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PART A

Part. A.

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Begins: 31/12/86.
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PO CH/NL/0480 PT. A.

Chancellor's (Lawson) Papers:
The Governments Monetary Policy.

DD's: 25 Years

21/2/96.

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Ch

Paras 56-64 present the fiscal versus monetary issues in what is generally a neat & balanced way. But the earlier sections labour to prove that a tighter fiscal policy would lead to lower interest rates & a better balanced economy.

Meeting on Thursday PM.

AA

Chief Economic Adviser to the Treasury

Mr Allan c. Mr Colpin

I attach Sir Terence Burns' draft of the Chevening Paper.

As necessary

CONFIDENTIAL

POLICY BACKGROUND TO THE 1987 MTFS

31/12/86

I. RECENT ECONOMIC DEVELOPMENTS

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

2. Although the monetary targets and the PSBR path have been subject to significant revisions, the overall thrust of policy as measured by money GDP has been achieved. The first two years of the MTFS saw a halving of money GDP growth from 20% in 1979-80 to 10% in 1981-82, and there has been a further decline since. During the current financial year money GDP is expected to grow at 5½% which is below trend. The rate of inflation, as measured by the GDP deflator, fell from 17% in 1979-80 to 4¼% in 1984-85, and is expected to be even lower this year after jumping up in 1985-86. The recent behaviour of money GDP, output and inflation is set out in Table 1 below.

Table 1

Money GDP and the Inflation/Output Split

(per cent per annum)

	1979-80	1980-81	1981-82	1982-83	1983-84[1]	1984-85[1]	1985-86[1]	1986-87[1]
Money GDP growth	19.9	13.8	10.0	9.2	8.3	8.6	8.2	5.4
Output growth	2.8	-3.8	0.1	2.0	3.6	4.0	2.1	2.3
Inflation								
GDP deflator	16.9	18.5	9.9	7.3	4.6	4.3	6.1	2.9
RPI	15.8	16.3	11.5	7.1	4.7	5.1	5.9	3.1

[1]Adjusted for the coal strike

3. The decline in the rate of inflation has been larger than that in money GDP growth, resulting in a marked improvement in the split of money GDP between output and inflation. Since the spring of 1981 annual output growth has been fairly steady, averaging over $2\frac{3}{4}$%. These output gains make up nearly two-fifths of the corresponding growth of money GDP.

4. Over the whole period since 1979 experience obviously looks less good, but even here a substantial improvement in the output/inflation split shows up relative to the previous six years (see Table 2). Output growth in 1979-86 was similar to that from 1973-79 despite the deep recession in 1980 and 1981, while inflation was halved between the two periods. In terms of the composition of real demand between expenditure categories the later period has seen a switch towards private consumption, and away from government consumption (see Table 3).

Table 2

Post Oil Shock Output/Inflation Split in the UK and Elsewhere

(per cent per annum)

	UK		OECD Major 6	
	1973-79	**1979-86**	**1973-79**	**1979-86**
Money GDP growth	17.7	9.6	11.2	8.0
Inflation (GDP deflator)	16.0	8.1	8.0	5.7
Output growth	1.3	1.4	2.9	2.2

Table 3

The Components of Real Final Demand

(per cent per annum)

	1973-79	**1979-86**
Private consumption	1.3	2.1
Government consumption	1.9	1.1
Fixed investment	0.2	1.0
Stockbuilding*	-0.2	-0.1
Domestic demand	1.0	1.6
Net trade*	0.6	-0.2
less Adjustment to Factor Cost* and statistical discrepancy	0.3	0.1
GDP(A) at constant factor cost	1.3	1.4

*Change as % of GDP

5. Table 2 also shows that the improvement in the UK output/inflation split following the second oil price shock has been relatively greater in the UK than in the major six OECD countries, mainly because the difference between the two periods has been less marked for the major six. (The UK split has still been worse in absolute terms). Clearly the gap between the performance of the UK and that of other countries has been much reduced in recent years.

6. The slightly better inflation/output split in the major six OECD countries following the second oil price shock probably owes something to the slowdown in real earnings growth (see Table 4). Productivity performance between the two periods was similar and so the lower real earnings growth enabled these countries to contain the inflationary impact of higher oil prices without the excessive squeeze on profits that characterised the years after the first oil price shock. As a result their unemployment has risen less than it otherwise might have done.

7. In contrast real earnings growth in the UK has been higher over the period 1979-86 than between 1973 and 1979. The productivity gap between the UK and the other countries had widened significantly between 1973 and 1979, providing plenty of scope for a major shake out of labour. In the event this occurred when the general economic climate changed in the early 1980s. The result has been a much faster rate of productivity growth than in 1973-79, spurred on by the relatively higher rate of real earnings growth. Indeed between 1979 and 1986 UK whole economy productivity growth has exceeded the average of the major six, and UK manufacturing productivity growth has been on a par with that of the major six after lagging well behind between 1973 and 1979.

7. This largely explains the bigger rise in UK unemployment in 1979-86 relative to 1973-79, despite similar output growth. It also partly explains the increase in UK unemployment relative to other countries, though here the slower average rate of output growth since 1979 also contributes. Further improvement in the UK inflation output split and a turnround in unemployment would seem to depend importantly on slower real earnings growth.

Table 4

Earnings and Productivity Growth

(per cent per annum)

	UK		OECD Major 6	
	1973-79	1979-86	1973-79	1979-86
Whole economy earnings growth:				
- nominal	16.5	10.0	13.0	8.2
- real*	0.9	1.9	3.9	2.0
Productivity growth:				
- whole economy**	0.4	1.6	1.3	1.3
- manufacturing	0.7	3.1	2.9	3.3
Unemployment†(%)				
- first year	2.1	4.3	3.8	5.1
- final year	4.3	11.5	5.1	7.2

*nominal earnings growth less RPI inflation

**excluding North Sea for UK

†Narrow, claimants basis for UK

II. ARRANGEMENT OF THE PAPER

8. Against the background of these recent economic developments, the paper first sets out the framework for setting policy, and then interprets and comments on the current situation. Although fiscal policy is the main focus of attention, it is discussed in the context of the overall stance of policy and the evolution of monetary conditions.

9. It is taken as given that money GDP will continue in the centre of the stage. The role of interest rates and fiscal policy in influencing money GDP is discussed, in the context of the original MTFS and our more recent perspectives. It is shown that whichever way one looks at it there is a tradeoff between using interest rates and using fiscal policy to keep money GDP on track over the medium term. The choice between them should depend on the implications of different mixes for the structural balance within the economy, particularly for the state of the current account and the share of consumption in GDP.

10. The current position is examined first from the point of view of the overall policy stance and then in terms of the policy mix. The implications of the October forecast for the overall policy stance are discussed, and indicators of monetary and fiscal stance are considered. Monetary and fiscal conditions are also relevant to an assessment of the policy mix. In addition, recent and prospective developments in the structure of the economy are examined.

III. THE FRAMEWORK

Money GDP

11. We assume that the growth of money GDP remains the main objective for the medium term. The transition to giving it greater emphasis in the 1986 MTFS went fairly smoothly, although there were some critical remarks, for example from the TCSC. Its role in the MTFS can now be consolidated.

12. Last year's MTFS set out an assumed path for money GDP growth showing a decline from just under 7 per cent in 1987-88 to 5½ per cent in 1989-90 (see table 5).

Table 5

Money GDP, Output and Inflation in the 1986 MTFS

(per cent change on previous year)

	1985-86	1986-87	1987-88	1988-89	1989-90
Money GDP	9½(8¼)[1]	6¾	6½	6	5½
GDP deflator	6	3¾	3¾	3½	3
Real GDP					
Non-North Sea	3¾	3	2¾	2¾	2¾
Total	3½	3	2½	2½	2½

[1]Figure in brackets is adjusted for the coal strike

13. It was assumed that the real GDP would grow at about 2½ per cent a year so that inflation would be reduced from 3¾ per cent to 3 per cent over the period.

14. At the same time we have accepted that:

- the division of money GDP growth between inflation and output growth is primarily a reflection of supply performance; and the main policy instruments for influencing unemployment are micro-economic measures;

- in the short run the speed of deceleration of money GDP growth will influence the inflation-output balance. A sharper deceleration of money GDP growth will mean a slower growth of output in the short term although inflation will be brought down more rapidly. By contrast if money GDP growth is not reduced output growth in the short term may be faster but it is unlikely that inflation will fall.

Original MTFS

15. In earlier versions of the MTFS £M3 provided the central framework of policy:

- the aim was to exert downward pressure on inflation by controlling nominal demand, much as now, although the role of money GDP was implicit rather than explicit;

- a gradually reducing growth of £M3 was expected to deliver gradually reducing growth of money GDP;

- for any given growth of £M3 the path of interest rates was held to depend on the stance of fiscal policy - the PSBR - and the demand for bank lending;

- this meant a declining path for the PSBR to avoid "excessive reliance" on interest rates in reducing monetary growth.

16. Essentially the principle that was followed was one of balance. Fiscal and monetary policy would be kept in balance with a progressive tightening of monetary policy accompanied by a falling PSBR ratio.

17. There were two reasons for seeking to avoid excessive pressure on interest rates:

- to minimise the pressure on investment and interest-sensitive components of demand;

- to increase credibility that the policy would be sustained given that politically-sensitive levels of interest rates were more likely to lead to a forced easing of monetary conditions in general.

Lombard Speech

18. It has become more difficult to articulate the role of monetary and fiscal policy without the anchor of the £M3 target.

19. However the essence of the approach remains intact. The primary aim of macro-economic policy is to deliver the desired medium-term profile for money GDP growth. The Lombard speech outlined that this was to be achieved by a continuing commitment to financial discipline. Monetary targets still have a role to play although that information must be supplemented by an intelligent assessment of monetary conditions, including the exchange rate.

20. We also continue to believe that fiscal policy must support monetary policy. The Lombard Speech (April 1986) argued that:

- it is important that public sector debt should not rise as a percentage of GDP;

- the Budget deficit must be set at a level that can be comfortably financed in a non-inflationary way;

- there should be scope for absorbing possible fiscal shocks.

21. This maintains the principles of the original approach towards fiscal policy. A level of public sector debt that is broadly steady as a percentage of GDP is consistent with balanced financing. It means that a gradually declining path for money GDP growth should be accompanied by a falling PSBR ratio. And the degree of comfort in financing the PSBR can be interpreted as the level of interest rates that has to be paid to achieve a full fund. Thus although we have moved some way from a framework based

on £M3, the need remains for the PSBR to decline as a ratio of GDP; and the essential trade-off between fiscal policy and interest rates stands.

The implications of an MO target

22. In the last MTFS targets were set for both broad (£M3) and narrow (MO) money. The basic principles were as follows:

- it is necessary to monitor the growth of broad money as it is not possible to tolerate an unlimited build-up of liquidity. We must satisfy ourselves that further increases in liquidity reflect the private sector's desires;

- MO must be watched to check that any level of liquidity is not being translated into higher spending.

23. During the past year £M3 has grown even more rapidly and it has become increasingly difficult to interpret the implications. Inevitably we have been thrown into placing more emphasis on the behaviour of MO.

24. When monitoring the growth of MO it is important to take into account a number of its features (see Annex A):

- the historical velocity trend is about 3½ per cent a year; **ceteris paribus** money GDP growth of 6-7 per cent a year is consistent with MO growth of 2½-3 per cent;

- movements in velocity relative to trend will be influenced by interest rates. When nominal interest rates are falling a given growth of MO is consistent with a slower growth of money GDP as the desired ratio of MO to disposable income shifts upwards;

- as it is closely related to spending its behaviour can be no more than a short leading indicator of money GDP;

25. One of the advantages of the £M3 framework was that it was easy, conceptually, to see the relationship between fiscal and monetary policy. The MO framework in fact implies a similar trade-off between fiscal policy and interest rates even though it is not as straightforward as the original £M3 framework.

26. A tighter fiscal policy will reduce MO for given interest rates as private sector post-tax money incomes grow less rapidly. Therefore to maintain the original profile for MO will require lower short-term interest rates. Returning MO to its target path will not be sufficient in itself to maintain money GDP growth unchanged because lower interest rates reduce velocity. In other words the lower interest rates have a bigger effect on MO than money GDP. But targeting MO leads to the right kind of response.

27. Thus the interest rate-PSBR trade-off is also an implicit characteristic of this framework. Rapid MO growth can be restrained either by interest rate increases or tighter fiscal policy.

Determinants of money GDP

28. As a basis for discussing the likely future growth of money GDP and the influence of policy instruments it is useful to consider the determinants of money GDP within a conventional income/expenditure framework:

- in addition to world factors and longer-term changes to the saving ratio and the supply side, money GDP will be influenced by interest rates and fiscal policy;

- fiscal policy works through the normal expenditure route, either changing public expenditure directly or private expenditure through changes in taxation or transfers;

- interest rates exercise their greatest leverage through exchange rate changes which have a major impact on money GDP through prices and net export demand. In addition we judge

that interest rates have an influence on consumer durables demand, fixed investment (especially house building) and stockbuilding;

- exogenous, or confidence-based, changes in the exchange rate exercise a separate influence on money GDP. For given interest rates and given fiscal policy, the lower the exchange rate the higher money GDP.

29. It follows that a lower PSBR will lead to slower growth of money GDP over the medium term for given interest rates; and hence lower interest rates will be consistent with the original money GDP path.

30. We would also expect that sustained changes in the balance between the PSBR and interest rates would affect the structure of demand within the economy and the current account of the balance of payments.

31. A combination of a lower PSBR and lower interest rates would be expected to lead to:

- a lower real exchange rate;

- lower real interest rates;

- a slower growth of domestic demand, partly due to the lower real exchange rate and partly due to the direct effects of fiscal tightening (although offset to some degree by lower interest rates). Total consumption would actually grow more slowly unless the fiscal tightening took the form of a reduction in public capital spending;

- an improved net exports balance because of better competitiveness and lower domestic demand growth;

- lower debt service costs that would make for a more comfortable fiscal position later.

32. Whether a switch of this kind, or vice versa, is needed depends upon the prospects for the economy. If an economy is expected, over a number of years, to experience some combination of rapid real domestic growth, high real interest rates, a high real exchange rate, high debt service costs and a current account deficit there would be some presumption of a move in the balance towards a lower PSBR and lower interest rates; and vice versa.

The Evidence

33. Although the trade-off between fiscal policy and interest rates remains fundamental it is not always clearly evident in the data (see Annex B). There are a number of reasons for this:

- the trade-off implicitly assumes unchanged money GDP or monetary growth. Historically there have been large fluctuations in money GDP growth which obscure the relationship;

- the relationship can also be obscured by the cycle: buoyant output tends to reduce the budget deficit and put upward pressure on interest rates;

- world interest rates influence domestic interest rates for a given fiscal deficit;

- the relationship depends on expectations in financial markets. If a high PSBR leads to doubts about the overall policy stance and hence pressure on the exchange rate, interest rates have to be higher than they might otherwise have to be to achieve a given GDP objective. On the other hand if there is confidence in the longer-term determination to maintain the desired growth of money GDP, interest rates can be lower.

34. But although these factors tend to obscure the relationship between fiscal deficits and interest rates **ex-post** they do not alter the message that action to reduce fiscal deficits permits

lower interest rates for a given growth of money GDP or money supply than would otherwise be the case.

35. In Annex C we show two sets of simulations of a change in the mix towards a lower fiscal deficit (brought about by higher income tax) and lower interest rates. In one money GDP is unchanged and in the other MO is unchanged. Within each set there is one simulation where markets expect the fiscal change to be temporary and another where the tightening of fiscal policy is accompanied by increased confidence that the path of gradually declining money GDP will be delivered, with positive confidence effects on the exchange rate.

36. The results do not differ significantly according to whether money GDP or MO is held unchanged. They can be summarised as follows:

- the scale of the interest rate decline is much bigger in the case where there are positive exchange rate consequences; [numbers]

- a move to tighter fiscal policy with lower interest rates leads to very little change in the output/inflation trade-off in the medium term;

- the main difference over the medium term is in the structure of the economy which may have longer-term effects if investment behaviour is changed. A tighter fiscal policy tends to lead to lower real interest rates, a lower real exchange rate, a better current account deficit and a smaller share of consumption in total expenditure. The simulation results suggest that these effects are modest but worthwhile. The greatest uncertainty inevitably centres on the behaviour of the exchange rate.

Policy implications

37. The implication of this analysis is that:

- interest rates and fiscal policy jointly affect both the growth of MO and money GDP; and different combinations can deliver the same outcome for money GDP;

- differences in the balance of instruments have an effect on the structural balance within the economy, particularly the state of the current account and the share of consumption in GDP.

38. In practice the way we deal with these ideas is:

- at Budget time we seek to set the overall stance of policy in the shape of a medium-term path for growth of money GDP and to choose a mix of instruments - interest rates and fiscal instruments - that will achieve both the money GDP path and structural objectives;

- between Budgets interest rates are the main policy instrument and are directed towards maintaining monetary conditions consistent with the medium-term profile for the growth of money GDP;

- if emerging circumstances require changes to the mix of instruments this can be done at Budget time as has happened in the past; but there is a presumption against frequent changes in the fiscal stance shown in the MTFS.

39. Choosing the right balance between fiscal policy and interest rates is obviously a matter for judgment and it is possible to reach different conclusions. In the second part of this paper we outline the various factors that need to be considered in the current position.

40. Ensuring that interest rates are adjusted within year to keep monetary conditions on track is also a difficult matter of judgment. In practice it is done by monitoring various key financial magnitudes as well as the progress of inflation and the real economy.

This paper does not address the questions of the continuous assessment of monetary conditions - which variables to targets, for how long, and what target ranges. Separate work is proceeding on this with MG in the lead.

IV. THE CURRENT POSITION

41. It is useful to divide our analysis of the current position into two:

- the overall stance of policy;

- the mix of interest rates and fiscal policy.

The overall stance of policy

42. In recent years we have focussed upon the growth of money GDP as the main indictor of the overall stance of policy over the medium term. The figures are shown in table 6 for the years since 1979-80 together with some five-year averages for earlier years.

Table 6

The Overall Stance of Policy

(Percentages, except exchange rate which is 1975=100)

	Money GDP Growth	MO Growth	Short-term interest rate	Exchange Rate	PSBR/GDP Ratio Actual	PSBR/GDP Ratio Excluding Privatisation Receipts	Govt. revenues[5] from N Sea : GDP
Annual averages[1]							
1951-55	7.3	5.0	2.5[7]	144.2[6]	3.2	3.2	-
1955-60	6.0	4.0	4.5[7]	144.2[6]	2.4	2.4	-
1960-64	6.6	3.4	4.5[7]	144.2[6]	2.5	2.5	-
1964-68	6.9	4.9	7.0	138.0[6]	3.3	3.3	-
1968-73	11.0	6.6	8.3	125.5	1.9	1.9	-
1973-79	17.6	12.8	11.1	90.7	6.6	6.7	0.2
Financial years							
1980-81	13.8	7.1	15.5	98.2	5.4	5.6	1.7
1981-82	10.0	5.2	14.2	92.3	3.3	3.5	2.5
1982-83	9.2	2.7	11.5	88.0	3.1	3.3	2.8
1983-84	8.3[2]	6.2	9.7	83.5	3.2	3.6	2.9
1984-85	8.6[2]	5.5	10.9	76.2	3.1[3]	3.7[3]	3.7
1985-86	8.2[2]	4.2	12.1	79.0	1.6	2.4	3.1
1986-87[4]	5.4[2]	3.8	10.5	71.1	1.9	3.1	1.2
	(6.7)	(2.6)	(11.2)	(73.3)	(1.9)	(3.1)	(1.6)
1987-88[4]	7.3	3.9	11.0	66.7	1.7	3.0	1.0
	(6.4)	(3.9)	(9.7)	(70.6)	(1.7)	(2.9)	(1.0)
1988-89[4]	8.0	3.5	11.0	64.7	1.6	2.7	0.9
	(6.0)	(4.9)	(8.5)	(69.1)	(1.6)	(2.7)	(1.0)

[1] Growth rates measured from first year to last; interest rates, exchange rate and PSBR/GDP ratios are averages of years excluding the first year

[2] Adjusted for coal strike. Unadjusted figures are:
1983-84 8.1 1984-85 7.3 1985-86 9.6 1986-87 5.5 (6.8)

[3] These figures would be 2.3 (actual PSBR) and 2.9 (PSBR excluding privatisation receipts) if they were adjusted for the coal strike

[4] The main figures are from the October forecast except for the 1986-87 PSBR/GDP ratios and North Sea revenues which are from the Autumn Statement. Those in brackets are from the MTFS projection

[5] Before ACT set off

[6] Sterling index not available prior to 1969. Figures based on movements in sterling/US$ rate

[7] Average Treasury Bill yields (later data are 3-month interbank rate)

43. There was a substantial reduction in the growth of money GDP between 1979-80 and 1982-83. Between 1982-3 and 1985-6 the growth of money GDP was broadly flat at between 8 and 9 per cent a year. Reflecting some tightening of policy in early 1985, and lower oil prices, the MTFS showed a significant reduction of money GDP growth this year. It also showed further steady reduction in money GDP in the years ahead.

44. However as the year has progressed it has become clear that money GDP growth this year has been less than was forecast in the FSBR. (The extent of this undershoot is still uncertain; different measures of GDP give different figures). But the October forecast showed a bounce-back occurring in 1987-88 and still higher money GDP growth in 1988-89. In other words rather than a steady reduction in money GDP growth the forecast suggests a return to the same sort of growth seen between 1982-83 and 1985-86.

45. Annex D is a diagnosis of the reasons for the faster projected growth of money GDP after 1987 compared with the MTFS. It concludes that the major identifiable factors are:

- a rather lower level of the exchange rate for given relative interest rates;

- a lower private sector net saving ratio;

- higher real wage growth.

These changes should not be interpreted as just the result of the forecasters revising their judgements. The MTFS was presented on the basis of a better outcome for inflation than shown in the internal forecasts.

