the paragraph - "But there is no lasting effect." - must surely be amended or omitted.

Paragraph 13

Is it not more accurate to say that money GDP is the best available indicator of the success of macro policy, not the best possible indicator.

Paragraph 14

We need to refer to money GDP growth being reduced in lines 4 and 5! More substantively, are we really able to say that growth can confidently be assumed at an underlying rate of $2\frac{1}{2}$ per cent? I would have thought we were relatively uncertain about the prospective growth rate in current circumstances, after the third oil shock. Perhaps it would be more helpful to say that, while there is considerable uncertainty about the prospects in these circumstances, the outcome for both output and inflation could be rather favourable given the reduction in oil prices.

Paragraphs 16 and 19

The draft at present implies that it is monetary policy alone which determines the path of money GDP. But in practice, surely both monetary and fiscal policy have a role to play. Fiscal policy is not purely subordinate to monetary policy, as the second sentence of paragraph 16 implies. Would it not be more accurate to argue that:

- it is the role of macroeconomic policy to deliver the path for money GDP, and

- there must be an appropriate balance of fiscal and monetary policy in order to achieve it.

Paragraph 20

As drafted, this says that monetary policy is a combination of indicators. Presumably what is meant that the effects of monetary policy are monitored by reference to the combination of indicators ...

Paragraph 32

In the last line you need to insert "growth" after "average velocity".

CJR

C J RILEY

I have now seen the revised draft circulated today. A number of the comments here are no longer strictly relevant.
But the comment about the primacy – or otherwise – of monetary policy still is. In particular, the last full sentence on the new page 5 is, in my view, misleading.

CJR

FROM: M C SCHOLAR
DATE: 11 April 1986

MRS LOMAX

cc: Economic Secretary
Sir P Middleton o/r
Sir T Burns o/r
Mr Cassell
Mr Peretz
Mr Sedgwick
Mr C Kelly
Miss O'Mara
Mr Walsh
Mr Pratt
Mr Ross Goobey

LOMBARD ASSOCIATION SPEECH

1. You asked for comments on the draft speech.

2. Some of the history seems to have gone awry. Para 8 says that we <u>began</u> the MTFS with a nominal framework and cash concepts for public expenditure, the PSBR and the money supply. But the first two versions of the MTFS set expenditure tax and borrowing in constant price terms ("1978-79 prices" in 1980 and "1979-80 prices" in 1981). Arguably, the tax figures were, at root, on a cash basis and merely expressed in constant prices. But the expenditure projections (and therefore the PSBR projections) were certainly not cash-based, as cash planning was not in operation at that time.

3. Similarly, I don't think we can say in para 25 that in the first version of the MTFS the possibility was recognised that £M3 would not remain a reliable guide as controls were removed. I can see no evidence at all for this in the 1980 FSBR: and in the 1981 FSBR what we said was that £M3 <u>had</u> not proved a good indicator of monetary conditions in the past year (but that it could prove a guide over the medium term, because over the medium term its velocity had been broadly stable).

4. I think it's a pity that in the section around para 31 on the chosen monetary indicator(s) we are not using the very clear formulation in para 2.10 of this year's MTFS: that the

ideal target aggregate would have three characteristics (transactions-related, responsive to interest-rate changes, stable relationship with money GDP), then checking off MO against them. More generally, I think that we might try to strengthen the advocacy (paras 32-36) of MO, giving more (even if boring) details of its stable velocity, and discussing at greater length its strengths (compared with what else is available) as a transactions-related aggregate.

5. There is very little about the decision to abandon overfunding. Perhaps there doesn't need to be, as there has been little probing of our reasons for doing so. But it does seem to me a lacuna in a speech which is billed as authoratitive and comprehensive, and I doubt if we could rest on the rather sudden single sentence at the end of para 28.

6. I think many people will find para 29 unsatisfactory. It looks rather casual to say merely that we are "trying" the 11-15% range for this year's £M3 target. If we are so unconcerned should we admit a few sentences later that an excessive build-up of liquidity could threaten our inflation objectives? If we are going to retain this formulation I think we should add a sentence or two explaining why we do not believe there are really any risks here (presumably on the lines of para 3.24 of the FSBR - that the higher levels of broad money probably reflect a permanent shift in the private sector's portfolio which is not likely to be reversed through higher spending).

7. Some more detailed points:-

(i) Page 1, para 1 insert "in 1980" after "publication" in line 1;

(ii) Page 1, para 1, final line, insert "at home and abroad" after "become";

(iii) Para 6, penultimate line, "growing" not "going";

(iv) Last 3 sentences of para 10 introduce a substantial new point. Need a paragraph of their own;

(v) Para 15 - shouldn't we set out, for completeness, problems there would be about using money GDP as a target - difficulties of interpretation, lateness of data etc?

(vi) Para 17, bottom of page, after "2½% of GDP last year" add "close to the level - itself a little below the average recorded in the 1960's - which we said in the first version of the MTFS we ultimately intended to achieve" [£5.9b = 1.64% of GDP compared with the 1½% - admittedly for 1983-84 - in the 1980 FSBR];

(vii) It is rather awkward in para 20 to explain what monetary policy is by immediate reference to "a combination of indicators". What about, "It is our policy towards money - a policy which manifests itself in decisions on interest rates, decisions guided by the indicators we use to assess the monetary health of the economy"?

(viii) Do we want to refer to house prices in para 20, given their recent surge? Can we ,say, formulate in terms of asset prices? At the end of that sentence shouldn't we say, "too lax or too tight"?

(ix) Instead of "the IMF discussions in 1976" in para 22, "the last government's dealings with the IMF in 1976";

(x) Para 25, line 6, delete "developed and";

(xi) Para 27, line 4, insert "i.e." after "real terms";

(xii) Para 30, last line, "sorts";

(xiii) Para 34, "illustrative ranges" not "target status" for MO for the last two years ;

(xiv) Para 35, penultimate line, "changes"; last line, "sign-post" not "guide-post";

(xv) Page "2", 8 lines from bottom, "developed" not "devolved";

(xvi) Page "3", end of second paragraph. Won't it sound a bit implausible to speak of a possible sharp reversal in the exchange rate in 1980? I would be inclined to omit this sentence;

(xvii) The following paragraph on p "3", like other material in this second section, is rather repetitive of the first half of the speech.

(xviii) Page "4", third paragraph, 3 lines from bottom, "moves" instead of "were to move". [Some will think £M3 is already moving outside its target range]

(xix) Page "6" - after first sentence insert something on the lines:

"You may think there is nothing surprising about this. But many doubted if it was possible in 1980 and 1981"

(xx) Last page, last paragraph. Isn't "learn to", 3 lines from the bottom, a bit too honest? I suggest substituting "despite all the problems of interpreting changes in the growth of the monetary aggregates and exchange rate movements" for the present "despite all the problems with the monetary aggregates, and the need to learn how to integrate exchange rate movements into that analysis". Delete "basically" in the penultimate line.

MCS

M C SCHOLAR

FROM: A ROSS GOOBEY
DATE: 11 APRIL 1986

PPS

cc EST
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Peretz
Mr Scholar
Mr Sedgewick
Mr C Kelly
Miss O'Mara
Mr Walsh

LOMBARD ASSOCIATION SPEECH

I am responding to the redraft by Sir P Middleton and Sir T Burns.

2. The problem that leaps off the page is the combination of paragraphs 26 and 29. If the average fall in velocity of £M3 is 4%, why is £M3's target 11-15% with a 6¾% money GDP forecast? The velocity figure quoted would only justify a 9-13% range. I believe that some mention of the recent range of velocity falls (2% to 6%) in para 26 and the reasons for expecting it to be at the high end of that range in 1986-87 is necessary.

3. The role of "other indicators" is reduced to a passing mention of house prices. Should the range of indicators be expanded upon and the reasons for treating them with some circumspection in an era of high real interest rates be mentioned?

4. The international background seems worth alluding to in the light of the IMF's investigation into "objective indicators". Also the following quote from Volcker's Humphrey-Hawkins testimony might be useful in the discussion of broad money aggregates:

> "We are well aware...of the long history and of the economic analysis that relate excessive money growth to inflation over time. The operational question remains as to what...is in fact excessive in the light of recent velocity behaviour."

5. There are some obvious typos:

- Para 35 "changes" for "changed"

- The Exchange Rate P2 last para "evolved" for "devolved"
  P5 insert "it is" in sentence: "it is sometimes suggested that (it is) quite different"
  Last P (7?) last sentence "delivering" for "delivery"

ARG

A ROSS GOOBEY

CONFIDENTIAL

FROM: MRS R LOMAX
DATE: 11 April 1986

MR CASSELL

cc PS/Economic Secretary
Sir P Middleton (or)
Sir T Burns (or)
Mr Peretz
Mr Scholar
Mr Sedgwick
Miss O'Mara
Mr C Kelly
Mr Walsh
Mr Ross Goobey

LOMBARD ASSOCIATION SPEECH

With time hanging heavy on my hands, I have taken it upon myself to tinker substantially with the draft I circulated yesterday. In particular, I have re-ordered to try and avoid repetition. I have also tried to anticipate the Chancellor's comments, based on what he said to me before he left for Washington. In the time available I have not taken account of all the comments on the earlier draft, but I shall try to do so this afternoon.

2. I would be most grateful for any further comments by close tonight - in particular could Mr Walsh kindly supply the missing figures on page 8.

RL

RACHEL LOMAX

LR1.58

LOMBARD ASSOCIATION SPEECH

April is the season of international meetings. My appearance here tonight is sandwiched between the Spring meetings of the IMF in Washington and the OECD in Paris.

Meeting other Finance Ministers, I am always struck by the extent to which we share a common approach to economic management.

[This year was no different. Our discussions were dominated by the dramatic fall in the price of oil, which certainly poses some unfamiliar problems for the world economy as well as the UK.

But there is nothing new about the framework within which those problems will be tackled.]

The need for firm financial discipline: the importance of reducing fiscal deficits: improving the working of markets and promoting greater competition. These priorities are taken for granted by all major countries today. We can take some credit for shaping this consensus

It is easy to forget how much has changed since we first took office 7 years ago.

An approach to economic policy that is now commonplace was then radical, even revolutionary. Especially in the UK.

Shortly before the 1979 Election I wrote "The time has come for a wholly new approach to economic policy in Britain. The overriding need is for a long term stabilisation programme to defeat inflation, recreate business confidence, and provide a favourable climate for economic growth".

Putting those brave words into practice has been one of this Government's major achievements. That is an important reason why foreign opinion is in no doubt that Britain is indeed on the right track.