46. In each case the revised assumption means that for given interest rates and PSBR profile there are additional pressures making for faster MO and money GDP growth than implicit in the MTFS. Within a non-accommodating financial framework this means higher interest rates or a lower PSBR.

47. The October forecast assumed that the PSBR would be as in the MTFS and that interest rates would be held steady rather than fall as they did in the MTFS assumptions. Even with no decline in nominal interest rates from their current high level the forecast concluded that MO growth would be in the upper end of the target range at between 3 and 4 per cent per annum. Although this was not low enough to deliver the MTFS money GDP profile, a conscious decision was made not to project even higher interest rates. The implied movement of velocity of MO is not out of line with the previous historical experience of a 4 per cent per annum trend. (In the detailed figures underlying the MTFS projections MO growth was also about 4 per cent. This was judged to be consistent with money GDP growth between 6 and 7 per cent because nominal interest rates were projected to fall significantly over the MTFS horizon thus keeping the increase in velocity well below its normal trend.)

48. At first sight it seems pessimistic to conclude that unchanged nominal interest rates and the declining path of the PSBR will not lead to downward pressure upon money GDP growth.

49. One possibility is that the projections are too gloomy. The record in Annex E shows that internal medium-term forecasts have tended to overstate the inflation rate and understated growth. In other words there has been more downward pressure upon money GDP than forecast; and a much better inflation/output split.

50. But there are dangers in assuming that the rising profile of money GDP growth is simply forecasting bias:

- more recently the evidence of bias is less apparent as the forecasts have adjusted to the new information particularly if account is taken of the effects of lower oil prices;

- part of the reason for the improved inflation/output split was the unexpected rapid growth of productivity. More recently productivity growth seems to have stabilised and we judge that there is less scope for large productivity gains.

This means that if there is to be a better inflation/output split it will have to come mainly through better real wage adjustment, and progress on this front remains disappointing;

- the projection of output growth in the MTFS is quite buoyant - close to 3 per cent, by comparison with rather lower figures that were typical in earlier medium-term forecasts.

51. It is difficult to be sure that all the bias has been removed from the forecast, but much of it should have been. Indeed it is interesting to compare the forecast for 1987-88 to 1988-89 with the outturn for 1983-84 to 1985-86. The figures are shown in table 7.

Table 7

The Overall Stance of Policy: Recent Past and Forecast

(Percentages)

	Money GDP Growth	MO Growth	Short-term interest rate	Exchange Rate Change[2]	PSBR/GDP Ratio Excluding Privatisation Receipts	Govt. revenues[3] from N Sea : GDP
Annual averages[1]						
1982-83 to 1985-86	8.4[4]	5.3	10.9	-6.2	3.2[5]	3.2
1986-87 to 1988-89 (October Forecast)	7.6	3.7	11.0	-8.1	2.8	1.0
1986-87 to 1988-89 (MTFS)	6.2	4.4	9.1	-5.5	2.8	1.0

[1] Growth rates measured from first year to last; interest rates and PSBR/GDP ratios are averages of years excluding the first year

[2] Lagged one year (ie average change from 1981-82 to 1984-85 for first period)

[3] Before ACT set off

[4] Adjusted for coal strike

[5] Not adjusted for coal strike. The figure would be 3.0 if it was adjusted for the coal strike.

52. In the earlier period:

- money GDP growth averaged 8½ per cent;

- interest rates averaged about 11 per cent;

- the exchange rate fell by between 15 and 20 per cent between 1981-2 and 1984-5;

- MO growth averaged about 5 per cent;

- and excluding privatisation receipts the PSBR ratio averaged 3¼ per cent over the three years.

53. For 1986-87 to 1988-89 the October forecast shows:

- a projected outcome for money GDP growth at 7½ per cent;

- interest rates at 11 per cent;

- a fall in the exchange rate of about 15 per cent between 1985-86 and 1987-88;

- MO growth is projected at under 4 per cent;

- and excluding privatisation proceeds the PSBR is set at $2\frac{3}{4}$ per cent of GDP over the two years.

54. In other words there is not a great deal of difference between the two periods although some account needs to be taken of the much higher level of North Sea revenues in the earlier period. If anything the forecast looks a shade pessimistic on inflation but not by much. What does stand out is that with the present stance of policy the MTFS figures for money GDP growth will be difficult to achieve unless labour market behaviour improves significantly.

55. It is difficult to escape the view that the overall stance of policy is on the easy side if we wish to maintain a profile of gradually declining money GDP over the next few years.

The mix of monetary and fiscal policy

56. What is not so clear is the extent to which any tightening of policy should be achieved by changes to fiscal policy or interest rates.

57. Based upon the previous discussion it is useful to examine the choice in terms of the following criteria:

- an assessment of monetary conditions;

- the stance of fiscal policy and

- the structural balance of the economy.

58. A number of annexes outline the detailed analysis. This section draws on that analysis and orders the material by first setting out the case for relying on higher interest rates; and subsequently setting out the case for tighter fiscal policy. The supporting material for each point of view is presented separately and no attempt is made to present counter-arguments alongside each point. In each case we look, in turn, at arguments relating to monetary conditions, fiscal conditions and the general balance of the economy.

The case for higher interest rates:

59. **Monetary Conditions:**

- all monetary aggregates are now flashing danger signals; broad money growth has been very rapid since the spring, house prices have been rising rapidly, and credit growth remains buoyant in the wake of financial deregulation.

Earlier in the year we had the compensating information that MO growth was well under control and PSL2 growth was fairly steady. But in recent months both MO and to a lesser degree PSL2 accelerated. Looking at the behaviour of the monetary aggregates as a whole a clear case can be made for higher interest rates;

- the main immediate problem has been the weakness of the exchange rate and our interpretation suggests that this is an important channel in putting upward pressure upon inflation. Higher interest rates are an obvious weapon and are likely to produce a predictable response;

- interest rates are higher in the UK than elsewhere because of private credit demand, wage growth, and uncertainties about monetary policy and the general election. Under these circumstances it will be difficult to avoid high UK interest rates.

60. **Fiscal Conditions:**

- the PSBR has been reduced; even excluding asset sales it is lower than since the early '70s; and the projected figures are close to the average ratio of the 1950s and 1960s;

- although the PSBR adjusted for asset sales has risen this year, oil revenues have fallen sharply and it is appropriate to absorb some of the revenue loss in higher borrowing;

- fiscal policy needs to be set on a long-term basis and should not be fine tuned in response to a changing assessment of the short-term prospects for money GDP;

- the present PSBR has been funded outside the banking system. The main reason for rapid broad money growth has been rapid growth of private sector credit demand.

61. **The Balance of the Economy:**

- tax reform requires some reduction in overall taxation, and tax reform is an important aspect of improving economic efficiency;

- the recent rapid growth of consumption in part reflects a rapid expansion of consumer credit largely as a result of financial deregulation. During the period of adjustment to a higher personal sector debt/income ratio it is necessary to have higher interest rates;

- the projected balance of payments deficit could well turn out to be mainly a presentational problem. We have amassed huge overseas financial assets and, because of improved competitiveness, the period of deficit could turn out to be transitional;

- private sector investment has risen markedly as a share of GDP and since the changes in the corporation tax regime we are likely to get better returns from that investment.

The case for a tighter fiscal policy:

62. **Monetary Conditions:**

- real interest rates in the UK are already much higher than elsewhere. Financial deregulation plays a part but it may also reflect both the PSBR and the fears of further exchange rate decline. Exchange rate weakness itself may be related **inter alia** to the prospective current account deficits, which themselves are partly a reflection of fiscal policy;

- even if the main stimulus to spending originates in private sector credit growth there is a case for offsetting some of its effects by a lower fiscal deficit;

- the rapid growth of monetary aggregates is partly a function of fiscal policy. In any case whatever the cause some tightening of fiscal policy would reduce monetary growth and would be a way of getting policy back on track without further rises in interest rates.

63. **Fiscal Conditions:**

- adjusted for privatisation proceeds the PSBR is still a little higher than during the average of the 1950s and early 1960s when money GDP growth averaged between 6 and 7 per cent. In addition to privatisation proceeds there are a number of other essentially capital transactions where the demand weight is very low (for example, council house sales, land sales, equity sales). These amount to about ½ per cent of GDP. If correction is also made for these the adjusted PSBR is estimated at 3-3½ per cent of GDP over the next two years. This is between ½ and 1 per cent higher than the average of the 1950s and '60s;

- although oil revenues have fallen significantly this year they are still making a contribution between ½ and 1 per cent to the Exchequer over and above the level of 'permanent income' from the North Sea;

- we have made much less progress since 1979-80 in reducing the budget deficit than Germany and Japan while the deficit in France is also below ours despite our North Sea revenues;

- in practice we are only able at present to fund the PSBR at exceptionally high real interest rates.

64. **The Balance of the Economy:**

- the economy has shifted noticeably in the direction of a higher ratio of personal consumption to GDP. Indeed if the 1987 forecast is correct, by then we shall have had the fastest five-year growth of consumer spending in

decades. And recently the growth of consumption in the UK is faster than the average of the main industrial countries. This is in part a function of the rapid growth of real incomes and is not sustainable;

- this picture is not changed if we take private and public sector consumption together. And it is happening at a time when relative to elsewhere the contribution of North Sea income is declining. This suggests that UK domestic demand will have to grow less rapidly than GDP whereas lower oil prices mean that for the industrialised countries as a whole domestic demand can grow faster than GDP;

- the balance of payments could become a serious problem. We should not take too much comfort from external assets and the invisible balance. External assets largely reflect revaluations and the effect of a falling exchange rate. Only £21 billions of the increase since 1979 reflects cumulative current account surpluses. The effect of the revaluations could of course of course be reversed with a weakening dollar or weaker stock markets. And much of the invisible surplus represents profits and dividends which in practice tend to be invested abroad rather than repatriated. So the underlying level of capital outflows might be increasing;

- the fall we have had in the exchange rate associated with the oil price fall points to the need for restraint of domestic demand to help shift resources into the external balance;

- the present levels of unemployment and capacity utilisation strongly suggest that we are in need of an expansion of industrial capacity, which in turn means a higher investment ratio. The prospective decline in revenues from North Sea oil point in the same direction;

- the declining share of the public sector in total investment and the need to encourage private investment both point to a lower level of public borrowing and lower interest rates.

Assessment

[To follow]

LIST OF ANNEXES

ANNEX A: VELOCITY OF M0

The velocity of M0 has grown at an average rate of 3½% over the last 20 years. This trend has been fairly steady and was associated with institutional and technological changes such as the decline in payment of wages in cash and the spread of bank accounts and credit cards.

2. From year to year there have been considerable fluctuations in velocity measured contemporaneously (Table A.1). These are mostly explicable by movements in interest rates. Falls in interest rates, as in 1977 and 1981-83, have led to a slower than average rise in velocity for a time (in 1978-79, 1983-84 and 1984-85) as people increased their cash holdings to a higher level relative to money GDP. Similarly the increase in interest rates in 1977-79 led to above-average growth in velocity in 1979-80 and 1980-81.

3. Interest rates affect the demand for M0 fairly quickly: nearly all the effect is through within a year. They affect money GDP more slowly: the extra impact in the second year is probably greater than in the first. Partly as a result of this difference in the lags there is a correlation between movements in M0 and those in money GDP three or four quarters later, as both respond to changes in interest rates. Movements in M0 that reflect interest rate movements act as an advance warning of the impact of interest rates on money GDP. This is apparent in the greater stability of the growth of velocity when it is measured as the ratio of money GDP to M0 in the previous year than when it is measured contemporaneously (Table A.1).

4. A given change in interest rates tends to have a proportionately greater impact on the demand for M0 than on money GDP. One would therefore expect the movements in lagged M0 velocity, to the extent that they are induced by interest rate changes, to show a similar pattern to those in contemporaneous velocity, but to have a smaller amplitude. There is some indication of this in the data.

Table A.1

Velocity of M0

(percentages)

	M0 Growth	Money GDP Growth	Growth of Velocity of M0: M0 in current year	Growth of Velocity of M0: M0 in previous year	Short-term interest rate
1976-77	11.0	16.7	5.1	3.0	12.0
1977-78	11.5	15.8	3.9	4.3	6.8
1978-79	15.1	14.1	-0.9	2.3	10.7
1979-80	12.1	19.6	6.7	3.9	14.9
1980-81	7.1	13.8	6.3	1.5	15.5
1981-82	5.2[1]	10.0	4.6	2.7	14.2
1982-83	2.7[1]	9.2	6.3	3.8	11.5
1983-84	6.2	8.3[2]	2.0	5.5	9.7
1984-85	5.5	8.6[2]	2.9	2.3	10.9
1985-86	4.2	8.2[2]	3.8	2.6	12.1
1986-87	3.8	5.4[2]	1.5	1.2	10.5

[1]Adjusted for change in bankers' balances in 1981

[2]Adjusted for coal strike

ANNEX B: THE FISCAL DEFICIT AND INTEREST RATES

The attached charts compare annual movements in the public sector financial deficit with those in short- and long-term interest rates. Chart B.1 shows the ratio of the PSFD to GDP and the 3-month interbank rate, and Chart B.2 the PSFD/GDP ratio and the yield on 20-year gilts.

2. The series move together over the medium term. In particular they both show a steep rise in the first half of the 1970s and a gradual decline since then. But, for the reasons explained in the text, one would not expect to observe a close year-to-year correlation in practice.

Chart B1

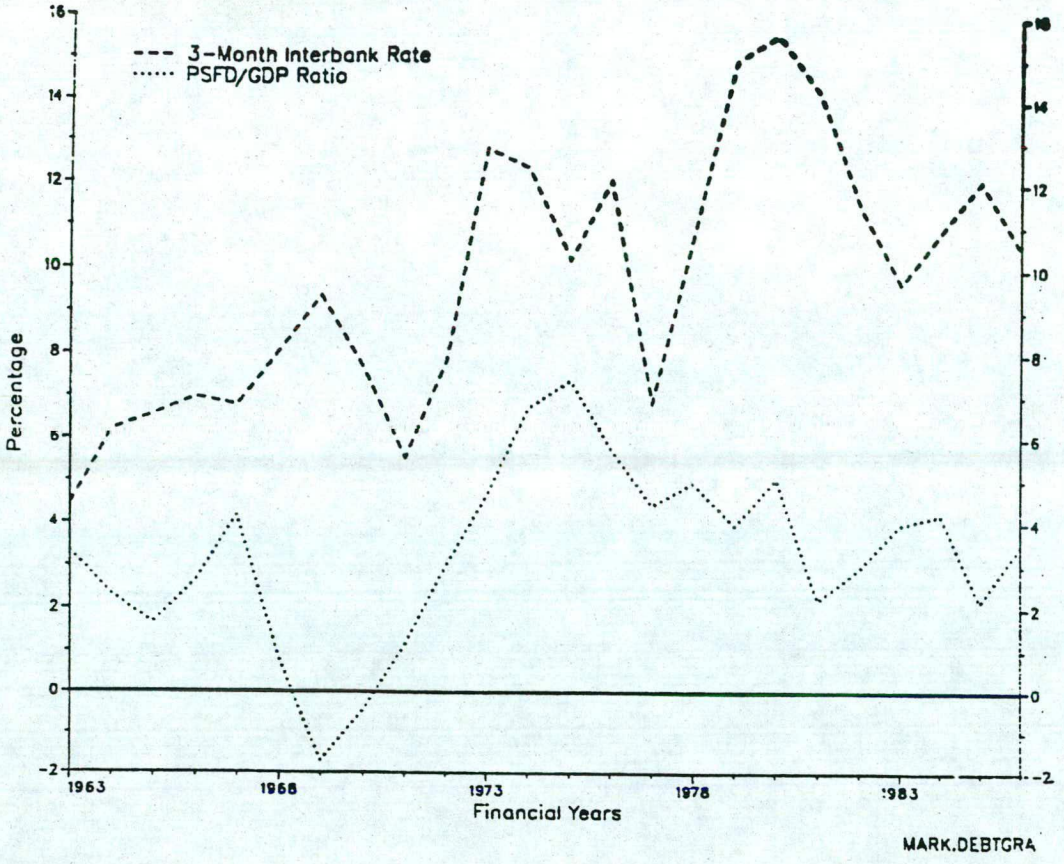
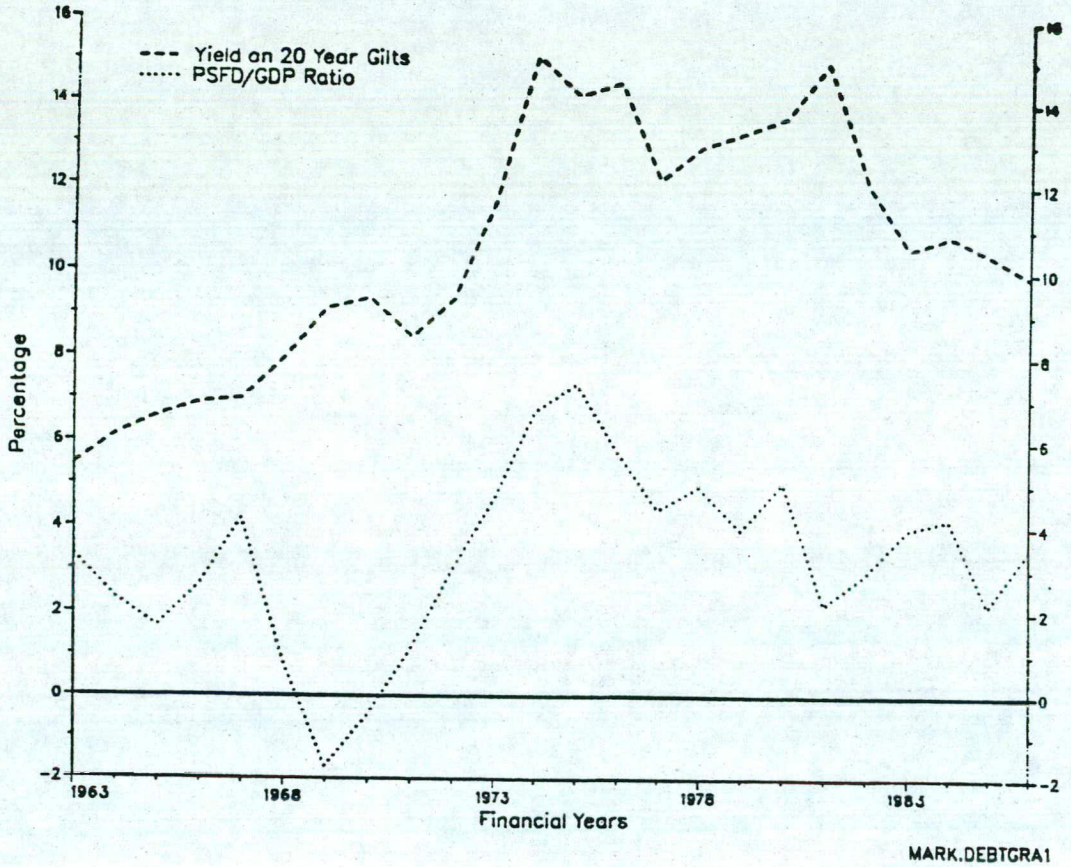


Chart B2



ANNEX C: SIMULATIONS OF CHANGES IN THE MIX OF POLICIES

This Annex presents the results of simulations in which the mix of fiscal deficits and interest rates is changed while still maintaining monetary conditions, measured by money GDP and M0, unchanged. The PSBR is raised by reducing income tax, and interest rates are then altered to ensure that first money GDP and second M0 are unchanged from base. The results would be qualitatively the same if an alternative fiscal instrument were used to raise the PSBR.

Fixed money GDP

2. The upper panel of table C1 assumes that confidence in the overall stance of policy is unchanged, with markets accepting that future money GDP growth will not be changed by the switch in policy mix. A move to tighter fiscal policy and lower interest rates has little net effect on inflation and output. Given the assumption about confidence the real exchange rate is likely to fall, reflecting the reduction in interest rates, and the current account will tend to improve. The estimated effect on the current account is eventually of the order of ½% of GDP for a 1 point PSBR reduction, with the full effect coming through by the third year.

Table C1: Effects of reducing the PSBR by 1% of GDP, with fixed money GDP

	Short term Interest Rates		Growth of M0	GDP(%)	RPI Inflation	Real exchange rate (%)	Current Account	
	Nominal	Real					% of GDP	£billion
Unchanged Confidence								
Year 1	-1.4	-1.2	+0.2	-	-0.2	-1.9	+0.2	+0.6
Year 2	+0.1	-0.4	-0.5	-	+0.5	-1.2	+0.3	+1.0
Year 3	-0.7	-0.8	-	-0.2	+0.1	-1.4	+0.5	+2.2
Year 4	-1.6	-1.2	+0.4	-0.2	-0.4	-1.3	+0.6	+2.8
Improved Confidence								
Year 1	-1.9	-1.5	+0.4	-	-0.4	-1.2	+0.2	+0.6
Year 2	-2.1	-1.6	+1.2	+0.3	-0.5	+0.5	+0.1	+0.2
Year 3	-1.7	-0.7	+1.9	+0.1	-1.0	+2.4	-	-
Year 4	-1.5	-0.4	+0.2	-0.6	-1.1	+2.6	+0.2	+0.9

3. The lower panel of the table illustrates what might happen if the market perceives the cut in the PSBR as foreshadowing a tightening of the overall stance of policy rather than just a change in the mix. A 1 point cut in the PSBR ratio would be consistent in the long run with a reduction in money GDP growth of about 2% per annum if it were accompanied by an equivalent tightening of monetary policy. If this is what the markets expect, the real exchange rate would tend to fall less (or possibly even rise) in which case the effects on inflation and (initially) output would be rather more favourable. But for essentially the same reason the gain to the current account would be reduced.

Fixed M0

4. Another way of looking at changes in the policy mix is to focus on PSBR and interest rates changes which leave M0, rather than money GDP, unchanged. The effects of reducing the PSBR by 1% of GDP with fixed M0 are illustrated in Table C2, again assuming the fiscal instrument is income tax, and using the same assumptions about confidence.