It would be idle to pretent that everything turned out as we expected. I want to spend my time tonight talking about one particular area where practice is considerably more complicated than theory - monetary policy.

The policy we are pursuing today is identifiably the same as the one we embarked on 7 years ago. But it has clearly evolved - both in terms of presentation and substance. I shall try to explain what has not changed - as well as what has, and why.

The Medium Term Financial Strategy

Our main priority in 1979 was to achieve a lasting reduction in the rate of inflation. So our first task was to replace the shifts and strategems of the 1960s and 1970s by a clear and unequivocal commitment to financial discipline. That was the role of the Medium Term Financial Strategy.

It had two features, both novel at the time. First it provided a medium term framework for monetary and fiscal policy. It symbolised the Government's break with policies of fine tuning and crisis management that had dominated British life for most of the post War period.

Second, it was a strategy about finance. Partly because inflation is a financial problem, and has to be controlled by financial means. And partly because the only levers at the Government's command are financial levers.

This approach to reducing inflation depended in the first instance on scaling down the growth of nominal demand in the economy - that is, the growth of money GDP. Nominal demand is an amalgam of two things: the real rate of growth and the rate of inflation.

The crucial mistake that earlier Governments made was to equate money demand and real demand. Expansionary policies boost money demand. But it was a dangerous illusion to suppose that this was automatically translated into a higher rate of growth of real output.

Experience shows just the opposite. During the 1970s GDP in money terms more than quadrupled: but of that increase only 1/20th represented an increase in real output, the other 19/20ths was reflected in sharply higher prices.

Alas there is no magic short cut to boosting the rate of growth of real output; in anything other than the very short term, the growth of output depends on the supply performance of the economy. And that can only be raised by a determined effort to remove restrictions, improve incentives and generally develop a dynamic and enterprising economy.

By contrast it is all too easy to raise the rate of inflation by allowing money GDP to grow in excess of the supply potential of the economy. The bigger the gap the greater the inflation.

But conversely the way to squeeze inflation out of the system is to reduce the rate of growth of money GDP. Which is exactly what the MTFS was - and is - designed to do.

The validity of this approach has been amply borne out by the record of the last 7 years. The growth of money GDP has been halved from over 15 per cent to under 8 per cent. Inflation has been reduced from 13 per cent to 5 per cent. And after an initial setback, we have seen a steady growth in output, of an average rate of 3 per cent a year since 1981.

The monetary and fiscal framework

Reducing the growth of money GDP requires above all an appropriately restrictive monetary policy. And as in most other countries with a serious commitment to financial discipline, this aim has been encapsulated in published targets for monetary growth.

Some commentators have argued that monetary targets are otiose. That we should simply publish targets for money GDP - or even inflation - and set policy in the light of the best available forecasts. That has not been our approach. For one thing we simply do not have a sufficiently detailed knowledge of the working of the economy to operate such a policy. And secondly, monetary policy is above all about markets, and one function of monetary targets is to provide an anchor for the market's expectations.

But we must never forget that targets are a means to an end. Their use depends on the robustness of a relationship between a particular measure of money on the one hand, and money GDP and inflation on the other. In the real world, no economic relationship is perfect. So monetary targetry was not and never can be a substitute for making an intelligent assessment of monetary conditions, based on all the evidence.

That is why the MTFS has always been more than a row of numbers. What it has been - and remains - is a commitment to maintain monetary conditions that will keep steady downward pressure on money GDP, and so on inflation.

I shall have more to say later about what this means in practice. But a discussion of the Medium Term Financial Strategy cannot be complete without a word on fiscal policy.

The classical framework for financial discipline - the gold standard and the balanced budget - had both a monetary and a fiscal component. So does the MTFS. From the start we recognised that a firm monetary policy has to be buttressed by setting public sector borrowing at a level that can be comfortably financed in a non-inflationary way. In theory of course there is no precise relationship between the PSBR and any given rate of monetary growth. But in practice the only way to be sure of financing the public sector soundly is to plan for a low PSBR.

Experience has shown the wisdom of leaving a margin of safety. The 1984-85 PSBR at 3 per cent of GDP was still the lowest for over a decade even though the £3 billion cost of the coal strike was met entirely by higher borrowing. The latest figures suggest that the PSBR was below 2 per cent of GDP last year. And it is planned to be below 2 per cent again in the current financial year - a level that will put us in a strong position to cope with unexpected developments, for example in the oil market.

It is worth recalling that little more than ten years ago - in 1975-76 - borrowing reached 9¼ per cent of GDP; and the last time the PSBR was below 2 per cent of GDP was in 1971-72.

This emphasis on low public sector borrowing has become part of the accepted wisdom in other major countries. It is a long time since OECD Ministers failed to refer to the need to reduce structural deficits over the medium term as an agreed tenet of fiscal policy.

Monetary policy

To recapitulate. While fiscal policy has an important supporting role, monetary policy lies at the heart of the MTFS. The central task of monetary policy is to create monetary conditions that will bring steady downward pressure on the rate of growth of money GDP, and hence on inflation.

In practice this involves a combination of economic analysis and market judgement. Policy must be continuously informed by a careful assessment of what monetary conditions are - and need to be - to meet the Government's objective. But implementing interest rate decisions in today's fast moving financial markets also requires a degree of tactical skill.

Let me be quite clear. Short term interest rates are above all an instrument of monetary policy. That is not to say that the market does not exercise an influence, certainly on the structure and also, at times, on the level of short term interest rates. But we have never suggested that the market could, entirely independently, set the level of interest rates.

The relationship between official influence and market factors was clearly set out in the 1980 Green Paper on Monetary Control.

> "The level of short term interest rates at any time is determined by the interaction of the markets and the authorities. The short term interest rates generated by the market are not necessarily those needed to achieve the monetary targets".

Put bluntly, even though the authorities are not the only players in the field, no Government that is interested in controlling the quantity of money can afford to ignore its price.

Let me give some examples. There are times when the structure of money market rates indicates very clearly the direction in which the market believes that interest rates should move. It is obviously right to validate a movement, if we believe it is justified by monetary conditions. Last week was such a time.

Less frequently, there can be times when it is dangerous for the authorities to resist a market led move in interest rates, if to do so would cast doubt on the Government's resolve to control inflation. So, for tactical reasons, it may sometimes be right to acquiesce in a change in interest rates, even when we are not convinced that it is justified by the fundamentals. The best example of this sort of situation is perhaps July 1984.

But there are certainly occasions when it is right to resist. This was the case earlier in the year. Interest rates were raised promptly early in January to prevent a downward movement in the exchange rate acquiring an unhealthy momentum. Subsequently, however, I took the view that the pressure for a further rise beyond 12½ per cent was not justified on monetary grounds, and was based on an exaggerated view of sterling's vulnerability to movements in the oil price. And interest rates were not allowed to rise.

Assessing monetary conditions

I have said enough to show that the timing of interest rate changes can often involve a delicate assessment of market tactics. Looking beyond day to day market management, however, the guiding principle is to maintain, on average, a level of short term interest rates that will deliver the monetary conditions needed to reduce inflation.

There is no mechanical formula for taking this crucial judgement. Assessing monetary conditions very often involves weighing movements in one indicator against movements in another.

That is not to deny the special status of the monetary targets. Movements in the aggregates outside their target ranges always establish a <u>presumption</u> in favour of changing short term interest rates.

But that presumption is not overriding. For two reasons:-

- First, we can never be completely confident that the target ranges have been set correctly: that is, that they have been based on a correct understanding of the relationship between the aggregate in question and money GDP.

- Second, in differing degrees all the monetary aggregates respond to changes in short term interest rates with a lag: so it takes time for policy action to bring them back within their target range.

For example, it was clear by last autumn that the target range for £M3 had been set too low. Indeed, with the benefit of hindsight, it is clear that there has been a change in the relationship between £M3 and money GDP in recent years.

Between 1970 and 1980, £M3 grew on average by 2 per cent <u>less</u> than money GDP. Since 1980 it has grown between 2 and 6 per cent <u>more</u>.

Put another way, while £M3 has grown by [ ] per cent over the past five years, money GDP has grown by only [ ] per cent, and prices by [ ] per cent. Over the previous five years, £M3 grew by [ ], but money GDP rose by [ ] per cent, and prices increased by [ ] per cent.

It is still not absolutely clear why this has happened, or how well established the new trend is. A combination of a freer banking system, greater international competition and new technology is certainly part of the story. So is the level of real interest rates. But what it means in practice is that the business of setting targets for £M3 is particularly hazardous.

In view of all the uncertainties, I set a target range for £M3 in 1986-87 that reflects the most recent trend in velocity.

The new range also allows for the possibility that heavy overfunding in some recent years had the effect of artificially depressing £M3 growth relative to the growth in money GDP.

more emphasis

These judgements will need to be assessed in the light of experience. That was why I decided not to publish illustrative ranges for later years.

Faced with difficulties with their main target aggregate, M1, the United States authorities have from time to time adopted a similarly cautious approach, relating it to what they call "monitoring status", during periods when there have been particular uncertainties about its velocity trend, ~~of M1~~.

Indeed, other major countries rarely if ever publish monetary targets for more than the year immediately ahead.

There are also considerable uncertainties about the relationship between £M3 and short term interest rates. Experience suggests that a change in short term rates is unlikely to alter the growth of £M3 significantly within the target period: and the very short term response to £M3 to a rise in interest rates is unpredictable, and may even be perverse.

The position with MO is more straightforward. Its relationship with money GDP appears to be relatively well established and stable. Money GDP seems to grow between 2 and 5 per cent more than MO in the previous year - very much the same sort of relationship as in the 1970s.

The growth of MO responds fairly rapidly and predictably to changes in the short term interest rates. So a rise in interest rates can be expected to bring MO growth back within its target range over the target period.

The messages coming from the different monetary aggregates need to be continuously tested against the evidence of other indicators, especially when, as sometimes happens, the various measures of money give conflicting signals. At such times, the exchange rate has often played an important role as umpire.

In an economy as open as the UK's there is a presumption that persistent exchange rate movements reflect, to some degree, underlying monetary conditions. And as I have frequently observed, significant movements in the exchange rate, whatever their cause, can have a short term impact on the general price level and on inflationary expectations which make sound internal policies harder to implement.

The timing of short term interest rate changes has often been strongly influenced by exchange rate movements. This has led some commentators to argue that the exchange rate is in practice the dominant influence on monetary policy, and even that we are operating some kind of informal exchange rate target.

Neither is true.

It is not entirely surprising that the exchange rate sometimes acts as a trigger for interest rate changes. The exchange rate is a sensitive barometer, responding rapidly to changes in short term interest rates and changes in market expectations. But it is patently untrue that every fluctuation in the exchange rate - or even every persistent movement - has produced an interest rate response.