Table C2: Effects of reducing PSBR by 1% of GDP, with fixed M0

	Short term Interest Rates		Growth of Money GDP	GDP(%)	RPI Inflation	Real exchange rate (%)	Current Account	
	Nominal	Real					% of GDP	£billion
Unchanged confidence								
Year 1	-1.2	-1.0	-0.2	-0.1	-0.2	-1.5	+0.2	+0.7
Year 2	-0.6	-0.6	+0.1	-	-	-0.5	+0.2	+0.9
Year 3	-1.0	-0.8	-0.4	-0.2	-0.2	-0.4	+0.4	+1.7
Year 4	-1.7	-0.9	-0.4	-0.3	-0.8	-	+0.5	+2.2
Improved Confidence								
Year 1	-1.3	-0.9	-0.3	-0.1	-0.4	-0.6	+0.2	+0.7
Year 2	-0.9	-0.5	-0.1	-	-0.4	+0.4	+0.1	+0.5
Year 3	-1.6	-0.9	-0.7	-0.3	-0.7	+0.7	+0.3	+1.1
Year 4	-2.5	-1.0	-0.9	-0.2	-1.5	+1.6	+0.3	+1.3

5. The main difference from the earlier results is that tighter fiscal policy tends to reduce the growth of money GDP. This is because the fall in interest rates required to bring M0 back to track reduces velocity; a given path for M0 means lower money GDP. (This effect is somewhat less pronounced with income tax than with other fiscal instruments because the direct effect of higher taxes is to reduce personal disposable income, and hence the demand for M0 at given level of money GDP.) The beneficial effects on the current account are eventually slightly smaller than with fixed money GDP because the real exchange rate falls rather less.

6. As in the case of fixed money GDP, the lower PSBR will be associated with a higher real exchange rate if it is viewed as a signal that the overall stance of policy will be tightened in the future. This is shown in the lower panel of Table C2. The higher exchange rate gives a bigger gain in terms of lower inflation but also reduces the extent of the improvement in the current account. The effect of differing confidence assumptions is less in the case of fixed M0 than with fixed money GDP; an expected reduction in M0 growth implies less of a tightening of policy than the same reduction in future money GDP growth because it means higher interest rates than otherwise, and thus higher velocity.

ANNEX D: MONEY GDP GROWTH IN THE OCTOBER FORECAST

1. The path of money GDP in the October forecast was significantly different from that set out in the MTFS. The growth rate in 1986-87 was put over 1 point lower than at budget time, largely reflecting weaker world activity. But after a rebound in 1987-88, taking the level of money GDP close to that in the MTFS, the growth rate was forecast to increase yet further in 1988-89. The details are set out in table D1.

Table D1: Money GDP growth in the October forecast and the MTFS

% per annum	1985-86	1986-87	1987-88	1988-89
MTFS	9.6	6.8	6.4	6.0
October forecast	9.6	5.5	7.3	8.0

2. The stance of fiscal policy as measured by the PSBR ratio was the same in October as in the MTFS. The paths of M0 were also similar, as shown in table D2. But from 1987-88 onwards the level of interest rates was significantly higher in October. The October forecast thus incorporated an ex ante boost to nominal demand which was offset partially, but not wholly, by higher interest rates. To some extent this reflected the removal of adjustments made to the January internal forecast in order to prepare the MTFS projection, rather than a change of judgement by the forecasters.

3. Although the higher interest rates in the October forecast were sufficient to bring M0 growth more or less back to the track in the MTFS projection, the resulting increase in velocity meant that money GDP growth remained above the MTFS path. In order to have brought money GDP growth back to track it would have been necessary to raise interest rates, with the consequence that M0 growth would have been at or below the bottom end of its target ranges.*

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* The target ranges were set on the assumption that nominal interest rates would fall over the MTFS period, and hence velocity would rise at less than its trend rate.

Table D2: M0 and interest rates in the October forecast and the MTFS

	1985-86	1986-87	1987-88	1988-89
Growth of M0 (% pa)				
MTFS	4.4	2.6	3.9	4.9
October	4.4	3.8	3.9	4.5
Target Range		2-6	2-6	1-5
Short term interest rates (%)				
MTFS	12.1	11.3	9.7	8.5
October	12.1	10.5	11.0	11.0

4. An attempt has been made to assess the main factors underlying the increase in money GDP growth between the October forecast and the MTFS. Inevitably it is not possible to isolate all the differences of judgement and environment which have contributed, so the focus has been on a limited number of important variables. These are:

- a lower path for the exchange rate
- faster growth of real earnings
- lower private net saving†

Differences in these variables from 1987-88 onwards between the October forecast and the MTFS are set out in table D3.

Table D3: Changes between the MTFS and the October forecast

	1987-88	1988-89
Exchange Rate (%)	-5.9	-7.0
Real Earnings (% growth over pay round*)	+1.1	+1.3
Private Net Saving** (% of GDP)	-0.6	-0.8

* Nominal earnings growth over the pay round less the rate of RPI inflation at the beginning of the round (Q3)
** Change since 1986-87

† Saving less investment.

5. The effects of these changes have been evaluated by means of simulations on the assumption of fixed growth in M0 and a fixed PSBR ratio. This provides an assessment of their contribution to the difference in money GDP growth and the path of interest rates, and the results are set out in table D4. But inevitably this is a rather approximate exercise, designed to illustrate the orders of magnitude of the main factors involved. By its nature it cannot provide an exact analysis of all the influences on the money GDP forecast.

Table D4: Contributions to changes in money GDP and interest rate forecasts

	1987-88	1988-89
Money GDP growth (%)		
Total change	+0.9	+2.0
Exchange rate	+1.3	+1.7
Real earnings	+0.2	+0.7
Net private saving	+0.9	+0.4
Interest rates (%)		
Total change	+1.3	+2.5
Exchange rate	+0.4	+1.5
Real earnings	+0.3	+0.5
Net private saving	+0.5	+0.9

6. The factors identified all add to the growth rate of money GDP over the timescale of the October forecast. The effect of the lower nominal exchange rate arises mainly from higher prices. Higher real earnings growth raises money GDP because it arises from higher nominal earnings growth. Lower net saving raises money GDP growth because it arises from higher expenditure.

7. The most important single factor is the lower exchange rate. This alone accounts for the bulk of the difference since the MTFS in the money GDP growth forecast for 1988-89. Taken together, the factors identified appear to over-explain the difference in forecast money GDP growth, though note that they are not strictly additive. There are, of course, other changes between the October forecast and the MTFS which will have tended to reduce money GDP growth.

8. Two of these offsetting factors can be readily identified. First, world activity is expected to be lower in 1986 than in the FSBR. Although growth in 1987 is now forecast to be higher than before, the level remains below that underlying the MTFS projections throughout the medium term. The revised view in the October forecast implies a less buoyant world economy than in the MTFS, tending to reduce money GDP growth over the period as a whole.

9. Second, there were different assumptions about trade performance. The MTFS took a more favourable view about the extent of the improvements in trade performance compared with long-term trends, for given levels of competitiveness and domestic demand in the UK and abroad. This implies that the October forecast had larger balance of payments deficits (smaller surpluses) on this account than the MTFS, contributing to lower rather than higher money GDP.

10. In conclusion, there are a number of factors which have pushed up the growth of money GDP in the October forecast relative to the path in the MTFS. This increase has occurred even though M0 growth was assumed to remain on broadly the same track, because higher interest rates mean higher velocity. The main factor appears to have been the lower nominal exchange rate, though different judgements on earnings and private saving have also made a noticeable contribution.

ANNEX E: ERRORS IN MEDIUM-TERM PROJECTIONS

This Annex looks at the errors in past medium-term projections of money GDP growth, inflation and output growth in the three internal forecasts undertaken in the autumn (A), winter (W) and summer (S) of each year. The MTFS projections are omitted because of their rather stylised nature.

2. The errors in forecasting money GDP growth, output growth and inflation are shown in Charts 1-3 and summarised in Table E.1. In each chart, the horizontal line shows the actual outturn for each variable for the year indicated on the vertical axis. The dotted lines show the values forecast for each variable by internal forecasts up to 4½ years ahead. The forecast errors are thus given by the gaps between the solid horizontal lines and the dotted lines. Table E.1 summarises the results; the upper panel shows average forecast errors for each variable, while the lower panel, showing root mean squared errors, gives an indication of the degree of uncertainty about each forecast (high numbers indicate greater uncertainty).

3. The important features displayed in the charts and table are the following:

- inflation has been over-estimated and output growth underestimated on average

- these errors have not entirely offset each other in forecasts of money GDP growth which have been too high on average

4. An important part of the explanation of the over-estimation of inflation and under-estimation of output growth in the early 1980s was that productivity growth was under-estimated. In more recent years the under-estimation of output growth seems to have been associated with the under-estimation of public consumption, private investment and world activity (and hence exports).

Table E.1

Errors in Medium-Term Projections[1]

(percentage points)

	Same year	One year ahead	Two years ahead	Three years ahead
Mean error				
Money GDP growth	-0.5	0.3	0.6	1.5
GDP deflator growth	0.1	1.2	2.1	3.5
Real GDP growth	-0.5	-0.8	-1.6	-1.7
Root mean squared error				
Money GDP growth	0.6	1.1	2.1	1.7
GDP deflator growth	0.5	1.8	2.8	3.8
Real GDP growth	0.7	0.9	1.7	1.9

(1) Averages of all internal summer, autumn and winter forecasts made in each financial year for financial years 0, 1, 2 and 3 years ahead. The averages include 12 observations: 3 forecasts a year for 4 years. Thus the average for same year projections includes forecasts made in 1982-83 to 1985-86 inclusive, and that for three year ahead projections includes forecasts made in 1979-80 to 1982-83.

Chart 1: Actual and Forecast Nominal GDP
(% Change)

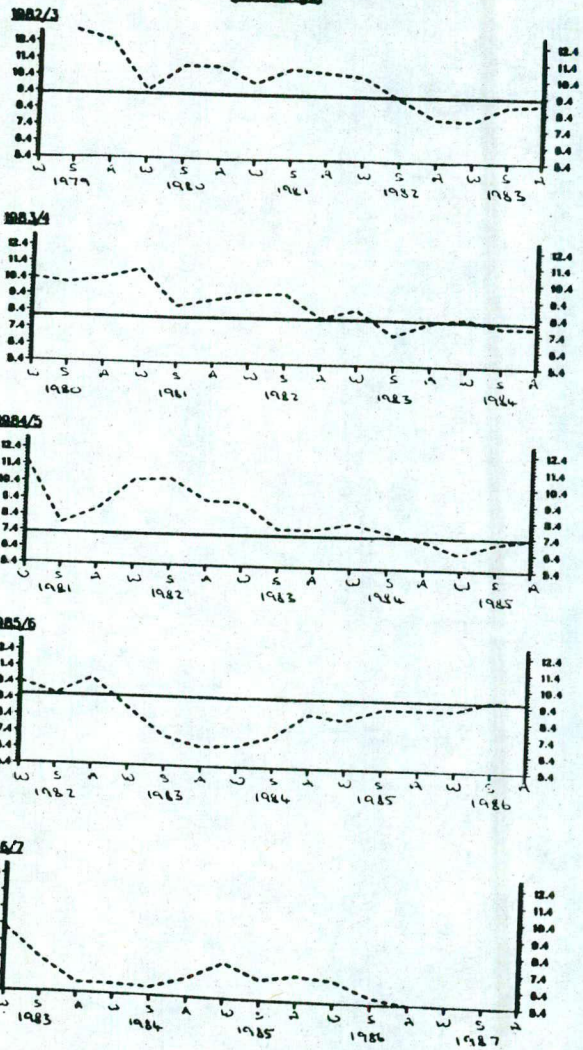


Chart 2: Actual and Forecast Real GDP
(% Change)

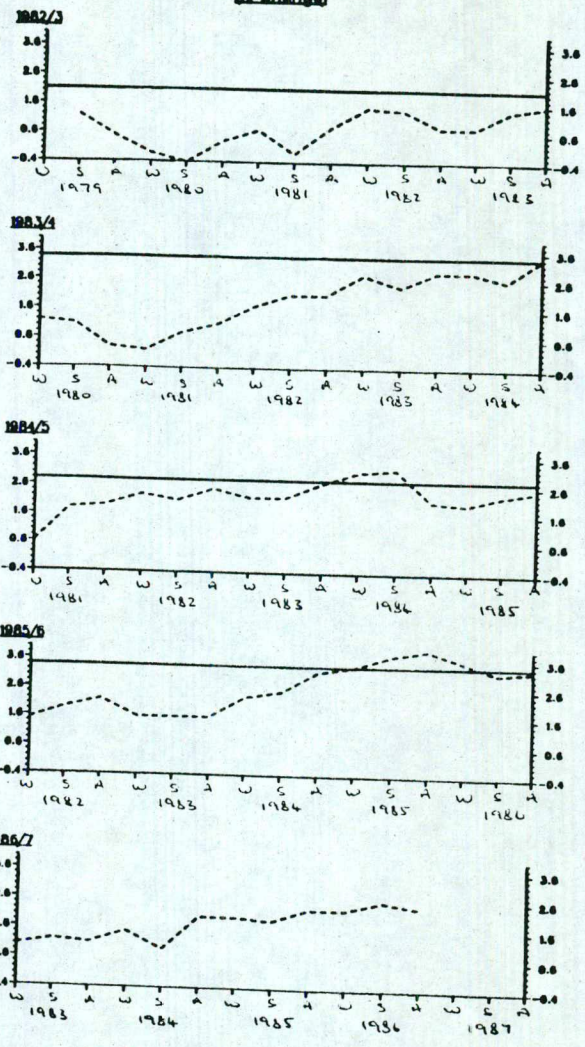
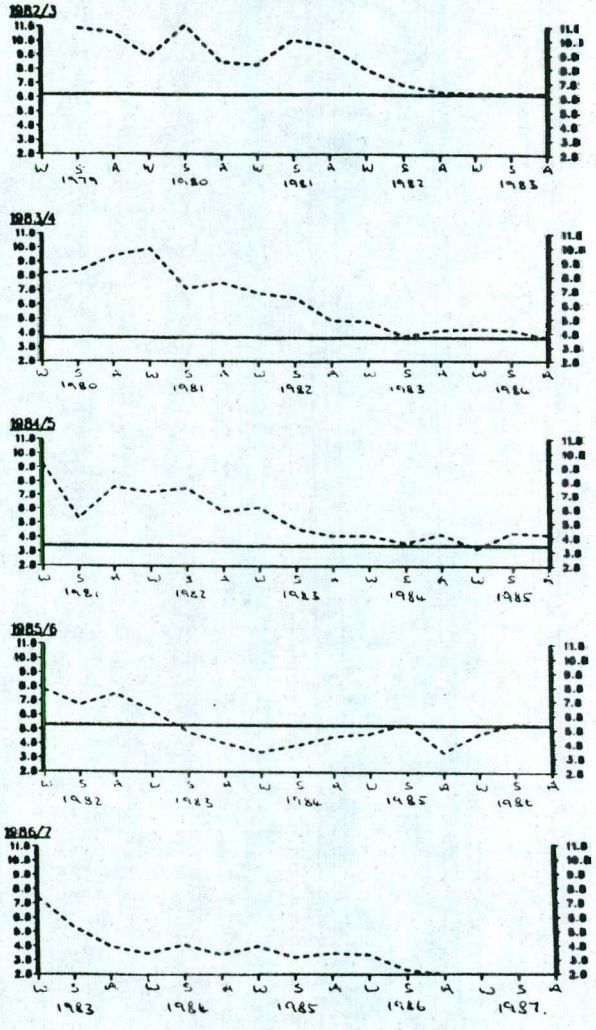


Chart 3: Actual and Forecast GDP Deflator
(% Change)



E3

ANNEX F: INDICATORS OF MONETARY CONDITIONS

The table below shows movements in the main indicators of monetary conditions:

	M0 growth (%)	£M3 growth (%)	Growth of credit[1] (%)	Exchange rate (1975=100)	House price inflation[2] (%)
1980-81	7.1	17.1	19.0	98.2	18.7
1981-82	5.2[4]	15.5	17.3[3]	92.3	5.5
1982-83	2.7[4]	10.4	21.7[3]	88.0	4.6
1983-84	6.2	10.9	17.4	83.5	10.5
1984-85	5.5	9.2	17.8	76.2	8.3 (7.8)
1985-86	4.2	13.4	18.0	79.0	8.2 (8.5)
Latest observation	4.9[5]	18.3[5]	19.5[5]	68.3[6]	21.5(13.6)[5]

[1] Bank and building society lending

[2] Percentage increase in DoE New House Price (Completions) Index. Halifax Index in brackets

[3] Affected by change from banking to monetary sector in 1981 Q4

[4] Adjusted for change in bankers' balances in 1981

[5] Twelve months to October

[6] 11 December

ANNEX G: INDICATORS OF FISCAL STANCE

This annex looks at recent movements in the PSBR and various other factors affecting the fiscal stance; and it traces some of the revisions made to the PSBR path in successive versions of the MTFS. Since there is no uniquely correct measure of fiscal stance, a number of alternatives are considered. Table G1 presents figures for the PSBR and the PSFD with a number of possible adjustments.

2. The main adjustments, shown in the upper part of the table, are for privatisation proceeds, other essentially capital transactions and North Sea revenues. The increase in the privatisation programme is reflected in a rise in proceeds from ¼% of GDP in 1979-80 to 1¼% in 1986-87 and future years. There has also been a small rise in other essentially capital transactions; these include net sales of council houses, land, and other existing buildings, and some net lending. By 1988-89 this item is not expected to be any higher than in 1980-81. However it remains nearly ½% of GDP, whereas in the 1950s and 1960s it was probably closer to zero if not negative.

3. North Sea revenues rose from 1% of GDP in 1979-80 to $3\frac{3}{4}$% in 1984-85, and are now near to 1% again. The transitory component is, of course, somewhat less than this. But the gap between total revenues and the transitory adjustment has decreased over time as a high proportion of the permanent income from the North Sea can be provided out of the interest "earned" from earlier "saving" of transitory revenue.

4. The PSBR has fallen from about 5% of GDP in 1979-80 and 1980-81 to around 2% in 1986-87. But the increase in privatisation proceeds and other capital transactions mean that the fall in adjusted PSBRs is rather less. Excluding privatisation proceeds, the PSBR is expected to decline from 5% to 3%. As transitory revenues from the North Sea (including notional interest savings) are now roughly equal to their level in 1980-81 they do not change the overall picture. Taking all these adjustments together suggests an underlying PSBR of the order of 4½-5% of GDP in 1986-87.

Table G1: Fiscal Indicators in Recent Years

% of money GDP	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	Autumn Statement 1986-87	October Forecast 1987-88	1988-89	1989-90
PSBR	**4.8**	**5.4**	**3.3**	**3.1**	**3.2**	**3.1**	**1.6**	**1.9**	**1.7**	**1.6**	1.5
Essentially capital transactions*	...	0.6	0.8	0.9	1.2	1.4	1.5	1.8	1.7	1.5	1.4
of which privatisation proceeds	0.2	0.2	0.2	0.2	0.4	0.6	0.7	1.2	1.2	1.1	1.1
North Sea revenues:	1.1	1.7	2.5	2.8	2.9	3.7	3.1	1.2	1.0	0.9	0.9
Adjustment for transitory component**	0.5	1.1	1.9	2.3	2.4	3.3	2.9	1.0	0.9	0.8	0.8
Council house sales	0.3	0.3	0.5	0.7	0.5	0.4	0.3	0.3	0.3	0.3	0.3
PSBR adjusted for privatisation proceeds	5.0	5.6	3.5	3.3	3.6	3.7	2.4	3.1	3.0	2.7	2.6
PSBR adjusted for essentially capital transactions	...	6.0	4.1	4.0	4.4	4.5	3.1	3.7	3.4	3.1	3.0
PSBR adjusted for transitory North Sea revenues	5.4	6.5	5.3	5.4	5.6	6.4	4.5	2.9	2.6	2.4	2.4
PSBR adjusted for essentially capital transactions and transitory North Sea revenues	...	7.0	6.0	6.3	6.8	7.8	5.9	4.7	4.3	3.9	3.8
PSFD	**3.9**	**5.0**	**2.2**	**3.0**	**4.0**	**4.2**	**2.2**	**3.3**	**3.1**	**2.8**	**2.9**
PSFD adjusted for council house sales	4.2	5.3	2.7	3.7	4.5	4.6	2.5	3.7	3.4	3.2	3.2

* Riley adjustments ** Includes interest saving ... Not available

5. In the MTFS the unadjusted PSBR declines to 1½% of GDP in 1989-90. The various adjusted measures also show a decline, but remain above the unadjusted PSBR. When adjusted for all essentially capital transactions, the PSBR in 1989-90 is about 3% of GDP, 1% below the levels attained in 1981-83. However, North Sea oil revenues have declined over this period by more than 1 percentage point.

6. The PSFD moves in a braodly similar way to the PSBR adjusted for essentially capital transactions. Thus it fell from 4-5% in 1979-81 to 3¼% in 1986-87 and a little under 3% expected in 1989-90. Whereas it is above the PSBR now, in the 1950s and 1960s it was usually below it because of positive net lending and the absence of privatisation proceeds (Table G2). The PSFD adjusted for council house sales is projected to be 3¼% of GDP in 1989-90, compared with 2½-3% in the 1950s and 1960s. But Transitory North Sea revenues are still about $\frac{3}{4}$% of GDP in 1989-90.

Table G2: Fiscal Indicators: Period Averages
(Percent of money GDP)

	1952-55	1956-60	1961-64	1965-68	1969-73	1974-79	1980-81 to 1986-87
PSBR	3.2	2.4	2.5	3.3	1.9	6.6	3.1
PSBR adjusted for privatisation proceeds	3.2	2.4	2.5	3.3	1.9	6.7	3.6
PSFD	3.0	2.4	2.4	2.5	0.9	5.5	4.0

7. The PSBR is higher than envisaged in earlier versions of the MTFS. The 1980 and 1981 versions, for example, envisaged PSBRs of 1½% and 1% in 1983-84 and 1984-85 respectively (Chart G1). But in more recent version, the paths for the unadjusted PSBR have not changed much, particularly from 1985-86 onwards. However, the path of the PSBR adjusted for privatisation proceeds has been revised upwards fairly steadily since the 1982 MTFS (see Chart G2).