Equally the fact that MO has rarely been the trigger for interest rate action is not evidence that it carries little weight in interest rate decisions. Its role has been less visible, but nonetheless important.

Arguments for higher interest rates - based on the behaviour of broad money, or over-pessimistic forecasts of inflation - have often been resisted, because of the more reassuring - and in the event more accurate - signals coming from MO.

But to return to the role of the exchange rate. I accept of course that membership of a fixed exchange rate regime can in principle be a substitute for monetary targets. The exchange rate can be a tough discipline: forcing the authorities to recognise when domestic policies are out of line with other countries.

But it is both risky and dangerous to try and operate a unilateral exchange rate objective, outside a formal fixed exchange rate system, shared by other countries, and supported by a co-ordinated approach to economic management and intervention.

We have not attempted to set a target exchange rate zone for ourselves.

Our interpretation of exchange rate movements does reflect a bias against sharp exchange rate changes; and a bias towards a firm rate, that will support the Government's general objectives on inflation.

But, in essence, the exchange rate is one input - and only one - to an overall assessment of financial conditions. Our aim is to strike a balance between domestic monetary growth and the exchange rate that will deliver conditions that keep downward pressure on inflation.

Evolution of the medium term financial strategy

Almost all my fellow Finance Ministers - and the Governors of their respective Central Banks - would recognise this description of how monetary policy is conducted in practice. Most well conducted countries operate policy in a very similar way. Those who are members of a fixed exchange rate system typically have domestic monetary targets; and those outside such systems still recognise the need to take account of the exchange rate.

But how different is it from the original conception of the MTFS?

It would have been surprising if there had not been some changes. There have been profound changes in the UK economy in the past 7 years; and nowhere has those changes been more pronounced than financial markets.

And, quite rightly, both the presentation and the substance of the MTFS have evolved in response to them.

To start with presentation.

At the time of the first MTFS almost everything remained to be done. Inflation, monetary growth and the public sector deficit were all high. The long process of containing public expenditure and dismantling the controls that were stifling the economy's natural growth potential had only just begun. I have explained how we had embarked on a policy very far from the accepted wisdom of the 1960s and the 1970s. Those who understood what we were about - and not everyone did - doubted our resolve.

In the circumstances of the time, the overriding need was for simplicity and clarity in getting across the central message. This Government - unlike its predecessors - was

determined to pursue a sustained programme of scaling down the growth in money GDP and squeezing inflation out of the system.

In a word, financial discipline was to be restored.

So we kept it simple. Monetary policy was expressed in terms of a target for a single aggregate: and that aggregate was one with which UK markets were already familiar - £M3.

Policy making in the real world is never that simple. But in presenting policy there is always a balance to be struck between clarity and openness.

~~Even~~ in the Green Paper on Monetary Control - 1980, we made it clear that no one aggregate could be a sufficient measure of monetary conditions; and that the definition and choice of target aggregates might have to change in response to circumstances. But the commitment to a target for £M3 was a useful shorthand for our resolve to reduce inflation and pursue prudent fiscal and monetary policies.

£M3 had been blessed by the IMF; it was well understood in the markets; and it was thought to indicate links with other policies - including most notably fiscal policy. So, in the words of the 1980 Green Paper, targeting of £M3 was widely understood to give "a general assurance that macroeconomic policies available to the Government will be used in a way which mutually support each other in the reduction of inflation".

This was an oversimplification. But in the early days of the MTFS, I am sure we were right to err on the side of clarity. Unlike Germany, the UK had no proven track record of prudent consistent and credible financial management. History was on the side of the sceptics.

Happily times have changed. Over the past 7 years the UK has had a Government that has pursued a consistent and responsible financial strategy. We are providing a model for others and not a cautionary tale.

It will take time before we build up a reputation equal to Germany's. But we are acquiring the right sort of track record. The evidence is there to show that we mean what we say.

We have not hesitated to raise interest rates as and when necessary; we have halved the rate of growth of money GDP; and the result over the past three years has been the best combination of output growth and low inflation for a generation.

As far as the presentation of policy goes, the presentational ~~the delicate~~ balance ~~between clarity and openness~~ has shifted. Because the basic framework of our policies are not in doubt, we can now afford to be franker about the difficulties and complexities of putting them into effect.

There have been changes of substance too. In recent years we have moved further and faster than most of our competitors in freeing up financial markets. A range of outdated controls have been abolished, starting with the abolition of exchange controls only six months after we took office.

In the longer term, I have no doubt that these changes are in the interest of the British economy. But their immediate effect has been to blur long standing distinctions between different financial assets, and between the activities of various financial institutions.

This has inevitably affected the significance of the various measures of money. Policy has had to respond,

and in the process, it has certainly become more complicated.

Broad money, including £M3 has been most profoundly affected. As a result it has come to pay a progressively smaller part in monetary policy decisions.

Problems started to emerge at a fairly early stage. As far back as the autumn of 1980, interest rates were reduced by 2 per cent, even though £M3 was way outside its target range, on the view that it was giving a misleading impression of the tightness of the monetary conditions.

The 1981 MTFS listed the factors that had underpinned this judgement: they included the behaviour of other narrower measures of money, and the exchange rate.

With the benefit of hindsight, this was clearly the right decision, as was the subsequent decision to raise the £M3 target substantially in the 1982 MTFS. Few would now dispute that £M3 has proved a relatively poor guide to monetary conditions for much of the 1980s. Indeed some would argue that the real question is why we have persisted with it for so long, and in particular why I did not drop it altogether at the time of the last Budget.

Difficulties of interpretation there have certainly been. But it would be quite wrong to conclude from recent experience that we can safely tolerate any build up of liquidity.

The risk in dropping ~~the~~ £M3 is that markets would do just that. The £M3 target is evidence of our continuing concern with liquidity.

We have taken the view that the growth of £M3 in recent years reflects a genuine desire on the part of the

private sector to build up its liquidity on a lasting basis. I believe that judgement to be correct. But it must be continuously tested against other evidence. A similar judgement proved disastrously wrong in the early 1970s.

One reason why we have come to put increasing weight on the exchange rate and narrow measures of money is because we would expect these indicators to give early warning were the rapid growth of broad money to start to make its way into higher spending. What went wrong in the early 1970s was that the clear signals from these indicators were ignored.

The reduced emphasis on broad money has also been reflected in funding policy. For many years the principal aim of funding policy was to control the growth of broad money and liquidity. From time to time this involved overfunding - that is, selling more debt than needed to fund the PSBR.

In recent years, the attempt to contain a strong growth in liquidity, the reasons for which were only partially understood, came to make overfunding almost a way of life.

This led to distorti~~i~~ons - not least the rapidly growing bill mountain~~s~~ - which were undesirable in themselves, and made policy harder to opeate.

I reached the view that this excessive reliance on funding policy was neither sensible nor desirable. Accordingly, I made it clear in my Mansion House Speech last year that the objective of funding policy was to fund the PSBR over the year as a whole: no more no less.

I have already explained why the problems of £M3 gave more prominence to the role of narrow money and the exchange rate. In particular, MO has been given target status for the last two years.

It is sometimes suggested that MO cannot be taken seriously because it covers only a narrow range of transaction balances. I accept that it is not ideal: but it has demonstrated a relatively stable velocity trend over a long period, and it shows a reliable and unambiguous relationship with short term interest rates.

Germans— CBM— are 50% notes & coin

It is important that the best should not be the enemy of the good. The fact is that MO is the best narrow aggregate we have. As in the United States, the more familiar narrow aggregate, Ml, has been seriously distorted by a rapid growth of interest bearing sight deposits, some of which were previously held in the form of term deposits. And the same developments have distorted its non-interest bearing component.

The truth is that it has become increasingly difficult to draw a line between money balances held for transactions and those held for savings. MO is only a proxy for transactions balances: but for as long as it continues to bear a reliable relationship with money GDP, we shall continue to give it a significant weight in our assessment of monetary conditions.

Conclusions

These are significant technical changes and much ink has been spilt in describing and explaining them. Rightly so. Neither the authorities nor the markets have anything to gain from deliberate obfuscation.

But it is important not to miss the wood for the trees. The essence of the policy is the commitment to reduce inflation.

That has not, and will not, change.

And after 7 years, we have the track record to prove it.

FROM: A ROSS GOOBEY
DATE: 14 APRIL 1986

pmp

MRS LOMAX

LOMBARD ASSOCIATION SPEECH

Suggested amendments as follows:

Page 1 last para ~~2, para 2~~ - omit.

Page 3 - Omit paras 3/4 (Alas, how is ... greater the inflation)

Page 4, para 2/3 - After "even inflation": "or unit costs - and set a policy in the light of the best available forecasts. This appraoch begs two questions: in all cases we could not know until after the event what trends in these variables were and secondly it is difficult to see what ~~additional~~ mechanisms could be invoked to control them additional to the ones we already use. Existing indicators will give a better guide to monetary conditions and short term interest rates remain the most effective lever of control. Monetary targets provide an anchor for the markets expectations, and where we could be self-critical is that we have allowed markets to concentrate on only one target for too long.

In a dynamic environment, the relationship of any particular measure of money, money GDP and inflation is bound to change. Any monetary targetry, whether it is money GDP or money aggregates, will still necessitate a judgemental and discretionary approach based on all the evidence".

Page 5, para 2 - "Our long term objective must be to prevent the debt/income ratio from creeping even higher and this would only be achieved at a level of PSBR slightly lower than our current plans. It is also prudent not to have a constantly changing level of either public expenditure or tax regimes to absorb temporary shocks to the system. I believe it is much preferable to have the level of PSBR set so that such shocks, be they the £3 billion cost of the coal strike or the sharp fall in oil revenues, can be absorbed in the markets without recourse to monetisation or an abrupt change in public expenditure or taxation.

Page 8, para 1: insert 1 - Prefer "assessment" to "understanding".

Page 8, para 5/Page 9, paras 1,2,3 - "This change in income velocity of £M3 has been caused by a combination of factors: the increasing range of interest bearing demand deposits, greater international competition, the level of real interest rates have all played their part. Overfunding may also have depressed £M3 growth relative to the growth of money GDP. We are not alone in facing this problem; in February Mr Volcker in his Humphrey Hawkins testimony to Congress said: "We are all aware of the long history and of the economic analysis that relate excessive money growth to inflation over time. The operational question remains as to what is in fact excessive in the light of recent velocity behaviour".

[illegible]

On our best analysis of the current velocity behaviour for £M3, we have set a target range of 11-15% for 1986-87 but, because velocity is changing all the time I have not published illustrative ranges for later years".

(?

Page ~~8~~ 9 - omit para 4.

Page 11, para 2 - Insert between "the" and "behaviour" "apparent".

Page 11, para 3 - after "Role of the exchange rate".

Paras 4,5,6,7 - "Having an explicit target for an exchange rate only makes sense in the context of an exchange rate regime. There are both advantages and disadvantages to membership of such a regime which have been discussed at great length. Suffice it to say that we are not a member of such a regime and we have no current intention of ~~being~~ joining one.

If you are outwith an exchange rate regime, it is clearly inappropriate to have an explicit exchange rate target because that simply invites speculation. The exchange rate must reflect over time the international relationships between pay and industrial costs, but it is in everyone's interests that sharp readjustments should be kept to a minimum. It has also been the case that benign neglect of the exchange rate is no defence to over reaction in the markets nor an effective way of increasing industrial competitiveness.

Our bias is for an exchange rate that will buttress the fight against inflation without contradicting the overall assessment of financial conditions. We are not indifferent to the exchange rate, and never have been."

Page 12, para 1 - Add after "Most well conducted countries now operate in a very similar way. Some commentators have claimed that the recent fall in commodity prices, including oil, has come about as the fortuitous gift of some global fairy godmother; the truth is that, just as the explosion in ~~physical~~ commodity prices in the 1970s was a consequence of a global monetary expansion of monetary aggregates so the return to prudent monetary policy in the 1980s, of which I am pleased to say this government was in the vanguard, has brought about the conditions for the more realistic valuation of commodities."

Page 13, para 3/4 - "Policymaking in the real world is never that simple, but it was important at that time to focus on a regularly published measure as an earnest of our intentions. Even in 1980 we made it clear that no one aggregate....."

Page 14, para 4 - "As far as presentation of policy goes, whereas seven years ago perhaps only five or six commentators analysed monetary policy, now there are dozens of people picking over every nuance of speeches like this one. We have a responsibility to describe to them in more sophisticated terms how policy works in practice, and because our fundamental commitment to monetary prudence is not in question we are able to discuss more openly the complexities of putting the policy into effect."

Page 17, para 1/2 - "As we said in the Budget "Red Book" the narrow money aggregate should reflect the assets used for making transactions; should respond unambiguously, but not be oversensitive to, interest rate changes; and should have a stable relationship with money GDP. MO has been unaffected by the spread of interest bearing sight deposits which have distorted M1 and despite representing a narrow range of transaction balances, is the best choice for target purposes.

As long as these relationships remain stable, MO represents the best measure of current monetary conditions."

ARG

A ROSS GOOBEY

Ch/
Seems fairly important points that you may want to take on board
RL 14/4

psp

FROM: F CASSELL
14 April 1986

MRS LOMAX

Quotes from 1810 Committee on gold bullion + Volcker in Peretz note below, in case you need them

cc Sir P Middleton
Sir T Burns
Mr Peretz
Mr Sedgwick

LOMBARD ASSOCIATION SPEECH

Eddie George rang this afternoon with some comments on the draft you sent to the Bank.

He thought the speech "pretty good" and did not wish to suggest many changes:

Page 12, fourth paragraph. This says that "... both the presentation and the substance of the MTFS have evolved ...". Up to now we have taken the line that the form has changed but not the substance. It would be best to stick to that line now (indeed this is one of the themes of the speech). So Eddie would replace "substance" by "implementation".

O.K

Page 14. The fifth paragraph again refers to "changes of substance". In this context it might be better to say "changes in the way policy is operated too".

Pages 15 and 16. Rather than saying that £M3 has played a progressively smaller part in monetary policy decisions, he would emphasise the other indicators that we have introduced alongside £M3; he also doubts whether there has been anything "progressive" about it (the most obvious overriding of £M3 was in 1980). To this end he suggests replacing the second sentence of the first full paragraph at the top of page 15 with: "As a result, its earlier predominant role in monetary policy decisions has been shared by a number of other indicators". And in paragraph 16 in the first line of the first full paragraph he would prefer "greater weight" to "increasing weight". In the first sentence of the next paragraph he would replace "reduced emphasis on" by "changed perception of".

He also thinks that the first paragraph at the top of page 17 overstates the virtues of MO, but did not make drafting suggestions beyond putting "reasonably" before "reliable and unambiguous relationship".

I have re-read your draft and would certainly endorse the verdict that it is "pretty good". I have only a few suggestions to add to those I mentioned earlier:

Page 2, second paragraph. This is presumably meant as a transition from the broader concepts of the opening paragraphs to the rather narrower one that is the focus of the talk. However, there is no apparent relationship between the first and second sentences.

> "Of course, not everything turned out as we expected. There are important lessons to be learned from this. I want to spend my time tonight looking at experience in one particular area - monetary policy. This is an area in which practice is considerably more complicated than theory."

In the next paragraph there is another reference to "substance" (overlooked by E George). We could simply say here "operation".

Page 3, Top. I do not like the idea of "nominal demand" being defined as an amalgam real growth and inflation - that is surely "nominal supply"; why not simply stick to "money GDP".

Page 5. The references in the first paragraph to the arguments for a low PSBR make no reference to interest rates. This is a linkage we have emphasised in the past, and it looks odd to omit it entirely here. It is presumably subsumed in"comfortably" and "soundly", but a more explicit reference could be made by inserting "at acceptable rates of interest" either after "soundly" or instead of it.

Page 13, third paragraph. "Openness" could be open to several interpretations. What is meant here, I take it, is frankness about the difficulties and uncertainties in operating policy. This perhaps does need briefly spelling out - eg "... openness about the complexities of the environment in which policy is being operated".

F CASSELL

FROM: **P N SEDGWICK**
DATE: 14 APRIL 1986

MRS LOMAX

LOMBARD SPEECH

(i) I favour making clear that acts of financial liberalisation enacted some time ago (eg removal of the corset) have had effects that are still occurring. (Some have argued that because there has been little liberalisation since 1980 this cannot be a factor behind the fast growth of broad money/credit in the recent past.) I therefore favour redrafting the penultimate paragraph of P.14 (the last full paragraph) as follows.

> This removal of controls has made possible a marked increase in competition between financial institutions to provide deposit and credit facilities to the private sector. We have not yet seen the full effects of this competition. In the longer term, I have no doubt that increased competition, and the innovation which it has made possible, are in the interest of the British economy. But the effect during the whole period since 1980 has been to blur long standing distinctions between different financial assets, and between the activities of various financial institutions.

2. I suggest adding before the first full paragraph on page 16 something like the following paragraph.

You may like to glance at the changes to Davies piece — especially the references to your Zurich speech on p15

CHANCELLOR OF THE EXCHEQUER
HONI SOIT QUI MAL Y PENSE

Ch/

I have been through this with Terry & most of the attached reports reflect our combined efforts.

14/4/86.

Alastair has produced some alternative suggestions, which I have indicated on the draft & are discussed in full in his note below.

I also attach Robert's comments & redrafts version (just arrived)

I think this is enough to be getting on with! RL 14/4.

CHANCELLOR OF THE EXCHEQUER

Ch.

This is my redraft of an original rather hurried Burns/Middleton draft (below, plus the many comments etc attached – many of which I have reflected in my redraft) Both B & M have been out of the office today & yesterday so they haven't seen it. They were aware their effort could bear improvement.

On the substance, you may well want to inject some topical stuff, emphasising this week's meeting - perhaps at the beginning. But I imagine I'd leave that to you. It rather tails off at the end: but you said you'd do the conclusions yourself.

It is slightly on the long side - but not much. Around 4,500 words or 30-35 mins at 135 wpm.

On timing, you promised the Gov a sight of the draft ahead of his Select Committee appearance on Monday afternoon (the briefing meeting is 11:30, so the earlier the better).

Rh. 11/4

*937 6953

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

1. Rachel
2. Chancellor

LOMBARD ASSOCIATION SPEECH

Lord Bruce-Gardyne* rang. He wd like to have an article in next week's Spectator picking up points from your monetary policy speech; but in order to do so he wd need to see a text by Tuesday morning at the latest.

Wd you be content to let him have a near-final

draft – if we have one! –
Monday night or Tuesday
morning?

AWK
11/4

Reference ....

MRS LOMAX

Some comments marked.

The main factual point comes at the foot of page 3. Since we're comparing 1979-80 with 1985-86 or 1979 with 1985, it's probably better not to refer to "7 years" but "under this Government" / "since we entered office" / "since 1979"

We're not sure which figures you want to compare but give them all here and you can take your pick!

	1979	1980	1985
Money GDP growth	17%	17%	9½%
or on fy basis	1979-80	1980-81	1985-86
	19¾%	15%	9½% [or 8¼% if adjusted for coal strike]
Inflation	1979	1980	"now"
	13%	18%	5%

The argument for using 1980 / 1980-81 would be that the MTFS first applied from

(PTO)

CODE 18-78

then but I don't think that's

conclusive.

You also need to say "around" 3%

for average annual GDP growth since

1981. Strictly, it's $2\frac{3}{4}$% from 1981 H1.

MOM

11/4

LR1.58

This has been round the office: a few small points marked in MS from Cassell, O'Mara & Scanlan. Generally felt to be an improvement on the B.M version.

LOMBARD ASSOCIATION SPEECH

April is the season of international meetings. My appearance here tonight is sandwiched between the Spring meetings of the IMF in Washington and the OECD in Paris.

Meeting other Finance Ministers, I am always struck by the extent to which we share a common approach to economic management.

The need for firm financial discipline: the importance of reducing fiscal deficits: improving the working of markets and promoting greater competition. These priorities are taken for granted by all major countries today.

It is easy to forget how much has changed since we first took office 7 years ago.

An approach to economic policy that is now [commonplace] widely accepted was then radical, even revolutionary. Especially in the UK.

Shortly before the 1979 Election I wrote "The time has come for a wholly new approach to economic policy in Britain. The overriding need is for a long term stabilisation programme to defeat inflation, recreate business confidence, and provide a favourable climate for economic growth".

Putting those brave words into practice has been one of this Government's major achievements. That is an important reason why foreign opinion is in no doubt that Britain is indeed on the right track.

cliché - but title of Economist series of articles is - the UK - an economy on the right track.

It would be idle to pretent that everything turned out as we expected. I want to spend my time tonight talking

A-RG (omit)

about one particular area where practice is considerably more complicated than theory - monetary policy.

The policy we are pursuing today is identifiably the same as the one we embarked on 7 years ago. But it has clearly evolved - both in terms of presentation and substance. I shall try to explain what has not changed - as well as what has, and why.