CHART C1

PSBR AS A PERCENTAGE OF GDP AT MARKET PRICES OUTTURN AND PLANS

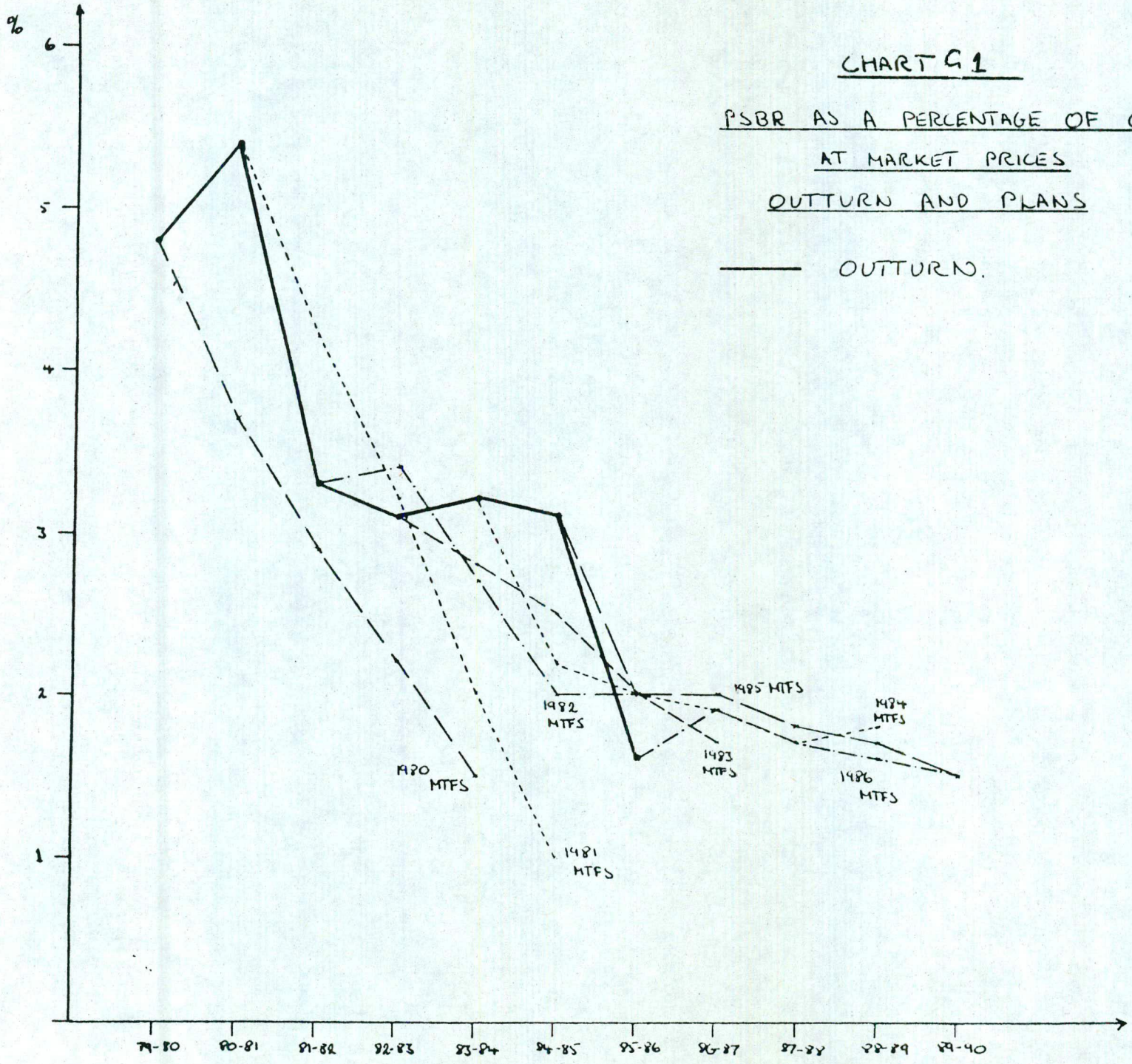
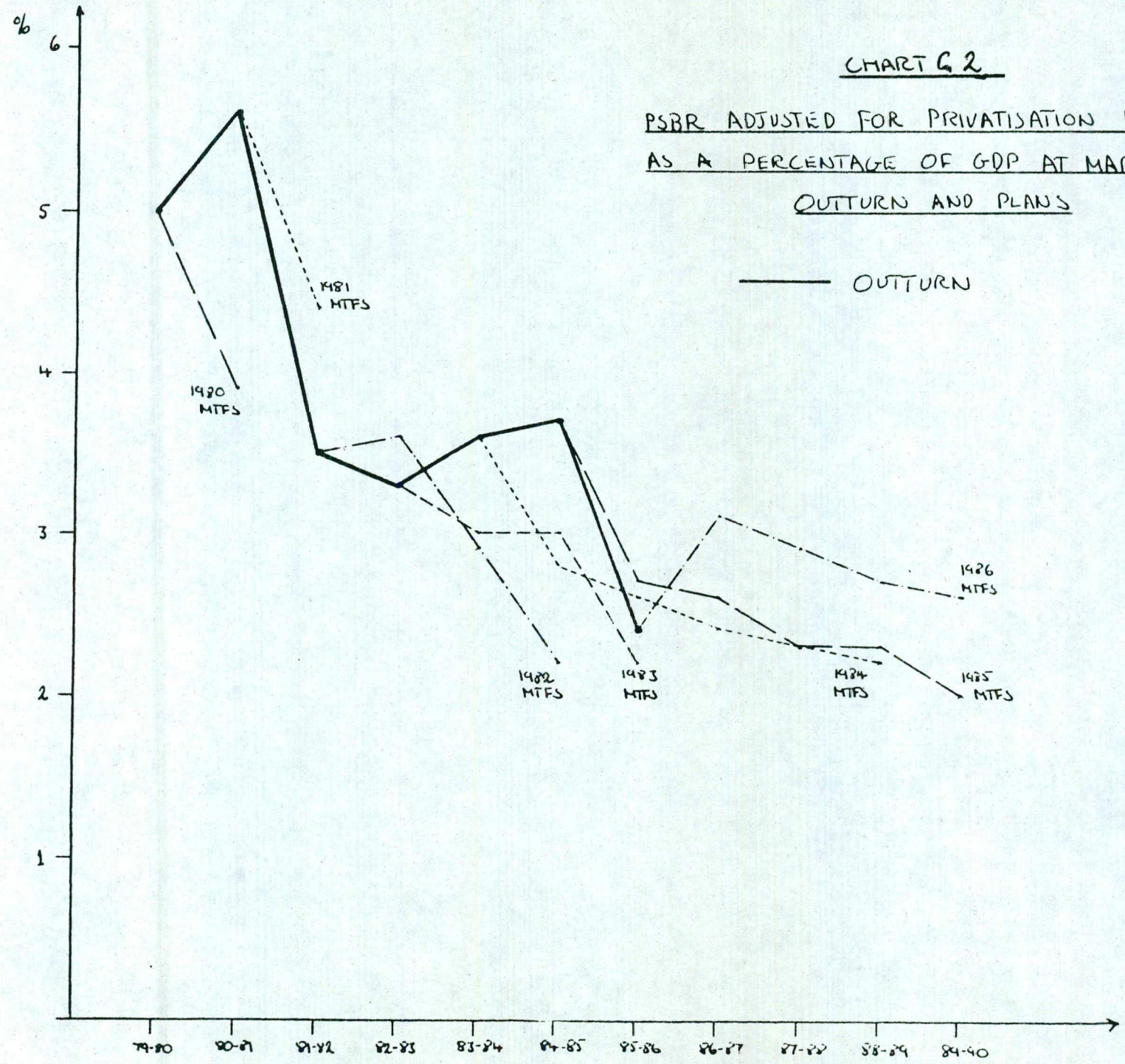


CHART G 2

PSBR ADJUSTED FOR PRIVATISATION PROCEEDS
AS A PERCENTAGE OF GDP AT MARKET PRICES
OUTTURN AND PLANS



ANNEX H: SECTORAL FINANCIAL BALANCES

Assessment of the appropriate stance of fiscal policy, given the objective for growth of money GDP, involves taking a view on the private sector's likely net demand for financial assets. It also reflects a view of the implications for the current account, and hence the net financial surplus/deficit of the overseas sector. Figures for sectoral surpluses and deficits since 1960 are shown in table H1.

Table H1: Sectoral Financial Balances

Per cent of GDP	1960-64	1965-69	1970-74	1975-79	1980-84	1985	1986	1987	1988
Public sector	-2.5	-1.7	-2.2	-5.5	-3.7	-2.7	-2.8	-3.4	-2.9
Private sector	2.3	1.9	2.0	4.3	5.4	4.7	3.5	3.8	2.9
Overseas sector*	0.2	0	0.4	0.4	-1.3	-1.0	0	0.4	0.8
Residual error	0	-0.1	-0.1	0.8	-0.4	-0.9	-0.7	-0.7	-0.8
Growth of money GDP(%)	6.6	7.0	12.0	18.7	10.3	9.6	6.0	7.1	7.6

* A positive number for the overseas sector balance is equivalent to a deficit on the current account.

2. In the 1960s, the surplus of the private sector and the deficit of the public sector both averaged a little over 2 of GDP. Although the balance of payments appeared at the time to be a problem, the data we now have suggest that the scale of the problem was small ex post. In the 1970s, however, both the public sector deficit and the private sector surplus increased. The rise in private sector net saving reflected the rise in inflation and the growth of money incomes. The rise in the public sector deficit was rather greater, however, and this was reflected in a current account deficit averaging around ½% of GDP.

3. In the first half of the 1980s, the build-up of North Sea oil contributed to both a turnaround in the balance of payments and a reduction in the public sector deficit. Both were also affected by the tightening of fiscal policy. However, the private sector surplus rose further, in spite of lower growth in money GDP. This probably reflected continuing attempts by the private sector to rebuild real net financial assets following the erosion by inflation in the 1970s, as well as a reaction to the re emergence of positive real interest rates.

4. There are signs that the private sector surplus is falling back somewhat in 1986, and the October forecast suggests a further reduction to about 3% by 1988 - around 1 point higher than in the 1960s. But this is not likely to be matched by an equivalent fall in the public sector deficit, given the PSBR path in the MTFS. The PSFD is forecast to remain around 3% of GDP in 1988, also around 1 point higher than in the 1960s. The counterpart to these movements is a deterioration of the current account worth nearly 2% of GDP between 1985 and 1988.

5. Movements in the sectoral surpluses and deficits are, of course, subject to measurement errors which mask underlying trends, particularly in the recent past. At present, measured aggregate expenditure is lower than aggregate income by $\frac{3}{4}$-1% of GDP, and it seems probable that <u>either</u> net exports and the current account are higher than recorded <u>or</u> the growth of domestic expenditure is higher.* But even if, as is possible, the current account is actually somewhat stronger than it appears, and hence the forecast is perhaps a little on the pessimistic side, the picture of a turnaround from sizeable surplus to deficit is almost certainly robust.

6. It is possible to shed further light on the situation by examining the balance sheets of the different sectors, and in particular their net financial worth. The data from 1960 are summarised in table H2.

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* It seems less likely, given movements in the output measure of

Table H2: Net Financial Worth by Sector

Percent of GDP	1960	1963	1966	1969	1974	1979	1984
Public sector	-98.9	-93.2	-78.3	-66.7	-42.3	-35.7	-36.8
Private sector	+102.7	+98.4	+82.7	+73.3	+45.5	+41.5	+60.6
Overseas Sector	-3.8	-5.2	-4.4	-6.6	-3.2	-5.8	-23.8

7. In the 1960s and the 1970s the private sector's net financial worth fell sharply as a share of GDP, matched by a falling share of public sector net debt. These changes reflect net saving/borrowing behaviour, the growth of money GDP, and revaluations of existing assets and liabilities. In the 1970s, inflation and rapid growth of money GDP played a relatively more important role than in the 1960s. In the 1980s, the private sector has rebuilt its net worth somewhat as a share of GDP. The main counterpart has been a rising share of net overseas assets, with little change in the share of net government debt.

8. Now that the growth of money GDP is expected to be close to the rates experienced in the 1960s, it may help to consider how changes in net financial positions since then might affect the pattern of financial surpluses and deficits. However this is far from straightforward.

9. One could argue that lower net financial worth of the private sector is likely to mean lower net surpluses in the future than in the 1960s. Despite the recent rise in private net financial worth, there would be no attempt to get back to the high levels of the 1960s, which were a legacy of enforced war-time saving. Lower net surpluses in future would be consistent with the observed switch in the pattern of investment since the 1960s, with private investment in dwellings and other assets having risen as a share of GDP with a largely offsetting fall in public investment. Insofar as this position is sustained, the public sector deficit would have to be lower than on average in the 1960s in order to maintain external balance.

GDP, that income growth has been lower.

10. But alternatively, the private sector may wish to continue rebuilding its net financial worth as a share of GDP as compensation for past inflation and to take advantage of high real interest rates, whereas in the 1960s the share was being reduced. That might point to higher private surpluses and higher public deficits now than in the 1960s.

11. Overall, the data we have do not allow a firm conclusion on this issue.

ANNEX I: THE STRUCTURE OF EXPENDITURE

There has been one long cycle over the last 30 years in the overall structure of expenditure. Total private plus public consumption accounted for 83½% of GDP in 1955-59, then fell gradually and remained at a fairly constant 81% from the mid-1960s to the late 1970s, since when it has risen and is expected to reach 83½% again this year (Table I1). Total investment, defined to include stockbuilding and net exports of goods and services, has moved in the converse direction: a rise then a fall.

2. Within total consumption there was a steady shift away from private to public consumption until 1981 when the private share of the total was only 73½%, compared with 80% in 1955. In recent years this has been reversed as the rise in public consumption levelled off at 21%-22% of GDP and private consumption grew more rapidly than GDP. The share of private in total consumption is forecast to have risen to 74½% this year.

3. The rapid growth of private consumption recently is illustrated in Chart I1, which shows growth rates over five-year periods up to the years shown. The growth rate of 3.1% over the five years to 1986 has been exceeded on only four occasions (on a five year basis) during the previous 25 years: twice in the early 1960s and twice in the early 1970s. If the October forecast for consumers' expenditure in 1987 and 1988 is correct, the five-year periods ending in these years will see growth rates greater than in any five-year period since 1960. On the other hand recent and forecast annual growth rates are not without precedent having been exceeded in both the early and late 1970s, and more or less matched in certain years during the late 1950s and early 1960s. The difference with recent and forecast growth is that it is on a more sustained basis.

4. There have also been some changes in the composition of total investment. The main differences between the 1950s and 1960s and now are:

- a fall in the share of stockbuilding by 1 percentage point of GDP, probably reflecting a structural change in desired stock-output ratios

- a fall in the public sector's share of total fixed investment, from 40% in 1960-64 to 20% in 1986*.

On the other hand the shares of both fixed investment and net exports in GDP are very similar, despite considerable fluctuations in the meantime.

5. There are various features of these figures on the current structure of expenditure in relation to past trends that are relevant for the consideration of policy:

- fixed investment and stockbuilding are not historically high relative to GDP, while the forecast share of total (private and public) consumption tends in the opposite direction. The forecast share of fixed investment indicates the possibility that output and employment growth over the medium term could be constrained by capacity shortages

- at the same stage the forecast trend in net exports will have to be reversed. If the pressures for higher public expenditure limit the practical scope for reducing the share of public consumption in GDP, and the share of fixed investment is not to fall, then a shift of resources into the balance of payments would necessarily require a lower share of private consumption in GDP.

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* In the absence of council house sales and privatisation the 1986 share of public sector investment in GDP would have shown a much smaller change compared to the early 1960s. Privatisation alone accounts for a switch from the public to the private sector of over ½% of GDP in 1986.

Table I1

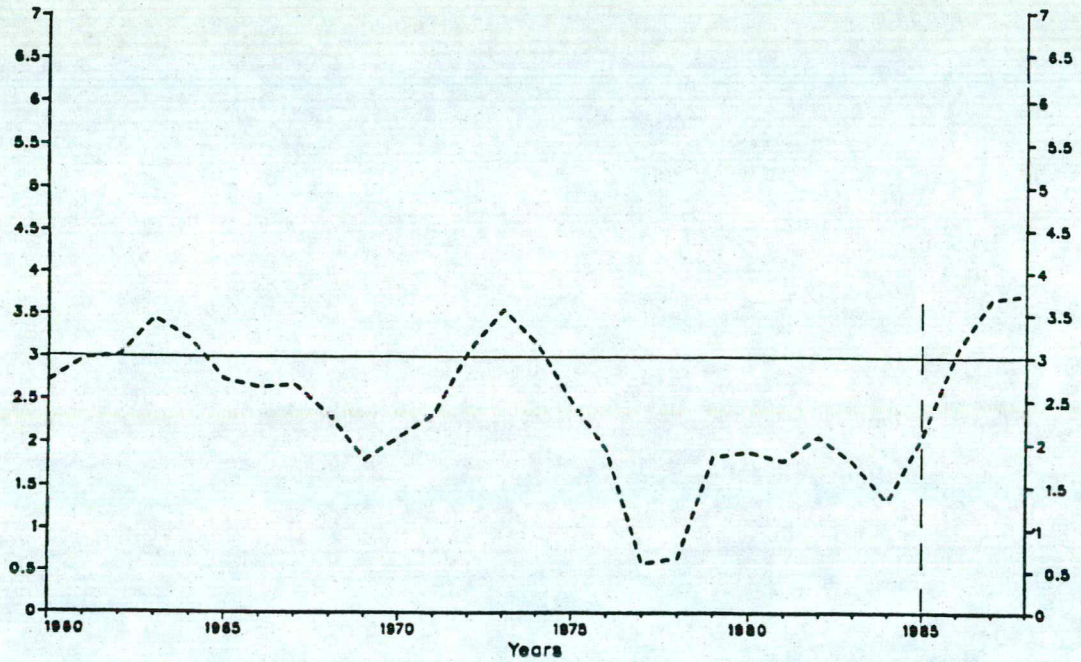
Structure of Total Expenditure

(percent of GDP(E) at current market prices)

	1955-59	1960-64	1965-69	1970-74	1975-79	1980-84	1985	1986	1987
Consumers' expenditure	67.0	65.9	63.5	62.6	60.1	60.4	60.6	62.2	62.5
Government consumption	16.6	16.7	17.3	18.3	20.6	21.7	21.1	21.3	21.3
Total consumption	83.6	82.6	80.8	80.9	80.7	82.1	81.7	83.5	83.8
Domestic fixed investment	15.5	17.2	18.8	19.4	19.0	16.9	17.1	17.3	17.1
of which:									
public sector	6.6	6.9	8.3	7.8	6.8	4.5	3.5	3.5	3.0
private sector	8.9	10.2	10.5	11.6	12.2	12.3	13.6	13.8	14.1
Stockbuilding	1.0	1.2	1.0	0.9	0.6	-0.5	0.2	0.2	0.4
Net exports	-0.1	-0.9	-0.6	-1.2	-0.3	1.5	1.1	-0.9	-1.3
GDP	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Components may not sum to totals due to rounding

Chart I.1: Real Private Consumption (% Changes)
:- 5-Year Moving Average



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ANNEX J: INTERNATIONAL COMPARISONS

This Annex contains data for the main industrial countries for real interest rates, fiscal deficits, government debt, current account deficits and consumption.

Real Interest Rates

2. The real interest rates in Table J.1 are measured, for both short and long rates, as nominal interest rates less the rate of growth of the consumer expenditure deflator over the previous year. There is a general pattern of low real interest rates in the 1970s and high rates in the 1980s, although German rates remained relatively high in the 1970s. The UK experienced more negative rates than elsewhere in the second half of the 1970s, and has higher real short-term, but not long-term, rates now.

Fiscal Deficits

3. The general government financial balances are shown in Table J.2 as percentages of GDP or GNP. Deficits and surpluses were generally small until the mid-1970s, since when all countries have experienced large deficits. Italy has a longer history of a large deficit, and its deficit since the mid-1970s has been an order of magnitude greater than elsewhere.

4. There has been some decline in recent years in deficits, especially in Germany and Japan. The decline in the UK is less marked, being partly obscured by the coal strike and other short-term factors. The decline in the public sector financial deficit has been greater than that in the GGFD in the UK, as the public corporations' deficit, which was 1.1% at its peak in 1980, has been eliminated; and the decline in the PSBR has been greater still, mainly because of the rise in privatisation proceeds.

Government Debt

5. All countries except the UK have experienced rising net debt/income ratios (Table J.3). The level of the ratio is higher in the UK than elsewhere, except Italy, which is why the UK can have higher than average deficits and still achieve a falling debt/income ratio.

Balance of Payments Current Account

6. Most G7 countries have experienced relatively small surpluses or deficits, less than 1% of GDP, in most periods (Table J.4). Apart from the present disequilibrium between the US, Japan and Germany, the main exceptions have been the surpluses of Germany in the 1960s and early 1970s and the UK in the 1980s, and the Canadian deficit of the late 1970s. Non-G7 OECD countries have often had larger surpluses and deficits.

Consumption

7. The growth of private consumption in the UK was until recently below that in other countries, reflecting the lower overall growth rate. However, forecasts of the growth of consumption over the 5-year periods ending in 1987 and 1988 show a faster rise in the UK than elsewhere (Chart J.1).

Table J.1

Real Interest Rates

(per cent)

	1965-69	1970-74	1975-79	1980-84	1985	1986
Short-term rates[1]						
US	1.6	-0.2	-1.4	3.4	4½	3¾
Japan	1.8	-2.9	-0.5	3.8	4¼	4½
Germany	2.7	3.2	0.6	3.9	3½	5
France		1.1	-1.5	2.1	4½	5
UK	3.2	-0.5	-5.1	3.0	7	7
Long-term rates[2]						
US	1.8	0.7	0.3	4.9	7	5½
Japan	1.7	-3.4	0.5	4.1	4½	4¼
Germany	4.7	3.3	3.0	4.2	4½	6¾
France	2.3	0.7	-0.8	3.0	5	6
UK	3.1	0.9	-2.3	3.0	4½	6½

(1) In most cases 3-month interest rates less rate of growth of the consumer expenditure deflator.

(2) Yield to maturity on medium-/long-term government bonds less rate of growth of the consumer expenditure deflator over previous year.

Table J.2

General Government Financial Balances
(Per cent of GDP/GNP at market prices)

	1965-69	1970-74	1975-79	1980-84
US	-0.4	-0.6	-1.3	-2.5
Japan	-0.5	0.9	-4.1	-3.5
Germany	-0.3	-0.1	-3.3	-2.9
France*	0.1	0.8	-1.2	-2.1
UK*	-1.0	-0.6	-4.0	-3.2
Italy*	-2.8	-7.6	-9.6	-11.4
Canada		0.8	-2.3	-4.6

	1979	1980	1981	1982	1983	1984	1985	1986	1987
US	0.6	-1.3	-1.0	-3.5	-3.8	-2.7	-3.4	-3.4	-2.3
Japan	-4.8	-4.4	-3.8	-3.6	-3.7	-2.2	-1.4	-1.5	-1.4
Germany	-2.6	-2.9	-3.7	-3.3	-2.5	-1.9	-1.1	-1.0	-0.9
France*	-0.7	0.2	-1.8	-2.7	-3.1	-2.9	-2.6	-2.9	-2.7
UK*	-3.5	-3.5	-2.8	-2.4	-3.6	-3.9	-2.6	-2.8	-2.9
Italy*	-9.5	-8.0	-11.9	-12.6	-11.7	-13.0	-14.0	-12.7	-12.2
Canada	-1.8	-2.8	-1.5	-5.7	-6.6	-6.6	-6.6	-5.4	-5.3

*Per cent of GDP; others GNP

Table J.3

General Government Net Debt

(per cent of GDP/GNP at market prices)

	1974	1979	1984	1985
US	22.2	19.8	26.0	28.1
Japan	-5.1	14.8	26.4	26.2
Germany	-4.7	11.5	23.0	23.1
France*	8.8	9.8	15.1	16.6
UK*	54.9	48.7	49.0	47.8
Italy*	49.2	65.5	91.0	95.7
Canada	1.0	12.3	30.0	33.9

*Per cent of GDP; others GNP

Table J.4

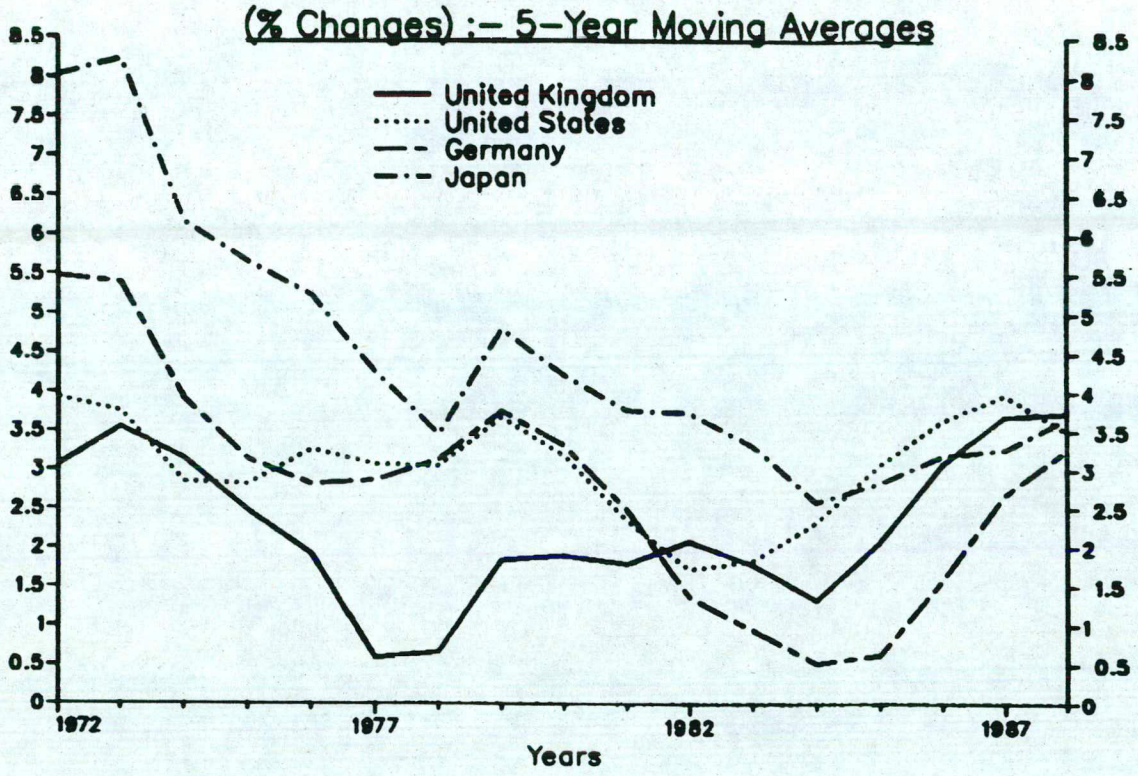
Balance of Payments Current Accounts

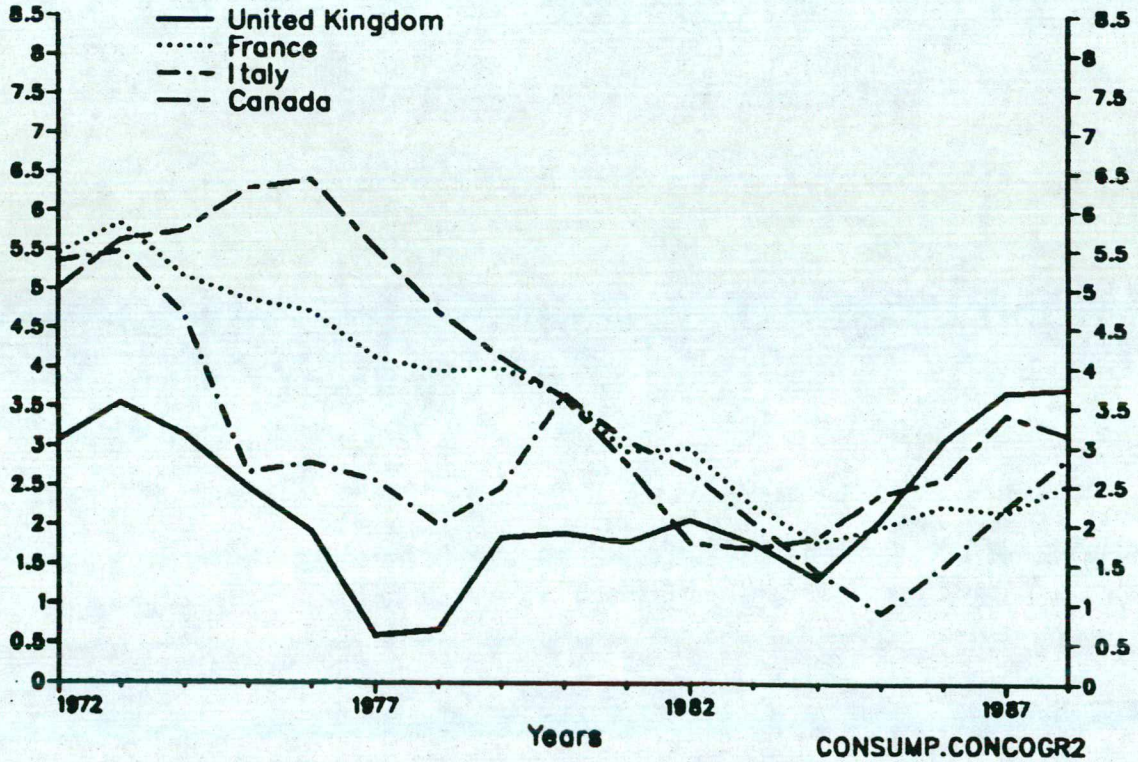
(Per cent of GDP/GNP at market prices)

	1965-69	1970-74	1975-79	1980-84	1985	1986	1987
US	0.3	0.0	0.0	-0.8	-3.0	-3.3	-3.1
Japan	0.8	0.9	0.6	0.9	3.7	4.3	3.7
Germany	0.2	1.1	0.7	-0.1	2.1	4.2	3.4
France*	-0.3	-0.1	0.4	-1.0	0.1	0.5	0.3
UK*	0.0	-0.3	-0.4	1.3	1.0	0.1	-0.4
Italy*	2.9	-0.4	0.6	-1.4	-1.1	1.8	1.7
Canada	-1.1	0.1	-2.2	-0.1	-0.6	-1.6	-1.2

*Per cent of GDP; other GNP

Chart J 1: Real Private Consumption Growth (% Changes) :– 5–Year Moving Averages





MONETARY BULLETIN

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Why Does The Chancellor Lack Credibility?

A Talk by Gordon Pepper to the Forex Association London on 2nd December 1986

I start by outlining Mr. Lawson's case, and then go on to that of the market place, before I attempt to reconcile the two differing views.

An historian dispassionately analysing the evidence to date is almost bound to reach the conclusion that Mr. Lawson has gone out of his way to explain how monetary policy is being operated in practice, and how it has evolved, probably more so than any previous Chancellor. He should be given credit for it.

A lot of evidence is contained in the annual "Red Book" - the Financial Statement and Budget Report - that accompanies each budget. The original statement of the Medium Term Financial Strategy was in 1980; it has been updated each year since then. An examination of the sequence of updates shows that policy has not chopped and changed but that there has been a continued drift, the possibility of which was clearly envisaged in 1980, both from broad to narrow money and towards greater emphasis on the exchange rate, especially the latter when data for the money supply are suffering from distortion.

Money Supply

In 1980, the Government said that "no single statistical measure of the money supply can be expected fully to encapsulate monetary conditions ..... in assessing monetary conditions, the authorities have to have regard to a range (of indicators)" and that "the way in which the money supply is defined for target purposes may need to be adjusted from time to time as circumstances change."

In 1981, the Government observed that "taken on its own £M3 has not been a good indicator of monetary conditions in the past year."

In 1982, a target was announced for narrow money, M1, as well as for broad money, £M3 and (PSL2). Narrow money was mentioned in second place.

In 1983, narrow money was mentioned first.

In 1984, it was stated that "broad and narrow money will have equal importance". This was later stressed in the Mansion House Speech. The previous year's speech had explained the change in the chosen measure of narrow money from M1 to Mo.

In 1985, narrow and broad money were again given equal weight. Later, in the Mansion House Speech, the Chancellor announced that he was "no longer seeking to control the recorded growth of £M3 by systematic overfunding" and that the target for £M3 "was clearly set too low."

Mr. Lawson elaborated on the March 1986 Red Book a few weeks later in his Lombard Association Speech. In this, he clearly highlighted Mo and downgraded £M3. Most recently, in his latest Mansion House Speech he stated that "neither broad money nor credit was a trigger for this week's rise in interest rates" and that the edging upward of the "more reliable" indicator Mo could not be ignored.

The detailed elaboration of the process of evolution has been given in a number speeches by the Chancellor. The most important of these were the 1983 Mansion House Speech, the 1984 Mais Lecture, the 1985 Mansion House Speech and the 1986 Lombard Association Speech.

Mr. Lawson's first Mansion House Speech in 1983 is, for example, well worth re-reading. The first part describes in detail the way in which policy had evolved under his predecessor, Sir Geoffrey Howe. He then "kite flew" the evolution to come. At the time I thought this part muddled but with the benefit of hindsight it becomes clear; for example, the decision not to overfund persistently and, if need be, to downgrade £M3, had already been taken.

Exchange Rate

The growth in the importance attaching to the exchange rate was also reported and discussed in very much the same way as the switch in emphasis from broad to narrow money.

As early as 1982, the Government explained how the exchange rate becomes crucially important when the monetary aggregates are known to be distorted. A fall, or a rise, in sterling is often the result of an easing, or a tightening, of monetary pressure in the UK relative to that abroad. So, the exchange rate can indicate a change in monetary pressure but its movements must be interpreted very carefully; they may arise from non-monetary causes.

Most recently we have seen that sterling can fall out of fear of a Labour Government or as a consequence of a fall in the price of oil. In these cases, it is not serving as an indicator of monetary pressure. This is why there can be no simple formula relating the exchange rate with monetary conditions. This point has been stressed again and again in Mr. Lawson's speeches.

Mr. Lawson has also explained that a large fall in the exchange rate for non-monetary reasons cannot be ignored, because of its direct impact on the price level. This is because a shock to the price level can easily translate into a rise in inflation, i.e. continuing increases in the price level. In other words, the authorities must make quite sure that monetary policy does not accommodate a rise in inflation the proximate cause of which is not monetary.

Mr. Lawson has also explained that the exchange rate can be very important for the timing of interest rate changes. His Lombard Association Speech gives four examples but stresses that, except in the short run, the objective is to deliver the monetary conditions which will reduce inflation.

After examining the evidence, a dispassionate observer from outside the City would most probably conclude that Mr. Lawson has done almost everything that might be expected

of him to explain a complex situation. Sir Alan Walters, the Prime Minister's Economic Adviser, has also given a full account of policy during Mrs. Thatcher's first term of office in his book, Britain's Economic Renaissance, Oxford University Press, 1986. As Sir Alan dryly observes: "Alas, boring though it may be to media men, the authorities (broadly speaking) carried out the policy consistent with the principles that had been announced; it is odd that few believed them."

Mr. Lawson, having made a considerable effort to communicate, has become frustrated by his lack of success and has lashed out on two occasions. The first time was the reference in last year's Mansion House Speech to no change in policy being frightfully annoying for the young Turks who write brokers' circulars. His second outburst was in this year's speech: "There are, I know, those who still complain of being confused - and judging by what they write, some are indeed confused. But they are either simply complaining that the world is a complicated place, which sadly is all too true, and is something that grown-ups have to come to terms with; or else they are so wedded to confusion that it would be grossly improper to try and separate them from it."

Again, the dispassionate observer would probably conclude that Mr. Lawson's outbursts, although unwise, are an understandable reaction of a frustrated human being who is basically in the right.

Case of the Market Place

There is an old maxim in the City:

> Ignore what the authorities say;
> Watch what they do.

What, according to this view, has the outcome been?

The Government has persistently either missed the targets set in the Medium Term Financial Strategy (MTFS) or fudged the figures. Asset sales, both the sale of council houses and the privatisation issues, are responsible for the reductions which have occurred in the PSBR. Even more difficult to swallow, asset sales are classified as negative expenditure and are responsible for public expenditure rising by only a small amount in real terms. In the same vein, Mo has been substituted for sterling M3. Missing or fudging the announced targets in the MTFS has made the City very suspicious.

And the proof of the pudding is in the eating. The MTFS should have restored the financial system to health over the medium term. People believed that interest rates would fall and the exchange rate would become firm. Instead, long term interest rates stand at about the same level as in the fourth quarter of 1982, base rates are considerably higher (11% against a low of 9%) and the exchange rate has fallen by about 25% (excluding the gyrations of the dollar). The MTFS has not delivered the goods expected of it. This is the most important reason for the City's loss of confidence.

Confidence is particularly low at present. Base rates had to be raised in October from 10% to 11%, the prices of long dated gilt-edged stocks have fallen by 16% since their peak in April, and sterling's effective exchange rate has fallen since then by 11%. In short, the City's loss of confidence is fact and not fiction.

Reconciliation

The Government's switch from sterling M3 to Mo, a switch from broad money to transactions money, has impeccable academic credentials. The home of monetarism is the

US. Milton Friedman and Anna Swartz were the founders, with Alan Meltzer and Karl Brunner eminent in the field. Alan Walters, the pioneering UK monetarist, was also resident in the US in the late 1970s and in 1980. In Switzerland, too, there is a strong monetarist school with, for example, Jurg Niehans a leading protagonist. In the second half of 1980, when sterling M3 started to deviate from Mo and M1, they were virtually unanimous in stressing the importance of watching transactions money. Walters and Niehans are on record advising the Prime Minister that monetary policy in the UK was viciously tight, quite contrary to the perception of the City. For example, Walters observes in his book:

> "to any scholar who had studied monetary behaviour in countries other than the United Kingdom, this combination of statistics would have been construed as evidence that there had been a substantial and sharp monetary contraction".

Our own position may also be of interest. Our research work, analysing the period between 1920 and 1955, was based on the old series for M2, which was dominated by transactions money. We switched to current accounts with the clearing banks, i.e. to a proxy for M1, between 1956 and 1972 when the official monetary series started. Between 1972 and 1979 we focused on sterling M3. In February 1980 we switched back towards transactions money. Summarising, apart from the period 1972 to 1979, we have in fact concentrated from 1920 to date more on transactions money than on broad money (although our reasons were complex).

As far as the fall in markets is concerned, it is best to analyse sterling first, and to focus on sterling's non-dollar index to remove the gyrations of the dollar. This index has fallen almost continuously, declining by some 25% since its peak in July 1985.

The most important explanation was, of course, the fall in the price of oil. Its price in sterling terms reached a peak in March 1985. This morning it was 62% lower.

A fall in sterling of roughly the size which has occurred was absolutely essential to correct the impact of the reduced price of oil on the UK's balance of payments. The authorities clearly wanted sterling to depreciate.

The second, and associated explanation, for sterling's fall was the decline in UK interest rates, both short and long rates. Base rates were reduced from 12½% last March to 10% in May. Twenty year gilt yields fell from almost 11% to 8½%.

The main reason for the reduction in rates was that those in the US were falling fast and the UK authorities wished to make their contribution to preventing an international trade war. Their hope was that the UK, in following the US, would encourage the German and Japanese authorities to reduce their rates.

The overall effect was, however, a substantial reduction in UK rates relative to those in Germany and Japan, the two nations with huge balance of payments current account surpluses to invest. The margin in favour of the UK on short rates fell from 7.1% to 5.4% against Germany, and from 6% to about 5% against Japan. The differential for ten year bond yields against Germany came down from 5% in January to 3% in May, and against Japan from 5.1% to 3.5%. The reduction of these differentials discouraged inflows into the UK of both short and long term capital. It also encouraged an outflow from UK investors.

The third explanation for sterling's fall was fear of a Labour Government and the publicity the Labour Party was receiving. Indeed, my own firm has been accused of starting the run on sterling because we hosted a dinner in New York in September to introduce Mr.

Hattersley to US institutional investors. It appears that they voted not with their feet but with their funds!

These three explanations taken together are fully capable of explaining sterling's fall. There is scarcely need for a fourth - the loss of confidence in Mr. Lawson.

This is probably the point to introduce one of my pet hobby horses. The behaviour of markets often determines confidence. My profession, stockbroking, and I suspect yours, has an unlimited ability to invent explanations for things we failed to predict. We have to have an explanation for the recent behaviour of our market or else we lose face. We invent an explanation, repeat it many times and end up believing it ourselves. Further, as I tease my friends at the FT, they too are human. If markets are rising, good news tends to appear on their front page and bad news on inside pages, and headlines tend towards the optimistic. If markets are falling, bad news appears on the front page, and headlines are pessimistic. The resulting tone of the financial press has a very important influence on confidence.

My point is that, because of the recent fall in markets, a lack of confidence in the Chancellor is absolutely inevitable. This does not, however, dismiss the case against Mr. Lawson because the causality can, of course, also run from confidence to the behaviour of markets, as well as the other way. What evidence is there in the gilt-edged market that the loss of confidence is independent of the behaviour of the level of markets?

One danger sign is the way in which the gap between the yields on conventional and index-linked gilt-edged stocks has widened. This gap should be a direct measure of inflationary expectations. The yield difference between 13½% Treasury 2004/08 and Index-Linked Treasury 2006 has widened from 5% in April to over 7% now.

Closer investigation shows, however, that the yield on the index-linked bond itself rose. If inflationary expectations were truly rising, investors switching out of conventional bonds into index-linked ones would have caused yields on the former to rise but those on the latter to fall. That yields rose on both suggests that investors sought protection in cash and not that inflationary expectations were altering for the worse. The conclusion is that inflationary expectations have probably not risen by very much.

A factor which does concern me is the way in which the yield curve has failed to react to October's rise in base rates. To take the opposite case for a moment, when a central bank is reducing interest rates, a clear warning that they have been reduced far enough for the time being is signalled when the bond market no longer responds favourably to a cut in short rates. Similarly, when interest rates are being raised, the change in the slope of the yield curve signals whether the market thinks that the hike in short rates is overkill or underkill.

Base rates have risen on four occasions during Mr. Lawson's period as Chancellor. They rose from a low of 8½% to 12% in July 1984, whilst twenty year gilt-edged yields rose by about 1½%, with the gradient of the yield curve, more precisely 20 year par yields less 3 month LIBOR, altering by about 2%. In January 1985 base rates rose from 9½% to 14% and the gradient of the yield curve altered by more than 3½%; this suggested overkill. In January 1986 base rates rose from 11½% to 12½% but three month money rates rose by a further half percent and the gradient of the yield curve altered by almost 1%. In October base rates rose from 10% to 11% but the gradient of the yield curve has not responded as long term interest rates have altered by roughly the same amount; this suggests underkill.

Finally, I come to the recent behaviour of transactions money. I have already reported Mr. Lawson's own observation that Mo edging upward was one of the reasons for the rise in base rates in October. Monetary statistics for 31st October were published yesterday and so

we now have more information. The year on year growth of Mo has risen from 3.1% in July to 4.9% in October. On an annualised and seasonally adjusted basis, its growth in the last six months was 5.9% and in the last three months growth was even higher at 6.3%. This should be compared with the target range of 2-6%.

There are two other reasonable measures of transactions money at present. Non-interest bearing M1 has accelerated even more than Mo. Its year on year growth has risen from under 4% in April to over 11%. There has also been an acceleration in M2, although October data are not yet available.