The Medium Term Financial Strategy

Our main priority in 1979 was to achieve a lasting reduction in the rate of inflation. So our first task was to replace the shifts and strategems of the 1960s and 1970s by a clear and unequivocal commitment to financial discipline. That was the role of the Medium Term Financial Strategy.

It had two features, both novel at the time. First it provided a medium term framework for monetary and fiscal policy. It symbolised the Government's break with policies of fine tuning and crisis management that had dominated British life for most of the post War period.

Second, it was a strategy about finance. Partly because inflation is a financial problem, and has to be controlled by financial means. And partly because the only effective anti-inflationary levers at the Government's command are financial levers. (Terry)

This approach to reducing inflation depended in the first instance on scaling down the growth of nominal demand in the economy - that is, the growth of money GDP. This is an amalgam of two things: the real rate of growth and the rate of inflation.

The crucial mistake that earlier Governments made was to equate money demand and real demand. Expansionary policies boost money demand. But it was a dangerous illusion to suppose that this was automatically translated into a higher rate of growth of <u>real</u> output.

Experience shows just the opposite. During the 1970s GDP in money terms more than quadrupled: but of that increase only 1/20th represented an increase in real output, the other 19/20ths was reflected in sharply higher prices.

The 'magic' of money

[Alas there is no magic short cut to boosting the rate of growth of real output; in anything other than the very short term, the growth of output depends on the supply performance of the economy. And that can only be raised by a determined effort to remove restrictions, improve incentives and generally develop a dynamic and enterprising economy.

A R-G suggests dropping (no) possibly shorten

By contrast it is all too easy to raise the rate of inflation by allowing money GDP to grow in excess of the supply potential of the economy. The bigger the gap the greater the inflation.]

This suggests that

But conversely the way to squeeze inflation <u>out</u> of the system is to reduce the rate of growth of money GDP. Which is exactly what the MTFS was - and is - designed to do.

The validity of this approach has been amply borne out by the record [of the last 7 years] since 1979. The growth of money GDP has been halved from over 15 nearly 20 per cent to under 8 10 per cent. Inflation has been reduced from 13 per cent to 5 per cent. [And after an initial setback,] we have seen a steady growth in output, of an average rate of around 3 per cent a year since 1981. (strictly 2 3/4 % since 1981 H1)

(MS nos compare FY 1985/86 and 1979/80 (1980-81 money GDP - 17%)

M Sieman – provocative omit (whole sentence edgy.)

<u>The monetary and fiscal framework</u>

Reducing the growth of money GDP requires above all an appropriately restrictive monetary policy. And as in most other countries with a serious commitment to financial discipline, this aim has been encapsulated in published targets for monetary growth.

See attached redraft (also A.R.G. alternative below)

Some commentators have argued that monetary targets are otiose. That we should simply publish targets for money GDP - or even inflation - and set policy in the light of the best available forecasts. That has not been our approach. For one thing we simply do not have a sufficiently detailed knowledge of the working of the economy to operate such a policy. [And secondly, monetary policy is above all about markets, and one function of monetary targets is to provide an anchor for the market's expectations.] - ~~See Cassell redraft~~

But we must never forget that monetary targets are a means to an end. Their use depends on the robustness of a relationship between a particular measure of money on the one hand, and money GDP and inflation on the other. In the real world, no economic relationship is perfect. So monetary targetry was not and never can be a substitute for making an intelligent assessment of monetary conditions, based on all the evidence.

That is why the MTFS has always been more than a row of numbers. What it has been - and remains - is a commitment to maintain monetary conditions that will keep steady downward pressure on money GDP, and so on inflation.

I shall have more to say later about what this means in practice. But a discussion of the Medium Term Financial Strategy cannot be complete without a word on fiscal policy.

The classical framework for financial discipline - the gold standard and the balanced budget - had both a monetary and a fiscal component. So does the MTFS. From the start we recognised that a firm monetary policy has to be buttressed by setting public sector borrowing at a

Fiscal Policy

The classical framework for financial discipline - the gold standard of the balanced budget - had both a monetary and a fiscal component. So does the MTFS. From the start we recognised that a firm monetary policy has to be buttressed by setting public sector borrowing at a level that can be comfortably financed in a non-inflationary way.

In the long run that means aiming for a level of borrowing that will contain - and preferably reduce - the burden of debt, relative to national income.

In the short run there is more latitude, at least in theory. In practice, however, the only way to be sure of financing the public sector soundly is to plan for a low PSBR.

If disruptive changes in public expenditure plans and tax rates are to be avoided - as they must, if the private sector is to plan ahead - the PSBR must be set low enough to act as a "shock absorber" if needbe. Experience has certainly shown the wisdom of leaving a margin of safety

...

level that can be comfortably financed in a non-inflationary way. In theory of course there is no precise relationship between the PSBR and any given rate of monetary growth. But in practice however the only way to be sure of financing the public sector soundly is to plan for a low PSBR. See attached redraft (*)

Experience has shown the wisdom of leaving a margin of safety. The 1984-85 PSBR at 3 per cent of GDP was still the lowest for over a decade even though the £3 billion cost of the coal strike was met entirely by higher borrowing. The latest figures suggest that the PSBR was below 2 per cent of GDP last year. And it is planned to be below 2 per cent again in the current financial year - a level that will put us in a strong position to cope with unexpected developments, for example in the oil market.

"close to the level - itself a little below the average of the 1960's - which we said in the first version of the MTFS we ultimately intended to achieve" (Mr. Peterson). I wouldn't bother with this.

A-RG alternative below

It is worth recalling that little more than ten years ago - in 1975-76 - borrowing reached 9¼ per cent of GDP; and the last time the PSBR was below 2 per cent of GDP was in 1971-72.

This emphasis on low public sector borrowing has become part of the accepted wisdom in other major countries. It is a long time since OECD Ministers failed to refer to the need to reduce structural deficits over the medium term as an agreed tenet of fiscal policy.

Monetary policy

To recapitulate. While fiscal policy has an important supporting role, monetary policy lies at the heart of the MTFS. The central task of monetary policy is to create monetary conditions that will bring steady downward pressure on the rate of growth of money GDP, and hence on inflation.

In practice this involves a combination of economic analysis and market judgement. Policy must be continuously informed by a careful assessment of what monetary conditions are - and need to be - to meet the Government's objective. But implementing interest rate decisions in today's fast moving financial markets also requires a degree of tactical skill.

Peretz.

Let me be quite clear. Short term interest rates are above all the essential an instrument of monetary policy. That is not to say that the market does not exercise an influence, certainly on the structure and also, at times, on the level of short term interest rates. But we have never suggested that the market could, entirely independently, set the level of interest rates.

The relationship between official influence and market factors was clearly set out in the 1980 Green Paper on Monetary Control.

> "The level of short term interest rates at any time is determined by the interaction of the markets and the authorities. The short term interest rates generated by the market are not necessarily those needed to achieve the monetary targets".

OT (stronger)

Put bluntly, even though the authorities are not the only players in the field, any no Government that is interested in controlling the quantity of money can afford to must exercise what ~~ignore~~ Sl. Radcliffe its price. influence it can over its price.

Let me give some examples. There are times when the structure of money market rates indicates very clearly the direction in which the market believes that interest rates should move. It is obviously right to validate a movement, if we believe it is justified by monetary conditions. Last week was such a time.

Less frequently, there can be times when it is dangerous for the authorities to resist a market led move in interest rates, if to do so would cast doubt on the Government's resolve to control inflation. So, for tactical reasons, it may sometimes be right to acquiesce in a change in interest rates, even when we are not convinced that it is justified by the fundamentals. The best example of this sort of situation ~~is~~ was perhaps July 1984.

But there are certainly occasions when it is right to resist. This was the case earlier in the year. Interest rates were raised promptly early in January to prevent a downward movement in the exchange rate acquiring an unhealthy momentum. Subsequently, however, I took the view that the pressure for a further rise beyond 12½ per cent was not justified on monetary grounds, and was based on an exaggerated view of sterling's vulnerability to movements in the oil price. And interest rates were not allowed to rise.

Assessing monetary conditions

I have said enough to show that the timing of interest rate changes can often involve a delicate assessment of market tactics. Looking beyond day to day market management, however, the guiding principle is to maintain, on average, a level of short term interest rates that will deliver the monetary conditions needed to reduce inflation.

There is no mechanical formula for taking this crucial judgement. Assessing monetary conditions very often involves weighing movements in one indicator against movements in another.

That is not to deny the special status of the monetary targets. Movements in the aggregates outside their target ranges always establish a presumption in favour of changing short term interest rates.

But that presumption is not overriding. For two reasons:-

- First, we can never be completely confident that the target ranges have been set correctly: that is, that they have been based on a correct understanding (assessment) of the relationship between the aggregate in question and money GDP.

A R-G

- Second, in differing degrees all the monetary aggregates respond to changes in short term interest rates with a lag: so it takes time for policy action to bring them back within their target range.

For example, ~~it was clear~~ we concluded by last autumn that the target range for £M3 had been set too low. [Indeed, with the benefit of hindsight, it is clear that there has been a [illegible]] given the cumulative evidence of a change in the relationship between £M3 and money GDP in recent years.

Between 1970 and 1980, £M3 grew on average by 2 per cent less than money GDP. Since 1980 it has grown between 2 and 6 per cent more.

Put another way, while £M3 has grown by [77] per cent over the past five years, money GDP has grown by only [52] per cent, and prices by [42] per cent. Over the previous five years, £M3 grew by [77], but money GDP rose by [117] per cent, and prices increased by [96] per cent.

TB: addition ⊗ This was initially interpreted as a one off response to the ending of direct controls. But the expected flattening in the velocity trend failed to materialise.

//

See also A-R-G redraft below (from // to //)

It is still not absolutely clear why this has happened, or how well established the new trend is. A combination of a freer banking system, greater international competition and new technology is certainly part of the story. So is the level of real interest rates. [But what all this [it] means in practice is that the business of setting targets for £M3 is particularly hazardous.

The recorded behaviour of velocity may not tell the whole story. Heavy overfunding in some years may have artificially depressed £M3 growth, masking the true extent of the underlying fall in velocity.

In view of all the uncertainties, I set a target range for £M3 in 1986-87 that both reflects the ~~most recent~~ trend in velocity since the ending of controls, and allows for some unwinding of the distortions caused by overfunding. My judgement is that a growth in £M3 of between 11 and 15 per

The new range also allows for the possibility that heavy overfunding in some recent years had the effect of artificially depressing £M3 growth relative to the growth in money GDP. will be fully consistent with a further fall in inflation.

But this These judgement~~s~~ will need to be reviewed ~~assessed~~ in the light of experience. That was why I decided not to publish illustrative ranges for later years.

Faced with difficulties with their main target aggregate, Ml, the United States authorities have from time to time adopted a similarly cautious approach, relegating ~~relating~~ it to what they call "monitoring status", during periods when there have been particular uncertainties about its velocity trend. //

Indeed, other major countries rarely if ever publish monetary targets for more than the year immediately ahead.

There are also considerable uncertainties about the relationship between £M3 and short term interest rates. Experience suggests that a change in short term rates is unlikely to alter the growth of £M3 significantly within the target period: and the very short term response to £M3 to a rise in interest rates is unpredictable, and may even be perverse.

The position with MO is more straightforward. Its relationship with money GDP appears to be relatively well established and stable. Adjusted for the change in the cash ratio arrangements in 1981, Money GDP has, in every year since 1976, ~~seems to~~ grown between 2 and 5 per cent more than MO in the previous year - very much the same sort of trend in velocity ~~relationship~~ as in the 1970s.

The growth of MO responds fairly rapidly and predictably to changes in the short term interest rates. So a rise in interest rates can be expected to bring MO growth back within its target range over the target period.

That is why I said in my Budget Speech that the £M3 target does not have the same operational significance as the MO target

But The messages coming from [the different] monetary both aggregates need to be continuously tested against the evidence of other indicators, especially when, as sometimes happens, the various measures of money give conflicting signals. At such times, the exchange rate has often played an important role as umpire.

In an economy as open as the UK's there is a presumption that persistent exchange rate movements reflect, to some degree, underlying monetary conditions. And as I have frequently observed, significant movements in the exchange rate, whatever their cause, can have a short term impact on the general price level and on inflationary expectations which make sound internal policies harder to implement.

The <u>timing</u> of short term interest rate changes has often been strongly influenced by exchange rate movements. This has led some commentators to argue that the exchange rate is in practice the dominant influence on monetary policy, and even that we are operating some kind of informal exchange rate target.

Neither is true.

It is not entirely surprising that the exchange rate sometimes acts as a <u>trigger</u> for interest rate changes. The exchange rate is a sensitive barometer, responding rapidly to changes in short term interest rates and changes in market expectations. But it is patently untrue that every fluctuation in the exchange rate - or even every persistent movement - has produced an interest rate response.

See my redraft of this page attached

[Equally the fact that MO has rarely been the trigger for interest rate action is not evidence that it carries little weight in interest rate decisions. Its role has been less visible, but nonetheless important.

Arguments for higher interest rates - based on the behaviour of broad money, or over-pessimistic forecasts of inflation - have often been resisted, because of the more reassuring - and in the event more accurate - signals coming from MO.]

Drop? (or move to the ending year changes at the p17 (Break here from here)

But to return to the role of the exchange rate. I accept of course that membership of a fixed exchange rate regime can [and in the right circumstances] in principle be a substitute for monetary targets. The exchange rate can be a tough discipline: forcing the authorities to recognise when domestic policies are out of line with other countries.

But it is both risky and dangerous to try and operate a unilateral exchange rate objective, outside a formal fixed exchange rate system, shared by other countries, and supported by a co-ordinated approach to economic management and intervention.

A R-C redraft from // to //

Michael thinks this reads like a coded plea for ERM membership. He would add a sentence saying that we do not judge the time ripe to join.

We have not attempted to set a target exchange rate zone for ourselves. [Nor do I believe the time is yet ripe for us to join the EMS?!]

Our [~~interpretation of~~ approach to the] exchange rate [~~movements~~] does reflect a bias against sharp exchange rate changes; and a bias towards a firm rate, that will support the Government's general objectives on inflation.]

//

But, in essence, the exchange rate is one input - and only one - to an overall assessment of financial conditions. Our aim is to strike a balance between domestic monetary growth and the exchange rate that will deliver conditions that keep downward pressure on inflation.

Evolution of the medium term financial strategy

Almost all my fellow Finance Ministers - and the Governors of their respective Central Banks - would recognise this description of how monetary policy is conducted in practice. Most well conducted countries operate policy in a very similar way. Those who are members of a fixed exchange rate system typically have domestic monetary targets; and those outside such systems still recognise the need to take account of the exchange rate.

A R-G insert (wrong place? - better at #?)

But how different is it from the original conception of the MTFS?

It would have been surprising if there had not been some changes. There have been profound changes in the UK economy in the past 7 years; and nowhere has those changes been more pronounced than financial markets.

And, quite rightly, both the presentation and the substance of the MTFS have evolved in response to them.

To start with presentation.

At the time of the first MTFS almost everything remained to be done. Inflation, monetary growth and the public sector deficit borrowing were all high. The long process of containing public expenditure and dismantling the controls that were stifling the economy's natural growth potential had only just begun. I have explained how we had embarked on a policy very far from the accepted wisdom of the 1960s and the 1970s. Those who understood what we were about - and not everyone did - doubted our resolve.

In the circumstances of the time, the overriding need was for simplicity and clarity in getting across the central to get this message across. This Government - unlike its predecessors - was

Terry's recording, but I think it's better. (my inserts)

In a word, financial discipline was to be restored.

In presenting policy there is always a balance to be struck between clarity and ~~openness~~ detail; and between following market opinion, and trying to shape it.

In the early days of the MTFS, I am sure we were right to err on the side of clarity. Unlike Germany, the UK had no proven track record of prudent consistent and credible financial management. History was on the side of the sceptics.

So we kept it simple. And we built in views then current in the market. Monetary policy was expressed in terms of a target for a single aggregate: and that aggregate was one with which UK markets were already familiar - £M3.

£M3 had been blessed by the IMF; it had been targeted by the previous Lab Government [it was well understood in the markets;] and it was thought to indicate links with other policies - including most notably fiscal policy. So, in the words of the 1980 Green Paper, targeting of £M3 was widely understood to give "a general assurance that macroeconomic policies available to the Government will be used in a way which mutually support each other in the reduction of inflation".

[But], Even in the 1980 Green Paper, we made it clear that no one aggregate could be a sufficient measure of monetary conditions; and that the definition and choice of target aggregates might have to change in response to circumstances. But the commitment to a target for £M3 was a useful shorthand for our resolve to reduce inflation and pursue prudent fiscal and monetary policies.

[As a result], happily, times have changed. Over the past 7 years the UK has had a Government that has pursued a consistent and responsible financial strategy. We are providing a model for others and not a cautionary tale.

It will take time before we build up a reputation equal to Germany's. But we are acquiring the right sort of track record. The evidence is there to show that we mean what we say.

We have not hesitated to raise interest rates as and when necessary; we have halved the rate of growth of money GDP; and the result over the past three years has been the best combination of output growth and low inflation for a generation.

In turn this has implications for the presentation of policy. The presentational delicate balance between clarity and openness has shifted. Because the basic framework of our policies are not in doubt, we can concentrate more on explaining more fully the difficulties and complexities of putting them into effect; and on educating market opinion, instead of simply following it.

determined to pursue a sustained programme of scaling down the growth in money GDP and squeezing inflation out of the system.

In a word, financial discipline was to be restored.

See Terry's reordering down to * attached

So we kept it simple. Monetary policy was expressed in terms of a target for a single aggregate: and that aggregate was one with which UK markets were already familiar - £M3.

Policy making in the real world is never that simple. But in presenting policy there is always a balance to be struck between clarity and openness. (? honesty) MoM suggests "simplicity and detail".

MoM & Scholar think this is awkward, maybe disingenuous. Honesty very much better.

Even in 1980, we made it clear that no one aggregate could be a sufficient measure of monetary conditions; and that the definition and choice of target aggregates might have to change in response to circumstances. But the commitment to a target for £M3 was a useful shorthand for our resolve to reduce inflation and pursue prudent fiscal and monetary policies.

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This was an oversimplification. But in the early days of the MTFS, I am sure we were right to err on the side of clarity. Unlike Germany, the UK had no proven track record of prudent consistent and credible financial management. History was on the side of the sceptics.

Happily times have changed. Over the past 7 years the UK has had a Government that has pursued a consistent and responsible financial strategy. We are providing a model for others and not a cautionary tale.

It will take time before we build up a reputation equal to Germany's. But we are acquiring the right sort of track record. The evidence is there to show that we mean what we say.

We have not hesitated to raise interest rates as and when necessary; we have halved the rate of growth of money GDP; and the result over the past three years has been the best combination of output growth and low inflation for a generation.

As far as the presentation of policy goes, the delicate balance between clarity and openness has shifted. Because the basic framework of our policies ~~are~~ is not in doubt, we can now afford to be franker about the difficulties and complexities of putting them into effect.

There have been changes of substance too. In recent years we have moved further and faster than most of our competitors in freeing up financial markets. A range of outdated controls ~~have~~ has been abolished, [~~starting with~~] (including the abolition of exchange controls only six months after we took office.

([illegible] our pay & price controls went earlier)

In the longer term, I have no doubt that these changes are in the interest of the British economy. But their immediate effect has been to blur long standing distinctions between different financial assets, and between the activities of various financial institutions.

This has inevitably affected the significance of the various measures of money. Policy has had to respond,

and in the process, it has certainly become more complicated.

Broad money, including £M3 has been most profoundly affected. As a result it has come to pay a progressively smaller part in monetary policy decisions.

Problems started to emerge at a fairly early stage. As far back as the autumn of 1980, interest rates were reduced by 2 per cent, even though £M3 was way outside its target range, on the view that it was giving a misleading impression of the tightness of the monetary conditions.

XR

The 1981 MTFS listed the factors that had underpinned this judgement: they included the behaviour of other narrower measures of money, and the exchange rate.

MoM - says we used this formula in 1985 Budget. Peretz

In retrospect

[With the benefit of hindsight] this was clearly the right decision, as was the subsequent decision to raise the £M3 target substantially in the 1982 MTFS. Few would now dispute that [the growth of] [£M3] [in relation to its targets] has proved a relatively poor guide to monetary conditions for much of the 1980s. Indeed some would argue that the real question is why we have persisted with it for so long, and in particular why I did not drop it altogether at the time of the last Budget.

Difficulties of interpretation there have certainly been. But it would be quite wrong to conclude from recent experience that we can safely tolerate [any] a build up of liquidity. on an unlimited scale

MoM - ambiguous

The risk in dropping £M3 is that markets would do just that. The £M3 target is evidence of our continuing concern with liquidity.

We have taken the view that the growth of £M3 in recent years reflects a genuine desire on the part of the

£M3 has not presaged higher inflation.

private sector to build up its liquidity on a lasting basis. I believe that judgement to be correct. But it must be continuously tested against other evidence. A similar judgement proved disastrously wrong in the early 1970s.