My conclusion is that the 1% rise in base rates in October was absolutely justified. Further, from my analysis of the yield curve, I have already suggested it might be inadequate. Given the latest monetary data, base rates need to rise by a further 1% before I can give Mr. Lawson an unqualified vote of confidence.

39/3067

CONFIDENTIAL

FROM: DAVID PERETZ
31 December 1986

CHANCELLOR

cc Chief Secretary
Economic Secretary
Financial Secretary
Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mrs Lomax
Mr Odling Smee
Mr Sedgwick
Mr Scholar
Mr Grice
Mr Kelly
Mr Riley
Mr Carr
Mr Ross Goobey

MONETARY POLICY AND THE 1987 MTFS

The attached paper is designed to act as background for the meeting arranged for 8 January. It reflects a preliminary discussion just before Christmas with Sir Peter Middleton and others.

2. The Bank of England have not seen the paper (though they saw an early version of parts of it). It is clear they have not yet got their own thinking together, and are unlikely to have done so for another week or so. But I hope that once we have had a chance to take your mind we might then be able to take any further work forward together with the Bank of England, to clear the ground for the meeting you usually have with the Governor a little later in the pre-Budget process.

3. It is probably best to leave discussion of what figures to choose for the target range or ranges until the MTFS arithmetic is more advanced. But there are plenty of other questions to be addressed first. On 8 January you might like to concentrate

PERETZ → CH/EX 31/12

the following:-

(i) **Have we identified all the potential options?**

Paragraph 8.

(ii) **Are there any options we can rule out, firmly, at this stage?**

No targets at all (paragraphs 9-12); an exchange rate guideline outside the ERM (paragraphs 13-20); DCE (paragraphs 21-23)?

(iii) **Have we correctly identified the criteria desirable in a target aggregate?**

Paragraph 25

(iv) **Do we want to continue to target M0?**

And publish ranges for later MTFS years? Could we have a target only for M0? (Paragraphs 26-29).

(v) **Target versus monitoring range versus nothing for broad money?**

Do we think the idea of a "monitoring range" has any attractions? If we have neither a target nor a monitoring range, should we say we continue to take account of the behaviour of broad money? (Paragraphs 39-41).

(vi) **What if any measure of broad money should we focus on?**

Case for switching to PSL2 or a new bank plus building society aggregate, now that building societies have their new powers? Implications for monthly money figures announcement, and for funding rule? (Paragraphs 30-38).

Under each heading we ought to consider presentational points as well as issues of substance; and whether any further work is required.

DLCP

D L C PERETZ

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MONETARY POLICY IN THE 1987 MTFS

Introduction

This paper reviews the options for monetary targets for 1986-88, and the related material on monetary policy to be included in the 1987 MTFS. It is designed to provide background for a preliminary discussion.

Work carried out last year

2. Extensive work on the choice of target aggregate was carried out during the second half of 1985. Many of the conclusions reached then still appear to hold good. Annex 1 displays the advantages and drawbacks, as potential targets, of the main monetary aggregates.

3. Among the **narrow aggregates**, MO still looks the best aggregate to choose for target status. Although in principle there would be attractions in adopting a wider transactions aggregate, such as M1, its behaviour continues to be distorted by the growth in interest bearing sight deposits. The same factor distorts the behaviour of non interest bearing M1.

4. If we are to continue to give any special status to a single **broad aggregate**, as last year the choice probably lies between £M3, PSL2 and a new building society/bank institutional aggregate (in effect £M3 extended to embrace building societies as well as banks).

5. The conclusions of last year's work were that it was doubtful whether the behaviour of any of the broad aggregates was sufficiently stable or predictable for target status. And there was the further point that there was no evidence that they would react to changes in interest rates within the target period; so that following the end of over-funding there was no instrument left with which to meet any target set. If any broad aggregate were to be given target status, it was concluded that a wider

aggregate such as PSL2 or a new institutional aggregate would have considerable advantage over £M3.

6. In the event it was decided to continue to target £M3 (but to raise its target range substantially), largely because of the market's familiarity with that aggregate. It was accepted that this decision might have to be looked at again before the 1987 MTFS, by when the building societies' new powers would be in operation. Although the range for £M3 continued to be described as a "target", it was made clear in the 1986 MTFS that were it to overshoot it would not necessarily be possible to get it back within its target range during the year, but that monetary conditions could be tightened in other ways.

7. Experience since March this year has confirmed the drawbacks of £M3 as a target aggregate. The fall in its velocity, which seemed to be speeding up a year ago, has accelerated sharply since. And it has continued to prove a good deal more volatile than the broader aggregates, as banks have gained market share at the expense of building societies, and building societies have switched to holding a greater proportion of their liquidity in the form of bank deposits.

Possible Options for 1987 MTFS

8. It may be worth considering the following options as possibilities for the 1987 MTFS. Some are clearly more realistic than others, and some are included mainly for expository purposes.

(a) We could abandon formal monetary targets altogether, and reaffirm that decisions on interest rates will continue to be made taking all the monetary evidence into account, with the aim of keeping clear downward pressure on inflation and securing the desired medium term path for money GDP.

(b) With or without abandoning monetary targets, we could seek to give the exchange rate a more explicit role. Apart from the ERM, one possibility might be to publish a "monitoring zone" for the effective index.

(c) In a situation with a deteriorating current account balance it can be argued that there might be a case for seeking to target an aggregate with an explicit link with the balance of payments. DCE has served this purpose in the past.

(d) We could follow last year's pattern, and fix formal targets once again for both MO and £M3.

(e) Alternatively, we could substitute a target for some wider aggregate for the £M3 target.

(f) Or we could have a formal target for MO, but some looser range, which we might describe as a "guideline" or "monitoring range" for one or other of the broader aggregates.

(g) We could adopt a formal target for MO only, perhaps "taking account of" the growth of broad money but with no mechanical rule - on very much the same formula as we use at present for movements in the exchange rate.

(h) If we continue to target MO we could give a range for 1987-88 only: or, as in 1986, we could continue to give indicative ranges for the later MTFS years.

Abandon targets altogether?

9. In the course of this year's IMF Article IV consultations, the IMF team suggested that the best approach for next year's MTFS would be to **abandon formal targets altogether.** They also suggest that at the same time we should give slightly increased status to the path for money GDP: making it clear that this path is an objective, set after taking account of expected rate of growth of productive capacity in the economy, not merely a forecast.

10. The arguments for abandoning monetary targets altogether

would be that:-

(i) the behaviour of all the monetary aggregates is now too uncertain for target purposes; and

(ii) the Government has an established counter inflationary track record, so that the need for clear external guidelines is less than it was.

11. Against that there would seem to be severe presentational disadvantages. It could all too easily be portrayed as a sharp break in policy, which would add unhelpfully to market uncertainties at a time when the market is in any event likely to become more unsettled as the date of the next election gets closer. Although we have established a counter inflationary track record, it is debateable whether it is sufficiently firmly set to let us do without any external guideline at all. Even the Germans see the need to maintain a monetary target, despite doubts somewhat similar to our own about the behaviour of their chosen target aggregate.

12. Attaching enhanced status to the money GDP path is to some degree a separate issue. It is of course not a new idea, and the difficulties are well known. The current behaviour of money GDP tends not to be a useful guide to policy, first because it is not known until sometime after the event. And second because changes in policy affect the future path of money GDP not its current level. Steering by money GDP alone would put excessive weight on our ability to forecast the effect of interest rate changes on future money GDP growth.

An exchange rate guideline?

13. We have felt (and argued publicly) that it would be wrong to establish an **exchange rate target** for sterling, outside the EMS, for two reasons. First, the exchange rate, taken by itself, is not always a good indicator of monetary conditions; it can be affected by external events as well as domestic ones, and, domestically, by supply side factors as well as demand ones. A movement in oil prices, for example, or a shift in productive

potential (such as would be caused by an oil price or other terms of trade change) ought to be allowed to feed through to the exchange rate. Though it would influence monetary conditions through its effect on inflation, it would not directly tell us very much about them. It is for this reason that we have argued that movements in the exchange rate need to be put into context, and interpreted alongside the other indicators.

14. Second, we have argued that if we were to adopt an exchange rate target, it would be foolish to do so other than in the context of a formal exchange rate system, shared by other countries, and supported by a coordinated approach to economic management and intervention. In market terms an explicit target is an open invitation to speculators to test the authorities' resolve. We would be much better placed to deal with this as part of an agreed international arrangement, such as the exchange rate mechanism of the EMS.

15. If we were to move away from this position and adopt a more formal target by ourselves this could only be because:-

(i) we had so little faith in the other monetary indicators that the disadvantages of an exchange rate target seemed relatively less important, and outweighed by the advantages of a clear explicit discipline; or

(ii) (a slightly different point) because we had persuaded ourselves that we wanted a more stable exchange rate, and that announcing a target or target range might help to achieve that; and

(iii) we had concluded for other reasons that we did not want to joint the ERM.

16. As to the form such a target or guideline would take, it is a little difficult to see logically where there is to stop between an explicit and precise target (ie joining the ERM) and our present position. But we might, for example, think in terms of some kind of "monitoring" zone, establishing a presumption

that if the rate moved outside the zone then clear contradictory evidence would be required from other indicators if there were not to be a shift in interest rates.

17. The most obvious way of expressing this would be in terms of the ERI, which would also have the advantage of familiarity. Alternatively, we could think in terms of an oil-adjusted ERI, or perhaps construct some different index altogether, more directly related to inflation. Whatever aggregate was used would clearly need to be published.

18. Presentationally, the main difficulty in operating a regime of this kind might be in explaining why it was preferred to joining the ERM - particularly given what we have said in the past about the disadvantages of setting an independent target. The answer would have to be expressed in terms of allowing us greater discretion to take account of other indicators. But the more we ran that line, the less credible the arrangement would be as providing a firm grounding for the operation of monetary policy. It would be assumed by many that we were not joining the ERM for political reasons.

19. Operationally, one of the main difficulties would be that any exchange rate index would be available more or less continuously. We would therefore have to be ready to respond on a similar basis. However much we described it as a zone with soft edges, the market would try to test our resolve - and we would quickly have to decide whether or not to defend the limits. The result, could, paradoxically, be to increase market instability rather than reduce it.

20. Some of these problems would be resolved if there were any prospect of an early **international move to some kind of exchange rate target zone arrangement** - say between G5 countries. But this seems unlikely. The US-Japan understanding appears to contain little of substance in terms of agreement about what if any action would be taken if the $/Yen rate were to change substantially. And there seems little prospect of the Germans agreeing to any wider arrangement.

A target with a balance of payments link?

21. With an uncertain prospect for the balance of payments associated in part with the volatile North Sea oil price, there might be advantage in targetting an aggregate linked in some way to the balance of payments. An obvious candidate would be **domestic credit expansion (DCE)** which served this role in the past. Broadly this can be thought of as the change in the total money stock adjusted for any reduction in the authorities' holding of foreign exchange reserves. In a fixed exchange rate system, the theoretical merit of such an aggregate is clear. If monetary policy is loose then residents may attempt to reduce their excess holdings of money either by buying foreign goods and services or by purchasing foreign assets. With a fixed exchange rate, the authorities would in effect have to sell the foreign exchange for the residents to do so, taking in the excess sterling in return. After the event, the monetary aggregates may not show that policy has been loose - because residents have successfully rid themselves of their excess sterling. But DCE, allowing for the change in reserves which the loose monetary policy occasioned, will prove the more accurate indicator of monetary conditions. It was presumably for this reason that targets were set for DCE in 1976-77 through to 1978-79 and, less formally, in the late 1960s.

22. But in present circumstances of more or less freely floating exchange rates, and in the absence of exchange controls, the potential benefit of DCE as a target would, even in principle, be much reduced. At best, it might serve as an indicator of the money supply adjusted for the temporary effects of the short term exchange market interventions. But at worst it could be seriously misleading. The abolition of exchange controls and advances in financial techniques, swaps in particular, mean that the recorded statistics on the split between the domestic and overseas credit counterparts to the money stock must be regarded as increasingly suspect. In these circumstances DCE would be unlikely to be a useful indicator, even if we were seeking to maintain a fixed exchange rate.

23. Noting the importance of these sorts of considerations,

the Bank of England Quarterly Bulletin announced in June 1983 that DCE would no longer be published. Since then, changing circumstances have increased the force of the arguments against DCE as a useful indicator.

Target Monetary Aggregates

24. Options (a) to (c), then, can probably be categorised as interesting, but not very practicable, with a range of real and presentational difficulties. That leaves us with the options of continuing to target one or more monetary aggregates (Options (d)-(h)).

25. The ideal target monetary aggregate would have a combination of the following features:

- a reasonably stable or predictable relationship with money GDP over time

- some lag in that relationship, with movements in the target aggregate preceding those in money GDP, or at least providing guidance about the contemporaneous behaviour of money GDP before the GDP data is available.

- it should respond to interest rates, with higher rates leading to lower growth within a reasonable period.

- it should also react in the right direction to changes in fiscal policy, at given interest rates

- we should not expect its velocity trend to be affected within the target period by institutional or technological change

- we should be prepared to act on it, and it should carry credibility with the financial markets.

Narrow money

26. In principle there would be a case for choosing an aggregate

that embraced all balances held for transactions purposes. However the growth of interest bearing sight deposits has affected the behaviour of both M1 and non-interest bearing M1, making them unsuitable for target purposes (see Chart 2 and 3). So of the possible target narrow aggregates, MO still comes the closest to meeting the criteria. (See Annex 1). The main difficulty is that MO is thought to be vulnerable to unpredictable innovation, even though this has so far proved not to be the case. Hitherto this has led us to wish to supplement a target for MO with a target for broad money as well, despite the difficulties we have encountered with £M3.

27. It is also worth noting a number of particular properties of MO that could have implications for the choice target range or the way that policy is operated, or both.

(a) While the velocity trend has been relatively stable, the velocity trend lagged by a year has been even more so. This suggests that MO is a useful **forward looking** indicator; a desirable characteristic.

(b) It is affected by **fiscal policy** as well as interest rates. Again, this is a desirable characteristic.

(c) Its **velocity appears to change,** a little, with the level of interest rates (with lower rates leading to faster MO growth for a given money GDP); and also with the composition of money GDP (with MO particularly sensitive to the growth of non-durable consumer spending). This second characteristic, is not necessarily a drawback, since we are probably not indifferent to the composition of money GDP. If the investment component of GDP were greater we might be able to accept a faster growth in total money GDP, with the same ultimate inflation objectives, since the economy would be building up productive capacity for the future; and if growth seemed to be concentrated in consumption, then arguably that should lead us to try to tighten policy even if that meant temporarily undershooting the MTFS money GDP path.

28. In any event, in principle a wide range for MO should provide whatever scope is needed to take account of such factors expected to lead to short term shifts in velocity. And we have, hitherto, had a wide range (4 percentage points, while the Germans have just widened their range for Central Bank Money to 3 percentage points (3-6%), to take account of uncertainties about its behaviour). In practice of course there may be less scope in one direction and more in the other for such variations if the range is wrongly centred when the target is set.

29. If we felt such factors were likely to change sharply from year to year that might constitute an argument against continuing to give indicative ranges for MO for the later MTFS years. It is always difficult presentationally to choose a target range for year 1 different from the illustrative range displayed the previous year for year 2. This would mean leaving the money GDP path as the only indicator of the Government's medium term policy commitment. Arguably, this would be sufficient. The issue is largely a presentational one. The real question is whether we can do without the buttress of a path for MO displayed for the whole MTFS period.

Broad Money

30. As noted earlier, it is a desirable property of a target monetary aggregate that it should have a stable or at least predictable velocity of circulation. For only then can a target range be set with confidence consistent with attaining the desired path for money GDP. All of the broad monetary aggregates are deficient in this respect. Charts 4-6 show clearly that velocity has been anything but stable - or predictable.

31. But if a broad target aggregate is to be used at all, then **£M3** has several advantages. It is familiar to the markets and long runs of past data are available which help interpretation of its behaviour. Moreover, it is the only aggregate which has been used as a target in successive versions of the MTFS; indeed, it was used as a target prior to the institution of the MTFS. Finally, it is the aggregate which squares most naturally with

the present funding rule. Changing to a different target aggregate would probably entail modifying the definition of full funding.

32. But £M3 suffers from the general defect of the broad aggregates that its velocity is volatile and wayward. Another major and long-standing criticism of £M3 is that it excludes the liabilities of building societies, institutions who over the years have come to behave increasingly like banks. This criticism has grown in strength as this evolution has proceeded. In the current financial year, its practical significance has been sharply demonstrated. After a run of years when the banks had been losing deposits share to the building societies, they contrived to increase their competitiveness and increase market share. This development, which has only limited implications for monetary conditions generally, would not have affected PSL2 but did inflate growth in £M3. This distortion may be worth perhaps 3 per cent or so of the current annual growth rate.

33. The building societies legislation, which comes into force on 1 January 1987, is expected to accelerate the process of building societies' behaving as banks. This gives further weight to the argument for giving **PSL2** target status. It has had target status in the past so that it is not wholly unfamiliar to the financial markets. But there are some difficulties. It is not just a straightforward extension of £M3 to include building society liabilities as well as those of the banks. It also includes non-bank, non-building society private sector holdings of CTDs, of local authority temporary debt and of some National Savings products, such as Invac and premium bonds. One consequence is that PSL2 is more complex than £M3 to understand or interpret. A further difficulty may be the very fact that it has been targetted before and then dropped. Some might argue that an aggregate which had been found unsuitable as a target in the past could not be expected to be any better in future.

34. A third drawback is that it would probably be necessary to change the definition of funding. It would make little sense to count building society purchases of public sector debt as funding if their liabilities were included in the broad target aggregate. Moreover, instruments such as CTDs or local authority

temporary debt could presumably be no longer counted as funding instruments since again they would figure as components of the target aggregate. These issues are discussed in more detail in Annex 2.

35. There are more general problems with PSL2. Some would argue that it is not a monetary aggregate at all since the majority of the assets it embraces probably should be regarded as accumulated savings and not transactions balances. But this criticism would apply to any broad aggregate, to £M3 for example, and in any case the behaviour of liquidity has a good claim to be taken as a key indicator of monetary conditions. It does mean, though, that PSL2 is likely to be at least as unresponsive to interest rates in the short term as is £M3. There may even be a perverse response.

36. A further difficulty is that PSL2 may have been affected by financial innovation and liberalisation to an even greater extent than £M3. First, it will have been affected by the evolving role and behaviour of the building societies whose position has been changing more rapidly than the banks. This may be accentuated in coming months as societies take advantage of their greater freedom under the new legislation. Second, the changes in persons' financial behaviour and their tendency in recent years to hold both greater assets and liabilities than previously will also have affected PSL2's behaviour. To the extent that it has a higher saving and lower transactions component than £M3, the effect will have been greater than on £M3.

37. Some of these difficulties - but not all - could be avoided by adopting the so-called **"institutional aggregate"** as the broad money target. It would be just like £M3 but extended to place building societies within the monetary sector. Such an aggregate would have three distinct advantages over PSL2 as a target:

(i) presentationally, it would be much easier to substitute the institutional aggregate. Given the changing roles and functions of building societies, it would not be difficult to justify changing to

an aggregate just like £M3 but with building societies treated as banks. With the building society legislation coming into force in January, the 1987 MTFS would be a natural opportunity to make a substitution of this kind;

(ii) it would be more easily understood and interpreted than PSL2;

(iii) there would need to be fewer changes to the funding rule. Funding would be defined as all public sector debt sales to non-banks/building societies rather than to the non-banks as at present.

38. Even so, some problems would remain. One awkwardness is that there is no published series for the institutional aggregate at present, though it is relatively easy to construct one from published sources. It would therefore be necessary to publish a back series for the aggregate at the same time as according target status to it. More fundamentally the institutional aggregate would - like PSL2 - probably be more subject to the consequences of financial innovation and liberalisation than would £M3. So although its velocity would not be affected by changes in the competitiveness of banks and building societies, in the way that £M3's behaviour has been, its velocity could turn out to be as difficult to predict as that of £M3.

Broad money target; monitoring range; or no range at all?

39. The Governor's Loughborough lecture has set the scene for dropping broad money targets altogether, if we wish to do so. The uncertainties about the behaviour of all the broad aggregates, together with their slow and possibly perverse response to interest rate movements, suggests that if a range were set for one of them it should be described as a "guideline" or "monitoring range", rather than target. The changed terminology would symbolise two features:

- we would accept that if there was a move outside the range, it is unlikely that an interest rate move would

return the aggregate to the range within the target period. (No change here from what is said about £M3 in the 1986 MTFS.)

- we might also say that if the guidelines were breached action would only be taken if there were some supporting evidence. (This would be a change from the 1986 MTFS presentation.)

40. This approach has the advantage of going some way to reflect the spirit in which we actually look at movements in broad money - while avoiding going so far as to abandon entirely the practice of publishing a range for the year ahead.

41. Arguably it would be better to go further still, and publish no range at all for broad money. The questions then would be how to describe the way in which we would continue to "take account" of the behaviour of broad money in setting interest rates; and which, if any, particular measure of broad money we should seek to highlight. At present we highlight £M3 by publishing it together with MO in the monthly "provisional" money numbers press release. We could in future include, say, PSL2 and the "institutional aggregate" in the provisionals press release as well. Or we could substitute one of these broader aggregates for £M3, possibly taking the opportunity at the same time to remove the counterparts analysis from the provisionals press release altogether. (Full information for other aggregates and the counterparts could be given with the full banking figures, which are published later.) Were we to substitute another broad aggregate for £M3 then it would make sense to make a corresponding change in our funding rule.

Choice of ranges

42. Discussion of the numbers to put on any range or ranges for 1987-88 will have to wait until work is further advanced on the January forecast and MTFS arithmetic. But it may be worth putting down some preliminary markers, and annexes 3 and 4 discuss MO and broad money respectively.