Insert (*)

One reason why we have come to put increasing weight on the exchange rate and [narrow measures of money] MO is precisely because we would expect these indicators to give early warning of such a move [were the rapid growth of broad money to start to make its way into higher spending.] What went wrong in the early 1970s was that the clear signals from these indicators were ignored.

The reduced emphasis on broad money has also been reflected in funding policy. For many years the principal aim of funding policy was to control the growth of broad money and liquidity. From time to time this involved overfunding - that is, selling more debt than needed to fund the PSBR.

In recent years, the attempt to contain a strong growth in liquidity, the reasons for which were only partially understood, came to make overfunding almost a way of life.

This led to distortions - [not least the] reflected in the rapidly growing bill mountain as well as £M3 - which were undesirable in themselves, and made policy harder to opeate.

I reached the view that this excessive reliance on funding policy was neither [sensible] necessary nor desirable. Accordingly, I made it clear in my Mansion House Speech last year that the objective of funding policy was to fund the PSBR over the year as a whole: no more, no less.

I have already explained why the problems of £M3 gave more prominence to the role of narrow money and the exchange rate. In particular, MO has been given target status [for the last two years.] since the 1986 MTFS.

PN Sedgwick

Let me make it absolutely clear ~~that~~, if it became apparent that liquidity and credit were growing at rates that were judged to be a threat ~~to our aim~~ to ~~reduce~~ inflation ~~further,~~ ~~then~~ I would not hesitate to ~~take action by~~ raising short term interest rates.

MO

In my 1981 Zurich speech I argued that "narrow money ... suffers from being almost too easy to control". I had in mind M1 and, more particularly non-interest bearing M1. ~~In~~ The interest rate elasticity of those aggregates is very high. This does not apply to MO whose sensitivity to interest rate changes seems to be neither too great nor too little. Indeed if we compare the movement of MO and NIB M1 over the past 10 years it is clear that they both move together over a period of 2 or 3 years but in the short term NIB M1 is much more volatile.

It is sometimes suggested that MO cannot be taken seriously because it covers only a narrow range of transaction balances. – though it compares favourably with the German focus on CBM, which is 50% notes and coin; I accept that ~~it~~ MO is not ideal: but it has demonstrated a relatively stable velocity trend over a long period, [A] and it shows a reliable and unambiguous relationship with short term interest rates.

German CBM

(response to G. Davies point flagged)

[Terry's insert attached*

It is important that the best should not be the enemy of the good. The fact is that MO is the best narrow aggregate we have. As in the United States, the more familiar narrow aggregate, M1, has been seriously distorted by a rapid growth of interest bearing sight deposits, some of which were previously held in the form of term deposits. And the same developments have distorted its non-interest bearing component.

The truth is that it has become increasingly difficult to draw a line between money balances held for transactions and those held for savings. MO is only a proxy for transactions balances: but for as long as it continues to bear a reliable relationship with money GDP, we shall continue to give it a significant weight in our assessment of monetary conditions.

Conclusions

These are significant technical changes and much ink has been spilt in describing and explaining them. Rightly so. Neither the authorities nor the markets have anything to gain from deliberate obfuscation.

But it is important not to miss the wood for the trees. The essence of the policy is the commitment to reduce inflation.

That has not, and will not, change.

And after 7 years, we have the track record to prove it.

45/67

FROM: ROBERT CULPIN
DATE: 14 APRIL 1986

MRS LOMAX

LOMBARD SPEECH

I have had a comatose go at some drafting suggestions. Here is a more or less clean version, to spare you my pencil scribble.

2. I am probably only rehearsing points which you have already considered and rejected. So feel free to ignore all this. But for what it is worth, the main points which struck me are these.

- I think the version you showed me could look to journalists too much like a recantation. It puts just a bit too much emphasis on the hopelessness of monetary targets and the reasons for ignoring or over-riding them.

- In the initial section on the MTFS, I don't think it helps to suggest that, in 1980, it was about reducing the growth of nominal demand. (It seemed to be about reducing the growth of the money stock.)

- I have tried to distinguish, a bit clumsily between ultimate objectives, intermediate objectives, and instruments.

- I think it worth coming a bit further out of the exchange rate closet, which will probably be newsy;

- and boasting explicitly about being prepared to ration credit by price.

- We need an example or two of leading the market on interest rates.

- I thought the section on assessing monetary conditions jumped backwards and forwards too much between MO, £M3 and the exchange rate. I have tried to take them in turn.

- I have also tried to tighten up a bit the last section before the conclusion.

3. Reading it through, I see that one of my amendments is repetitive. I have put a short paragraph on the choice of aggregates on my page 4, which is not very different from one on page 17. The point of putting it on page 4 is that I think we need something on quantities before banging on about price.

RC

ROBERT CULPIN

LOMBARD ASSOCIATION SPEECH

April is the season of international meetings. My appearance here tonight is sandwiched between the Spring meetings of the IMF in Washington and the OECD in Paris.

Meeting other Finance Ministers, I am always struck by the extent to which we share a common approach to economic management.

The need for firm financial discipline: the importance of reducing fiscal deficits: improving the working of markets and promoting greater competition. These priorities are taken for granted by all major countries today.

It is easy to forget how much has changed since we first took office 7 years ago.

An approach to economic policy that is now commonplace was then radical, even revolutionary. Especially in the UK.

Shortly before the 1979 Election I wrote "The time has come for a wholly new approach to economic policy in Britain. The overriding need is for a long term stabilisation programme to defeat inflation, recreate business confidence, and provide a favourable climate for economic growth".

Putting those brave words into practice has been one of this Government's major achievements. That is an important reason why foreign opinion is in no doubt that Britain is indeed on the right track.

It would be idle to pretend that everything turned out as we expected. I want to spend my time tonight talking about one particular area where practice is considerably more complicated than theory - monetary policy.

The policy we are pursuing today is identifiably the same as the one we embarked on 7 years ago. But it has clearly evolved - both in terms of presentation and substance. I shall try to explain what has not changed - as well as what has, and why.

<u>The Medium Term Financial Strategy</u>

Our main priority in 1979 was to achieve a lasting reduction in the rate of inflation. So our first task was to replace the shifts and strategems of the 1960s and 1970s by a clear and unequivocal commitment to financial discipline. That was the role of the Medium Term Financial Strategy.

It had two features, both novel at the time. First it provided a <u>medium term</u> framework for monetary and fiscal policy. It symbolised the Government's break with policies of fine tuning and crisis management that had dominated British life for most of the post War period.

Second, it was a strategy about <u>finance</u>. Partly because inflation is a financial problem, and has to be controlled by financial means. And partly because the only levers at the Government's command are financial levers.

This approach to reducing inflation depended in the first instance on scaling down the growth of nominal demand in the economy - that is, the growth of money GDP. This is an amalgam of two things: the real rate of growth and the rate of inflation.

The crucial mistake that earlier Governments made was to equate money demand and real demand. Expansionary policies boost <u>money</u> demand. But it was a dangerous illusion to suppose that this was automatically translated into a higher rate of growth of <u>real</u> output.

Experience shows just the opposite. During the 1970s GDP in money terms more than quadrupled: but of that increase only 1/20th represented an increase in real output, the other 19/20ths was reflected in sharply higher from over 15 per cent to under 8 per cent. Inflation has been reduced from 13 per cent to 5 per cent. And after an initial setback (which we expected), we have seen a steady growth in output, of an average rate of 3 per cent a year since 1981.

Intermediate objectives: the monetary and fiscal framework

Reducing the growth of money GDP requires above all an appropriately restrictive monetary policy. And as in most other countries with a serious commitment to financial discipline, this aim has been encapsulated in published targets for monetary growth.

Some commentators have argued that monetary targets are otiose. That we should simply publish targets for money GDP - or even inflation - and set policy in the light of the best available forecasts. That has not been our approach. For one thing we simply do not have a sufficiently detailed knowledge of the working of the eeconomy to operate such a policy. And secondly, monetary policy is above all about markets, and one function of monetary targets is to provide an anchor for the market's expectations.

But we must never forget that targets are a means to an end. Their use depends on the robustness of a relationship between a particular measure of money on the one hand, and money GDP and inflation on the other. In the real world, no economic relationship is perfect. So monetary targetry was not and never can be a substitute for making an intelligent assessment of monetary conditions, based on all the evidence.

That is why the MTFS has always been more than a row of numbers. What it has been - and remains - is a commitment to maintain monetary conditions that will keep steady downward pressure on money GDP, and so on inflation.

I shall have more to say later about what this means in practice. But a discussion of the Medium Term Financial Strategy cannot be complete without a word on fiscal policy.

The classical framework for financial discipline - the gold standard and the balanced budget - had both a monetary and a fiscal component. So does the MTFS. From the start we recognised that a firm monetary policy has to be buttressed by setting public sector borrowing at a level that can be comfortably financed in a non-inflationary way. In theory of course there is no precise relationship between the PSBR and any given rate of monetary growth. But in practice the only way to be sure of financing the public sector soundly is to plan for a low PSBR.

Experience has shown the wisdom of leaving a margin of safety. The 1984-85 PSBR at 3 per cent of GDP was still the lowest for over a decade even though the £3 billion cost of the coal strike was met entirely by higher borrowing. The latest figures suggest that the PSBR was below 2 per cent of GDP last year. And it is planned to be below 2 per cent again in the current financial year - a level that will put us in a strong position to cope with unexpected developments, for example in the oil market.

It is worth recalling that little more than ten years ago - in 1975-76 - borrowing reached 9¼ per cent of GDP; and the last time the PSBR was below 2 per cent of GDP was in 1971-72.

This emphasis on low public sector borrowing has become part of the accepted wisdom in other major countries. It is a long time since OECD Ministers failed to refer to the need to reduce structural deficits over the medium term as an agreed tenet of fiscal policy.

Monetary policy: instruments

But while fiscal policy has an important supporting role, monetary policy lies at the heart of the MTFS. And the essential instrument of monetary policy is the level of short term interest rates. No government that is interest in controlling the quantity of money can afford to ignore its price.

This is determined, in the words of the 1980 Green Paper, by the interaction of the markets and the authorities. Let me give some examples of that interaction at work.

There are times when the structure of money market rates indicates very clearly the direction in which the market believes that interest rates should move. It is obviously right to validate a movement if we believe it is justified by monetary conditions. Last week was such a time.

There are other times when the authorities think it right to lead the markets. [MLR in January 85? Reduction in summer 85? Increase in January 86?]

Less frequently, there can be times when it is dangerous for the authorities to resist a market led move in interest rates, if to do so would cast doubt on the Government's resolve to control inflation. So, for tactical reasons, it may sometimes be right to acquiesce in a change in interest rates, even when we are not convinced that it is justified by the fundamentals. The best example of this sort of situation is perhaps July 1984.