43. So far as the **MO range** is concerned, there must be a strong presumption on presentational grounds that for 1987-88 we will stick to the 2-6% illustrative range set out in the 1986 MTFS. Nevertheless we will have to consider whether there is an overwhelming case for a change, and whether any change should be made to the illustrative path for later MTFS years. Annex 3 discusses some of the factors that may be relevant. These include the expected composition of GDP (how much consumers' expenditure); the fiscal monetary mix (how high interest rates); and our assessment of whether or not policy is too lax now, with MO growth of around 5%. It may also be relevant that in the 1986 MTFS we stuck to a 2-6% range even though, arguably, that was too high in relation to our central projection at Budget time of MO growth of under 3% by the end of 1986-87.

44. Choosing a **range for broad money**, if we were to have one, would be difficult. Over the last few years, the velocity of all of the broad monetary aggregates has been falling but at an erratic and largely unpredictable rate. Since 1980, for the most part, PSL2 and the institutional aggregate have shown more rapid falls in velocity than £M3. But that position has been markedly reversed in the current financial year as the banks have recaptured market share from the building societies. This erratic behaviour has been reflected in the outturns for broad money relative to the targets. For substantial periods, broad money growth has overshot the targets even though monetary conditions have turned out to be appropriate for achieving the Government's inflation objectives.

45. It is not difficult to find explanations for this unexpectedly rapid growth in broad money. Annex 4 discusses the development of private sector portfolios in some detail. Since 1980, the private sector's net financial assets overall have grown very rapidly in relation to money GDP under the influence of rising asset prices and positive real interest rates which have made financial assets attractive to hold. Given increased opportunities for borrowing which the process of financial liberalisation has allowed, gross financial wealth has also grown more rapidly than money GDP and indeed than broad money. Despite the apparent rapid growth in broad money, its share of private sector portfolios

has fallen to historically low levels on any of the three measures considered.

46. But while it is one thing to explain broad money's behaviour after the event, it is another thing to predict its behaviour in future. There may be room for some further improvement in asset prices, though more limited in extent than in recent years, and private sector portfolios may continue to rise a little faster than money GDP. On the other hand, given the attractive real rates of return to holding money and the fact that other financial assets may be looking less attractive than in recent years, it is possible that the private sector will wish to restore its broad money holdings to more usual portfolio proportions. Together these factors would suggest that the velocity of the broad monetary aggregates will show a further substantial fall in 1987-88.

47. One other factor which needs to be considered is whether the banks will be able to extend their advance in market share at the expense of the building societies. On balance this seems unlikely. Banks' margins are increasingly under pressure from declining interest rate spreads on their business, which must be expected to limit their ability to compete yet more fiercely. Thus there is a case for expecting £M3 velocity to return towards that of PSL2 and the institutional aggregate in 1987-88. Given the considerations of the preceding paragraph, velocity could continue to fall more rapidly than the average since 1980 but perhaps less quickly than in the current year. This would suggest that a further decline in velocity of the order of 6-8 per cent could be in prospect. But this can be little more than an informed guess; and our track record for such guesses is not impressive.

Conclusion

48. Leaving aside the more radical, and probably unrealistic, options, it looks as if we may be faced with a choice between:-

(i) a **target range for MO**, with or without illustrative ranges for later MTFS years; combined with

(ii) for **broad money** either a **target range**, a **monitoring range**, or simply a suitable statement about our intention to continue to **take account** of its behaviour;

(iii) with for broad money a choice between highlighting **£M3**, **PSL2** or a new **bank/building society institutional aggregate** (acknowledging the building societies' new powers);

(iv) and with the description of how we take account of other factors, in particular the exchange rate, set out in familiar terms.

49. Discussion of what any target or monitoring ranges should be is best left until the MTFS arithmetic is more advanced.

MO VELOCITY

CHART 1

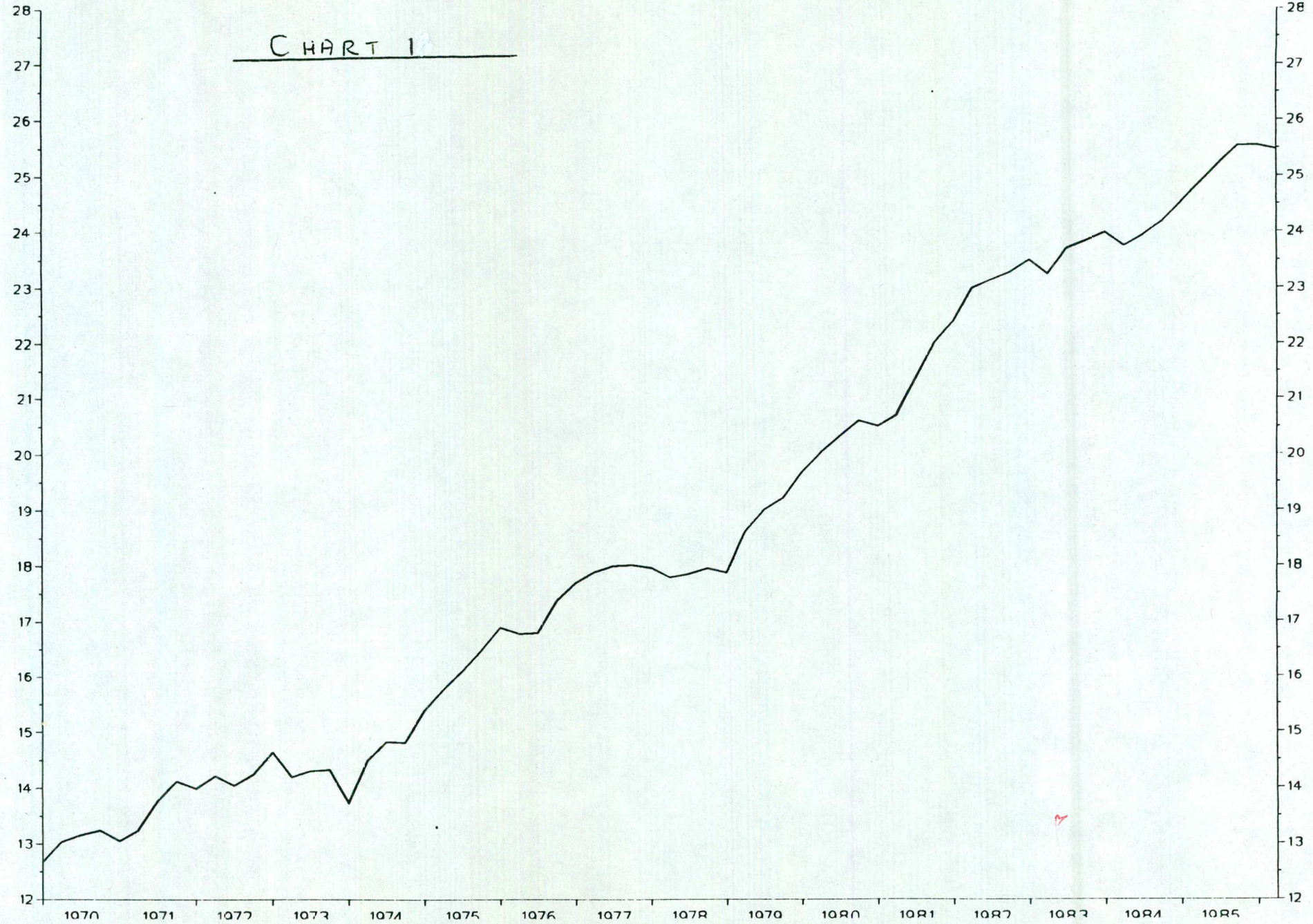


CHART 2

NON-INTEREST BEARING M1 VELOCITY

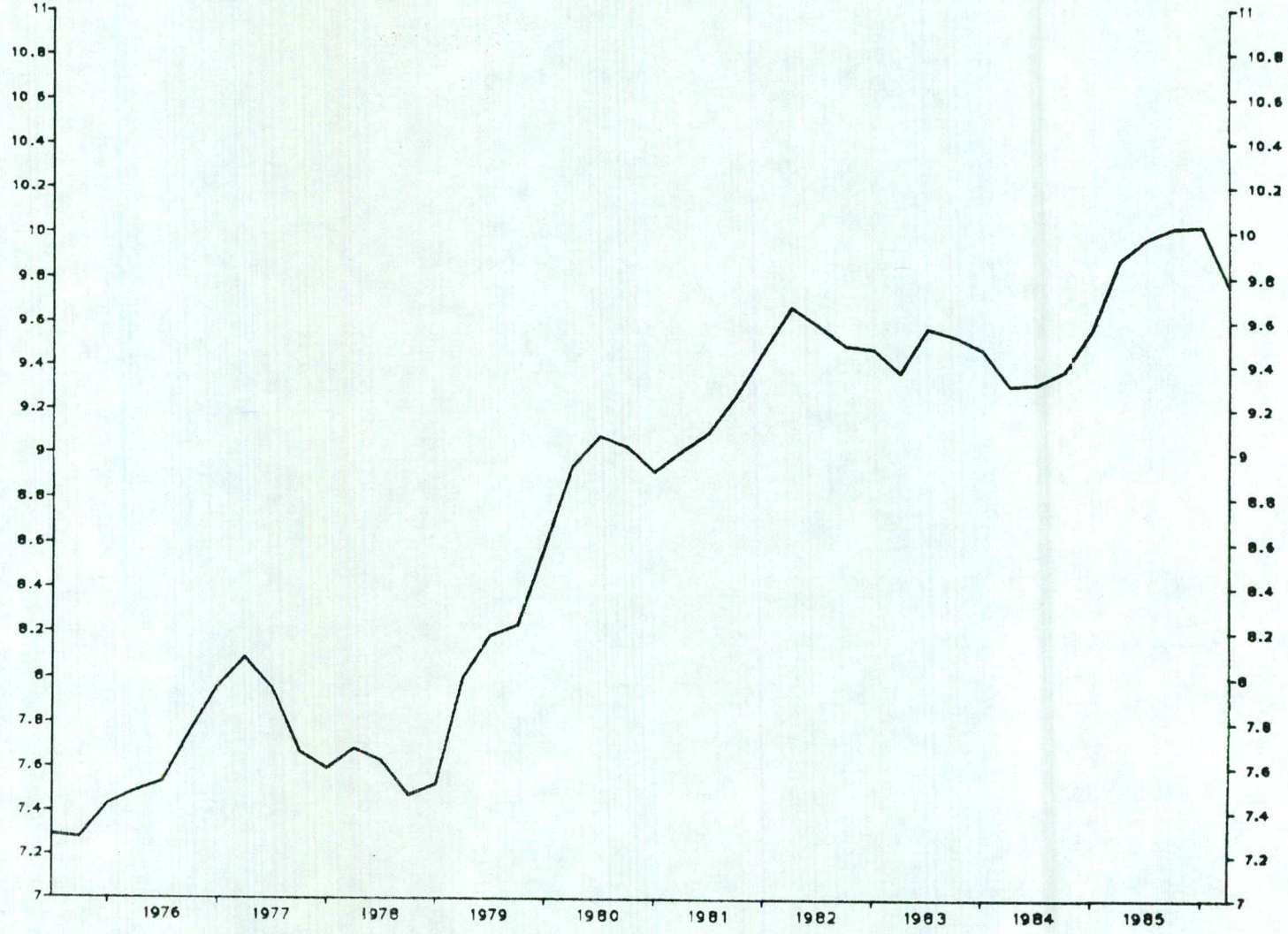
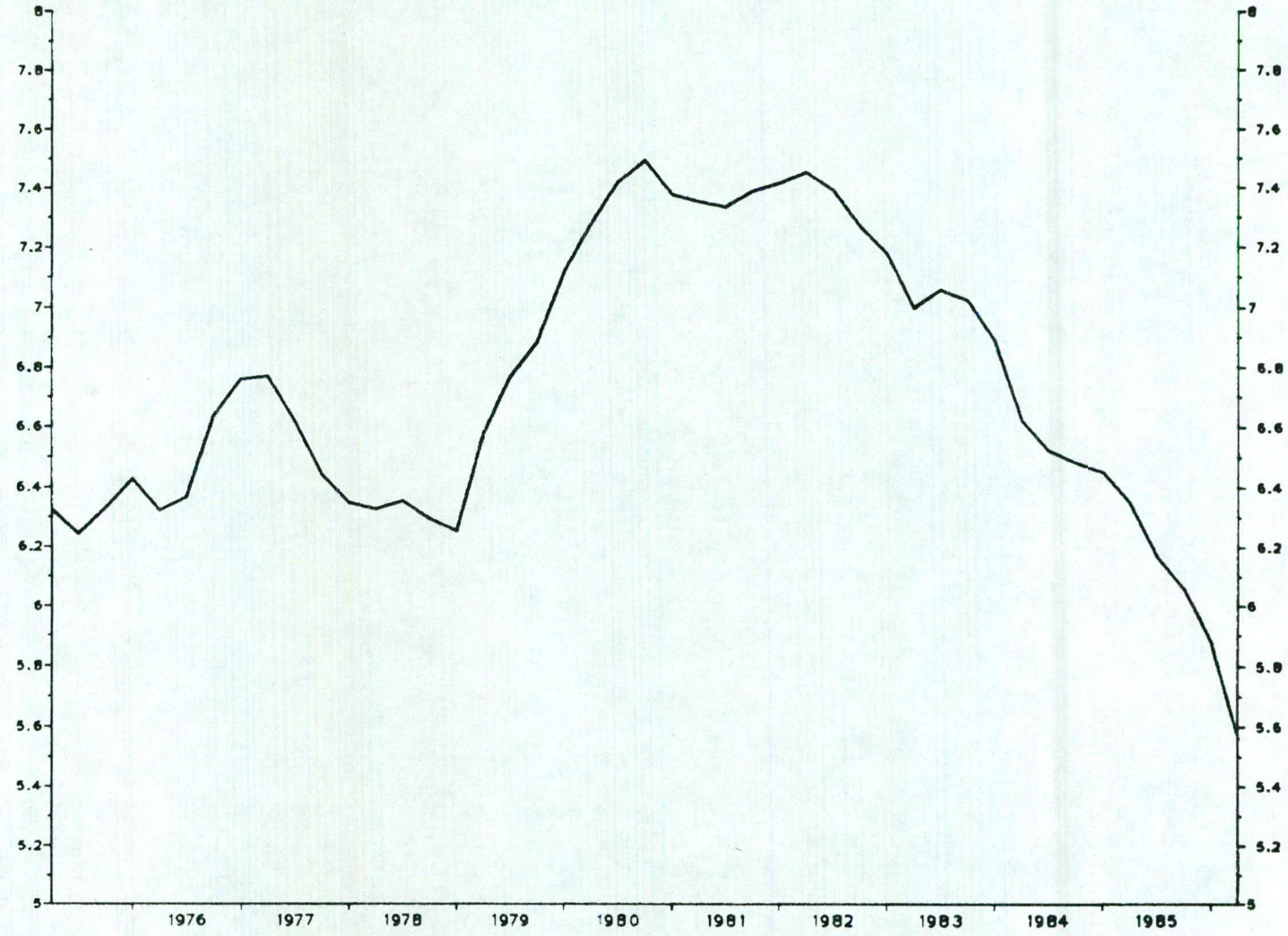