But there are certainly occasions when it is right to resist. This was the case earlier in the year. Interest rates were raised promptly early in January to prevent a downward movement in the exchange rate acquiring an unhealthy momentum. Subsequently, however, I took the view that the pressure for a further rise beyond 12½ per cent was not justified on monetary grounds, and was based on an exaggerated view of sterling's vulnerability to movements in the oil price. And interest rates were not allowed to rise.

Assessing monetary conditions

I have said enough to show that the timing of interest rate changes can often involve a delicate assessment of market tactics. Looking beyond day to day market management, however, the guiding principle is to maintain, on average, a level of short term interest rates that will deliver the monetary conditions needed to reduce inflation.

There is no mechanical formula for taking this crucial judgment. When he introduced the MTFS in his 1980 Budget Speech, my predecessor said that "sustained monetary restraint is not an easy, automatic or painless solution". Assessing monetary conditions very often involves weighing movements in one indicator against movements in another.

First and foremost, movements in the monetary aggregates outside their target ranges always establish a presumption in favour of changing short term interest rates.

The position with MO is relatively straightforward. Its relationship with money GDP appears to be fairly well established and stable. Money GDP seems to grow between 2 and 5 per cent more than MO in the previous year - very much the same sort of relationship as in the 1970s. The growth of MO responds fairly rapidly and predictably to changes in the short term interest rates. So a rise in interest rates can be expected to bring MO growth back within its target range over the target period.

The fact that MO has rarely been the trigger for interest rate action is not evidence that it carries little weight in interest rate decisions. Its role has been less visible, but nonetheless important.

Arguments for higher interest rates - based on the behaviour of broad money, or over-pessimistic forecasts of inflation - have often been resisted, because of the more reassuring - and in the event more accurate - signals coming from MO.

Were MO to expend more rapidly - as it did, for example, in the early seventies - we should take that as pretty strong evidence that we should tighten monetary policy.

The position with £M3 is more complicated. It was clear by last autumn that the target range for £M3 had been set too low. Indeed, with the benefit of hindsight, it is clear that there has been a change in the relationship between £M3 and money GDP in recent years.

Between 1970 and 1980, £M3 grew on average by 2 per cent <u>less</u> than money <u>GDP</u>. Since 1980 it has grown between 2 and 6 per cent <u>more</u>.

Put another way, while £M3 has grown by [77] per cent over the past five years, money GDP has grown by only [52] per cent, and prices by [42] per cent. Over the previous five years, £M3 grew by [77], but money GDP rose by [117] per cent, and prices increased by [96] per cent.

It is still not absolutely clear why this has happened, or how well established the new trend is. A combination of a freer banking system, greater international competition and new technology is certainly part of the story. So is the level of real interest rates. But what it means in practice is that the business of setting targets for £M3 is particularly hazardous.

In view of all the uncertainties, I set a target range for £M3 in 1986-87 that reflects the most recent trend in velocity.

The new range also allows for the possibility that heavy overfunding in some recent years had the effect of artifically depressing £M3 growth relative to the growth of money GDP.

These judgments will need to be assessed in the light of experience. That was why I decided not to publish illustrative ranges for later years.

Faced with difficulties with their main target aggregate, M1, the United States authorities have from time to time adopted a similarly cautious approach, relating it to what they call "monitoring status", during periods when p.s.

FROM: M C SCHOLAR
DATE: 14 April 1986

MRS LOMAX

cc: PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Peretz
Mr Sedgwick
Miss O'Mara
Mr C Kelly
Mr Walsh
Mr Ross Goobey
Mr Pratt

LOMBARD SPEECH

You asked me to suggest a revised draft of the passage (fourth paragraph of p 14 of your draft of 11 April) which I criticised in my minute to you of 11 April.

2. I attach a passage which avoids the objections I voiced - but, no doubt, will encounter fresh difficulties!

3. It would fit in in substitution for the present fourth paragraph of p 14. As a consequential, the fourth and fifth paragraphs of p 13 would need to be omitted.

4. It could be shorter, but I think there is a good deal of mileage in dwelling on the 1980 Green Paper (which, as you suggested, I have been re-reading).

MCS

M C SCHOLAR

As we have acquired this track record, we have needed to think carefully further about the presentation of monetary policy.

At the start, when the MTFS was new, the need was all for clarity and simplicity. That was necessary to bring home to the markets and the public our determination to meet our monetary objectives, and to defeat inflation.

But that clarity and simplicity carried with it a risk. We recognised at that time - the 1980 Green Paper is eloquent on the point - that no one measure of the money supply can be a sufficient measure of monetary conditions, and that the definition and choice of target aggregate might have to change in changing circumstances. We recognised, in other words, that in targeting a single aggregate we risked creating an over-simplified view of the complex relationships between monetary growth and nominal incomes, and of how we would operate policy in the face of these complexities.

I am quite sure that, at the start of the MTFS, it was right to take that risk, and to demote to a subordinate position - as the introduction to the Green Paper did - our intention to take account of, and to bring about a sustained reduction in, other monetary aggregates besides £M3.

But, now that the markets and the public have seven years' evidence of our determination to stick firmly to sound financial policies, the situation has changed. With clarity on this main point, the presentation of monetary policy can now afford more closely to reflect its complexities; and the market, for its part, is now more sophisticated in its appraisal of the difficulties and subtleties of interpreting monetary conditions.

So much for the presentation of policy. But there have been important changes of substance too.

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

Sir T Burns

LR1.65

PSP

FROM: MRS R LOMAX
DATE: 15 April 1986

SIR T BURNS

SPEECHES

The Chancellor was most grateful for your contributions to the New York speech and the Lombard speech.

RL

RACHEL LOMAX

FROM: ROBERT CULPIN
DATE: 15 APRIL 1986

CHANCELLOR

Sir P Middleton
Sir T Burns
Mr Cassell
Mr Pickford

LOMBARD SPEECH

You need to decide ground rules for tomorrow.

2. Following their normal practice, the Lombard Association propose:

a. not to admit journalists;

b. to invite you to answer questions.

Given a., I strongly recommend you to decline b.

3. There is a lot of press and market interest in what you are going to say. If we can give journalists the text and say that's it, fine. But if hacks and other pundits think they are missing private answers to supplementary questions - however innocuous they may be - there will be all sorts of ill feeling, and probably irritating attempts to discover what you said from wholly unreliable sources. Best just to deliver a good speech and have done with it.

4. If you agree, we must tell the Lombard Association now that you will not be answering questions. I don't think they will object. Please may we do so?

OK - providing they don't object & you explain why.
N.

RC

ROBERT CULPIN

pmf

15 April 1986

LOMBARD ASSOCIATION SPEECH: SOME COMMENTS

Structure

The structure of the speech is not clear. There is too much chopping and changing - promising to return to points or restating them. The crucial discussion of the relationship between Sterling M_3 and Money GDP (beginning on page 8) is introduced by fleshing out an example of how decisions on interest rates have been taken: it needs much better signalling.

The main theme of the speech is that what once was presented in a simple way must now be seen in its full complexity. So after opening on the MTFS, the final section explaining why the MTFS was originally formulated in much cruder terms should be brought forward to the beginning. It should also be more aggressive - the Government wanted to bring down inflationary expectations rapidly so union negotiators would not inadvertently price their members out of work. The directness of the message was intended to help the labour market.

The speech could then discuss how crucial relationships between financial indicators have changed. Two relationships should be distinguished and then discussed in turn:

- The breakdown of nominal GDP between output and inflation. It is a positive achievement of the

Government that, for any given growth of nominal GDP, you now get less inflation and more output than in the past. This means that even assuming that the demand for broad money remained constant, the relationship between £M_3 and inflation would have changed. People have not understood that the "good thing" and "bad thing" objection to nominal GDP also applies to £M_3. For any given growth of £M_3, we now get more output and less inflation.

- The relationship between £M_3 and nominal GDP has itself changed for the reasons set out in the speech.

Then follow this with an account of the factors that are looked at in assessing monetary conditions. The discussion of the <u>exchange rate</u> needs to take the EMS question head on. Pros and cons of joining the EMS should be openly set out. It fits neatly into the theme of the speech, because the charm of the EMS is that it offers us the simplicity which we enjoyed back in 1979. But is this charm spurious?

Flesh out the discussion of M_0. At the moment it sounds defensive, and we are merely offered an econometric black box link between M_0 and inflation. The causal mechanism needs to be set out.

Then explain why £M_3 is kept as a target.

Conclude with the discussion of the rôle of interest rates as an instrument of policy, and how short-term decisions are taken. Operational practice must seem to flow from some account of underlying policy considerations, not the other way round.

Other comments on the draft

Page 2 The assertion that "the only levers at the Government's command are financial" needs further justification or should be dropped.

Page 4 The objections to simply setting targets for nominal GDP or inflation should be put more strongly. The inadequacy of nominal GDP for operational decisions should be stressed. Why not openly cite the autumn 1982(?) attempt to reflate because of the misplaced view that nominal GDP was undershooting?

?

Page 8 The problem of the relationship between target ranges and money GDP is surely better described as arithmetical than conceptual. Delete "understanding" and put "estimate".

Page 9 The view of overfunding here is crucially different from that in the other discussion of overfunding on page 16. The version on page 16 is more accurate. Overfunding genuinely - not "artificially" -

depresses £M_3 and liquidity. The objection to it is surely its effects on the money markets.

<u>Page 11</u> The first sentence is baffling. If M_0 has not been the trigger for interest rate action, one needs to offer some pretty good evidence that it carries weight in interest rate decisions, because prima facie it does not. We presumably need to argue that the behaviour of M_0 affects our understanding of underlying financial conditions.

LR1.68

FROM: MRS R LOMAX
DATE: 15 April 1986

Done

MR CULPIN

cc Sir P Middleton
Sir T Burns
Mr Cassell
Mr Pickford

LOMBARD SPEECH

The Chancellor has seen your minute of 15 April. He agrees that you should tell the Lombard Association that he will not be answering questions tomorrow - provided you explain why, and they do not object.

RL.

RACHEL LOMAX

24/4

LR1.68

[redacted]

pmp.

FROM: MRS R LOMAX
DATE: 15 April 1986

MR CULPIN

cc Sir P Middleton
Sir T Burns
Mr Cassell
Mr Pickford

LOMBARD SPEECH

The Chancellor has seen your minute of 15 April. He agrees that you should tell the Lombard Association that he will not be answering questions tomorrow - provided you explain why, and they do not object.

RL.

RACHEL LOMAX