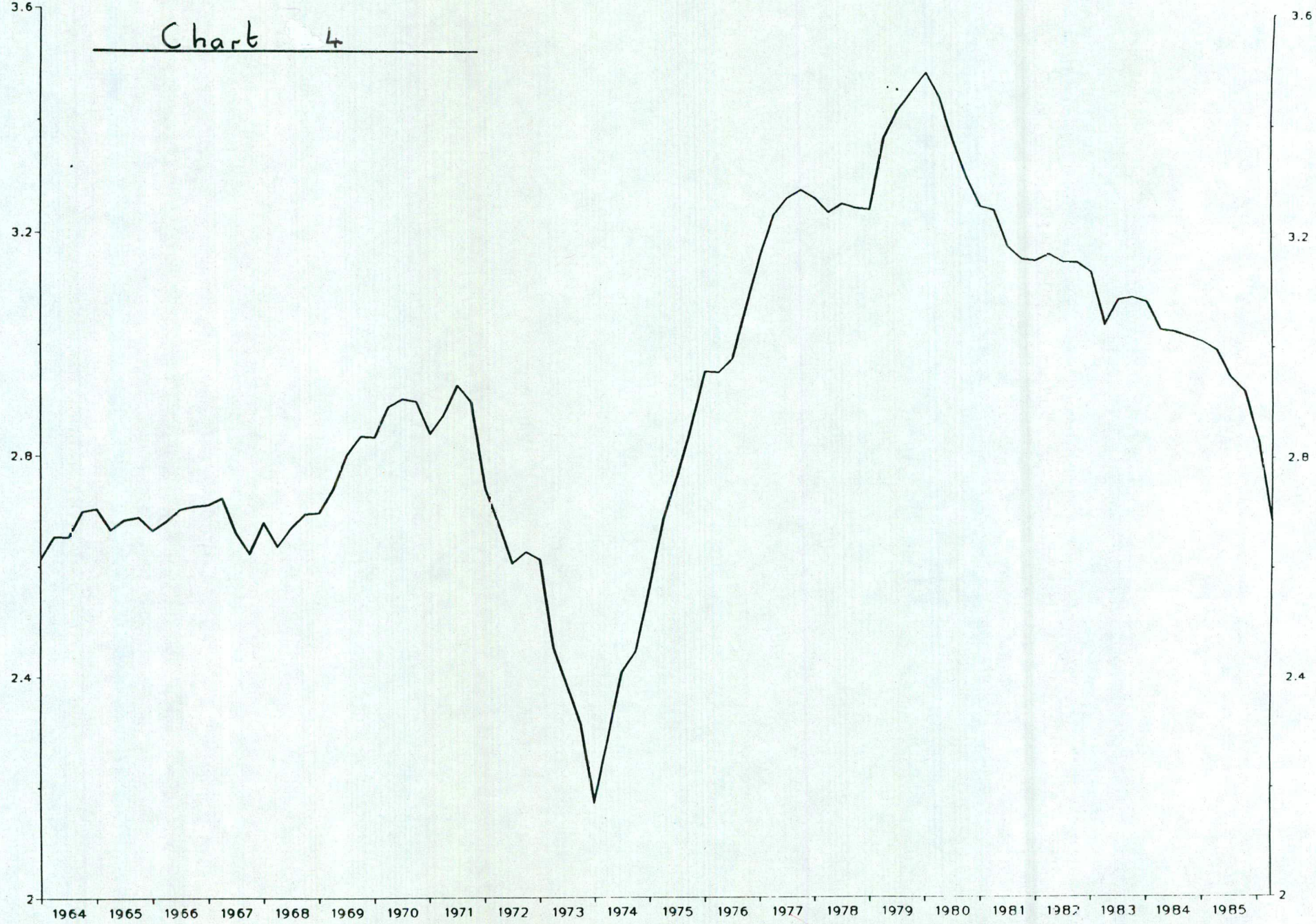
CHART 3

M1 VELOCITY



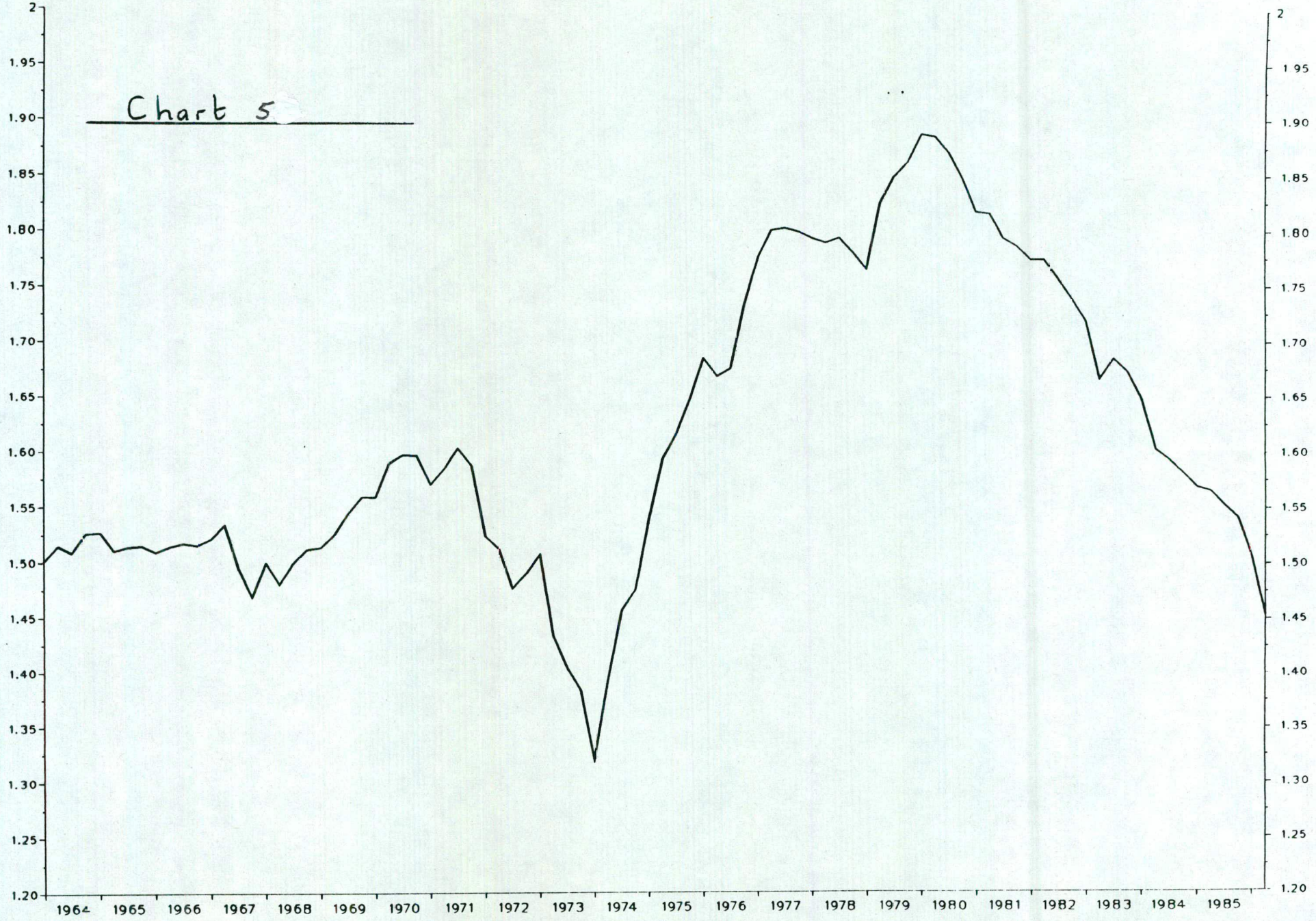
STERLING M3 VELOCITY

Chart 4



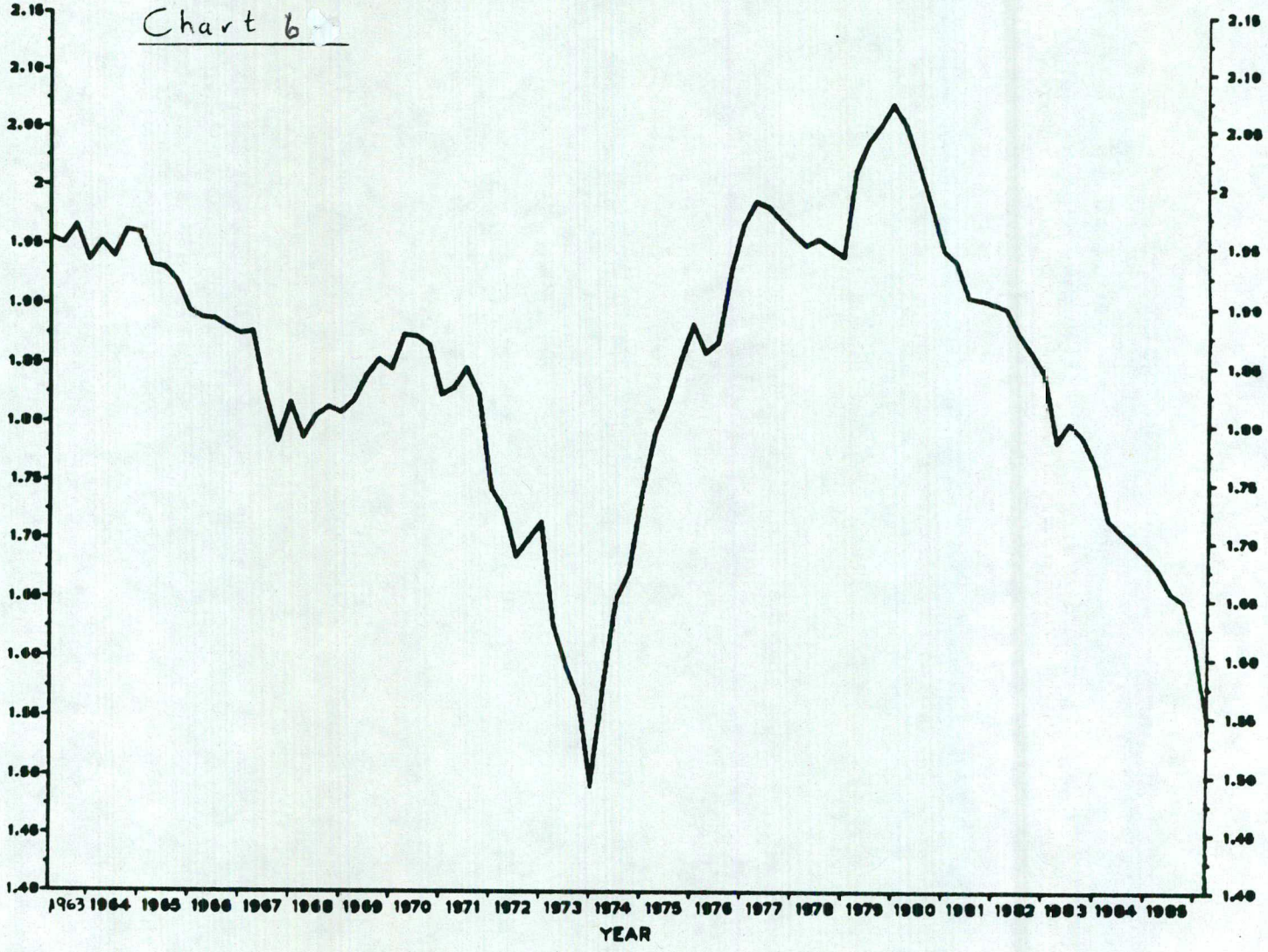
PSL2 VELOCITY

Chart 5



VELOCITY OF INSTITUTIONAL AGGREGATE

Chart 6



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SUMMARY OF ADVANTAGES AND DISADVANTAGES OF THE MAIN AGGREGATES AS TARGETS

	Advantages	Disadvantages
MO	- Current target aggregate - Relatively stable velocity trend over a long period. - No interest bearing element, so unambiguous response to interest rates (though timing and scale uncertain). - Well established concept, defined in terms of the authorities' monetary liabilities. - Data available quickly, and for a long run.	- Lacks credibility at present, because excludes the bulk of transactions balances; and because thought to be subject to unpredictable innovation. - The small bankers' balances component fluctuates erratically. (But an aggregate consisting only of notes and coin would lose some the other advantages of MO).

	Advantages	Disadvantages
NIB M1	- A comprehensive measure of of non-interest bearing transactions balances. Therefore should have more credibility than MO.	- Growth distorted, downwards, because of continued rise in use of interest bearing current accounts, which is not a steady or predictable process.
M1	- A comprehensive measure of money realisable on demand [other than building society deposits.]	- Growth biased, upwards, by continued growth in interest bearing current accounts, through substitution out of time deposits. So ambiguous response to interest rates.
	- Previously used as a target aggregated (but dropped for reasons that remain valid).	- Includes large amount of interest bearing wholesale deposits.
M2	- Specifically designed as a measure of retail transactions balances at banks and building societies.	- Little known about long run characteristics, with only 4 years' data. - Development of "instant access" facilities means M2 now contains a large portion of building society deposits almost certainly held for savings rather than transactions purposes. - Data unreliable at present, subject to mis-reporting and revision.

	Advantages	Disadvantages
£M3	- Counterparts analysis links monetary and fiscal policy.	- Excludes building society accounts even though big societies becoming more like banks.
	- Familiar to market commentators.	- Contains large interest bearing element and so may react perversely to interest rate changes.
	- Includes all residents' sterling bank deposits so unaffected by switches between types of bank deposits.	- Velocity not predictable.
		- Didn't predict recent downturn in inflation.
PSL2	- Includes building societies which are becoming more like banks.	- Interest response may be perverse.
	- Unaffected by switches between building societies and bank accounts.	- Poor predictor of inflation since 1980.
	- Has been a target aggregate.	- Affected by financial innovation/ liberalisation, both hard to predict (eg effect of forthcoming legislation).
	- Includes all building society deposits regardless of maturity.	- Adoption would require changes in funding definition.
INSTITUTIONAL AGGREGATE	- Similar advantages to PSL2.	- Similar disadvantages to PSL2.
	- Easy to understand; excluding small items included in PSL2, unrelated to bank/building society deposits and not generally likely to be regarded as money.	

	Advantages	Disadvantages
DCE	- Links with £M3 and with balance of payments - Has been given target status in past	- Similar disadvantages to £M3 - No published series at present - Diminished usefulness with a floating exchange rate - Since abolition of exchange controls, could be unreliable.

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ANNEX 2

FUNDING POLICY

Current funding policy is a full fund of the PSBR on the wide definition; that is, the PSBR is financed over the year by sales of public sector debt to the non-bank private sector (nbps) and by external and foreign currency finance of the public sector. Funding this serves to reduce the growth of the targetted broad money aggregate (£M3).

2. This note assumes that if £M3 is replaced as the targetted aggregate, then funding policy would also change so as to be directed at the new aggregate. It would be inconsistent to select one broad aggregate as a preferred indicator of monetary conditions, but to tailor funding to another. (Of course, if two broad aggregates were targetted - or if none was - then the choice of funding policy would be open; but whatever policy was chosen might be taken by the market to indicate some preference for the relevant aggregate).

3. If PSL2 replaced £M3 as the target aggregate, there would be two direct consequences for funding:

a. Nbps net purchasers of certain short term debt instruments would no longer score as funding, because they are included among the components of PSL2. The principal instruments affected would be CTDs, Invac, Ordinary Account, Premium Bonds, and local authority temporary debt.

b. Net purchases of public sector debt (ie gilts) by building societies would neither depress PSL2 nor score as funding. Under a PSL2 regime the domestic side of full funding would presumably redefined as debt sales to the non-bank and non-building society private sector.

4. The main effects of these changes would be two fold. First,

ANNEX 2

the funding instruments deployed would be more exclusively long-term than present. Not only would liquidity be locked away for lengthier periods; there would also be no shocks to the full fund arithmetic from unforeseen movements in say CTDs or l.a temporary debt.

5. The second effect would be on the funding requirement for gilts and sales of DNS instruments excluded from PSL2. It is not easy to gauge the direction of these changes in relation to funding, let alone to quantify the effects. If net sales of the relevant instruments were expected to increase, a PSL2 funding policy would involve higher gilts sales and yields, and larger money market shortages, than present funding policy (for a constant contribution from other NS instruments). But in some of the above categories we have suffered net de-funding in 1986-87 and/or could do so next year:

a. Invac has consistently contributed to funding in the past, and might be expected to yield about £400-£500m next year.

b. The Ordinary Account is under a policy of managed decline and currently defunds by about £40m a year.

c. Premium bonds appear to be contributing about £60m a year to funding.

d. It is not policy for CTDs to contribute to long-term funding, although the scheme has done so in recent years. At present the scheme is under review; a pattern of keener interest rates could well mean that the stock would continue to decline from recent highs.

e. Local authority temporary debt to the nbps has fallen sharply in 1986-87 (encouraged by our NLF policy) from about £1.9 billion in March to about £1.2 billion mid-September (latest figure). Under the current funding regime, this increases the annual gilts sales task.

f. Building societies have been running down their gilts holdings since the beginning of 1985 as a result of

liquidity pressures, high yields on bank deposits, and the prospect of tighter capital adequacy rules; capital adequacy requirements in the new year could serve further to depress their gilt holdings.

6. The net effect of all this can only be a matter of judgement. If all other factors netted out to neutral, the loss of Invac funding might add some £0.5 billion to the annual gilts sales task. This would hardly be significant over the year, being the rough equivalent of a tranchette package. But gilts yields would be marginally higher, and short term interest rates marginally lower than under a £M3 funding regime. Money market assistance might also increase by £0.5 billion.

The institutional aggregate

7. If the institutional aggregate was targetted, and funding policy remodelled accordingly, net debt purchases by building societies would not score as funding; but short term instruments would (ie the changes would be confined to paragraphs 3b and 5f above).

8. If funding policy changed, we should need to reconsider the future of the instruments affected. Although a number of other factors would need to be taken into account, there could be a presumption that sales of non-funding instruments would be pursued less vigorously than at present. If we targetted PSL2, holdings of say CTDs and Invac could diminish, thus bringing PSL2 much closer to the institutional aggregate.

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ANNEX 3

RANGES FOR MO

Past performance

The target bands for MO set out in the 1984, 1985 and 1986 MTFS are shown in Table A3.1 along with the outturns.

Table A3.1: MO Targets and Outcomes

	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90
1984 MTFS	4-8	3-7	2-6	1-5	0-4	
1985 MTFS	4-8	3-7	2-6	1-5	0-4	
1986 MTFS	4-8	3-7	2-6	2-6/2-5	1-5	1-5
Outturn	5.5	4.4				

MO has generally remained within its target ranges. In large part this reflects the predictability of MO's velocity. As chart 1 shows, there has been a relatively steady increase over a number of years. But to a degree, it appears that interest rates have also affected MO's velocity and it is not hard to see why that should be so. Higher interest rates increase the opportunity cost of holding non-interest bearing notes and coins and encourage people to hold less of them for any given level of money GDP: lower interest rates have the opposite effect.

2. Perhaps related to this is the fact that the ratio of money GDP to MO in the previous year has risen more steadily than velocity itself. It may be that this is explained by the relative speeds with which money GDP and MO respond to changes in interest rates. When interest rates change MO tends to react fairly quickly; money GDP takes longer to respond.

Behaviour in the current year

3. Table A3.2, below, shows the development of the annual growth

ANNEX 3

rate of MO, throughout the current year.

Table A3.2: Growth of MO in 1986: Percentage change on previous year

	MO	Notes & Coin		MO	Notes & Coin
Jan	3.9	3.6	Jul	3.2	3.6
Feb	3.8	3.6	Aug	4.1	4.2
Mar	3.6	3.4	Sept	4.8	4.4
Apr	2.8	2.8	Oct	4.9	4.8
May	3.2	3.3	Nov	5.3	5.3

4. Two features seem to be apparent:

(a) for MO, the year breaks into two relatively clear sub-periods. Up to July, MO was subdued. The annual growth rate fluctuated in the bottom half of the target range. But since July, growth has quickened and there has been a bumpy but sustained acceleration; but

(b) to some extent this may be illusionary and caused by erratic movements in bankers' balances. Looking at notes and coin alone suggests a rather steadier acceleration in growth from about the beginning of the financial year. No, it doesn't

5. MO's behaviour stands in some contrast to what was expected at Budget time. Then, the annual growth rate was expected to remain around or a little below 3 per cent in 1986-87 with the rate at the end of the financial year below that at the beginning. On the current predictions, by February 1987, MO would be growing virtually at the top of its 2-6 per cent target range.

6. It is worthwhile, therefore, considering the main factors that could have been responsible for this unanticipated behaviour.

(i) Interest rates. As noted above, MO is thought to be fairly responsive to interest rates. Since the Budget, short term interest rates have fallen on average by a larger amount than

the predictions underlying the FSBR allowed for.

Table A3.3: Short Term Interest Rates (3 month Interbank Rates):

Per cent

	FSBR Projections	Autumn Statement Projections
1986 Q1	12.5	12.4
Q2	12.0	10.2
Q3	11.5	9.9
Q4	11.0	11.0

[Latest actual (30 December) 11.3]

Whilst the rise in interest rates since mid-October has left them near to the level anticipated at Budget time, they were well below expectations for most of the period up to mid-October. Because people take time to react to changes in circumstances, it seems likely that MO reacts with a lag to changes in interest rates. For this reason, a sizeable part of the higher MO growth now being experienced and projected for the rest of the year could be due to the effects of the past lower interest rates.

(ii) The balance of expenditure It is also likely that the demand for MO will depend upon the composition of expenditure as well as its level. Notes and coin are more likely to be used for expenditure on consumption - especially non-durable consumption - than they are for example, in payments for plant and machinery or exports. Since Budget time, there has been a marked movement in the balance of expenditure towards consumption so that, although money GDP as a whole is running at levels probably below those expected, consumer expenditure is above its anticipated path.

Table A3.4: The Balance of Expenditure

	FSBR Projections			Autumn Statement Projections		
	Non-durable Consumption (£m)	Money GDP (£m)	Consumption Proportion (Per cent)	Non-durable Consumption (£m)	Money GDP (£m)	Consumption Proportion (Per cent)
1986 Q1	54709	91520	59.8	56202	92353	60.9
Q2	56185	83708	60.0	57244	92527	61.9
Q3	57356	94320	60.8	58690	94093	62.4
Q4	58298	96742	60.3	60005	95705	62.7
1986	226548	376290	60.2	232142	374678	62.0

Autumn Statement figures for the third and fourth quarters are obviously subject to revision. But the more timely information on retail sales - which constitute about half of total consumers' expenditure - makes it clear that consumption is at high levels. This circumstance again is likely to explain part of the unexpectedly rapid growth in MO.

(iii) Financial Innovation Improvements in the technology of money transmission over time means that people are able to economise to an increasingly greater extent over time on their holdings of notes and coin. This is the main reason for the trend increase of the velocity of circulation associated with MO. In principle, it is possible that the pace of financial innovation could have slowed in 1986 from the rates of previous years and this would tend to raise the MO growth rate above that expected. It is hard, however, to confirm whether such an explanation has any role to play. Objective indicators of advances in innovation - the number of bank or building society accounts per head, for example, or the number of cash dispensers in operation - are available only with a long lag and are hardly relevant to the period in question. The indicators that are available, however, give no grounds for believing that financial innovation has slowed. Nor does informal or anecdotal evidence point in this direction.

Prospects

7. The previous discussion has identified two principal factors which may be responsible for MO's unexpectedly rapid growth: a movement towards consumers' expenditure in the balance of money GDP and the lagged effects of lower than expected interest rates. Table A3.5 shows how, in the Autumn Statement projections these factors are expected to develop compared with what was allowed for at Budget time.

Table A3.5: Projections of Factors relevant to MO

Projections at Budget Time

	3 month Interbank Rates (%)	Consumers' Expenditure - % change over 12	Money GDP months -	Consumption Proportion (%)
1987 Q1	10.5	8.3	6.5	60.8
Q2	10.3	7.8	6.5	60.7
Q3	10.0	7.4	6.3	61.5
Q4	9.4	6.3	6.3	60.3
1987	10.0	7.4	6.4	60.8
(1986)				(60.2)

Autumn Statement Projections

1987 Q1	11.0	8.1	5.9	62.1
Q2	10.4	6.8	6.8	61.9
Q3	10.4	7.1	7.3	62.3
Q4	10.4	7.1	7.7	62.3
1987	10.6	7.3	6.9	62.2
(1986)				(62.0)

8. The 1986 FSBR projection itself incorporated an acceleration in MO growth in 1987 - to nearly 5 per cent by the end of the year. But the Autumn Statement projections suggest that the current overshooting of MO may have become less pronounced by the end of the year:

(i) interbank rates are expected to be higher on average in 1987 than was expected at the last Budget;

(ii) although the Autumn Statement projected faster money GDP growth in 1987, there was little difference in the projected growth rate of consumers' expenditure. Although the consumers' expenditure proportion of money GDP is now expected to remain higher than the FSBR allowed for, the rise from present levels is less.

CHOICE OF RANGES FOR THE BROAD AGGREGATES

As is well-known, the velocity of circulation of the broader monetary aggregates has been falling since 1980. Table A4.1 shows the speed of the decline:

Table A4.1: Velocity of Circulation of the Broad Monetary Aggregates

	Velocity of Circulation			Percentage Change		
	£M3	PSL2	"Institutional Aggregate"	£M3	PSL2	"Institutional Aggregate"
1979-80	3.44	1.87	2.06			
1980-81	3.34	1.87	2.01	- 2.85	-0.11	-2.22
1981-82	3.18	1.80	1.92	- 4.68	-3.64	-4.62
1982-83	3.15	1.75	1.87	- 1.00	-3.00	-2.70
1983-84	3.07	1.67	1.79	- 2.45	-4.52	-4.47
1984-85	3.02	1.59	1.70	- 1.62	-4.80	-5.03
1985-86	2.92	1.54	1.65	- 3.38	- 2.88	-3.30
1986 Q2	2.69	1.45	1.54	-10.32	-7.22	-8.07
Q3	2.61	1.43	1.52	-11.38	-8.04	-8.42
Average: 1979-80 to 1985-86				- 2.69	-3.18	-3.33

2. It should be noted that this decline is by no means a trend phenomenon. Chart 2, for example, shows £M3 velocity since 1964. Its velocity fell sharply after the introduction of Competition and Credit Control but rose after 1974 somewhat erratically. Despite the sustained decline since 1980 £M3's velocity remains above its nadir in 1974. So although it is tempting to project a further fall in broad money velocity in 1987-88 and the following years of the MTFS in recognition of recent experience, this should not be an automatic response without consideration of the factors which have been associated with recent behaviour of velocity.

Factors affecting Velocity

3. Net financial wealth. Any explanation of the decline in broad money velocity in recent years needs to take into account that not just broad money but the private sector's net financial worth as a whole has increased in relation to gross domestic product. Table A4.2

shows the net financial wealth (including equities) of the non-bank private sector.

Table A4.2: Net Financial Wealth of Non-bank Private Sector

	Net Financial Wealth (£bn)	Ratio to Money GDP	Real Interest Rate
1975	89.7	0.852	-16.5
1979	147.1	0.746	- 0.8
1980	184.1	0.802	- 3.1
1981	204.8	0.808	2.3
1982	258.3	0.933	4.6
1983	311.9	1.036	5.0
1984	368.7	1.143	5.8
1985	411.3	1.163	6.4
1986 Q1	477.7	1.293	6.5

4. Part of the explanation for the rise in net financial wealth must be the buoyancy in asset prices. The Financial Times Government Securities index has risen by some 25 per cent since 1979 whilst the All Share index has risen by 255 per cent over the same period reflecting the rise in company profitability. But it is not only **actual** net financial wealth which has increased relative to money GDP; it seems likely that **desired** net financial wealth has also risen as a proportion of income. In particular, there has been a steady rise in ex post real interest rates which has made financial assets increasingly attractive to hold. Between 1975 and 1979 they were on average negative to the extent of 5.7 per cent. Since 1980, when broad money velocity began to rise, they have been positive at an average level of 3.2 per cent.

5. Further evidence of the increasing attractiveness of financial assets comes from data for the personal sector. The proportion of total wealth accounted for by net financial wealth has risen in each year since 1980. Similar evidence, however, for sectors other than persons is not readily available.

Table A3: Personal Sector Net Financial Wealth as a Percentage of Total Wealth

1975	1979	1980	1981	1982	1983	1984
32.5	28.8	30.6	31.4	34.3	35.2	37.3

6. Gross Financial Wealth. In relation to income, gross financial

wealth has also risen strongly since 1979 though the increase is less striking than in the case of net financial wealth.

Table A4.4: Gross Financial Wealth of the Non-bank Private Sector

	Gross Financial Wealth (£bn)	Ratio to Money GDP		
		Gross Financial Wealth	Net Financial Wealth	Liabilities
1975	154.8	1.456	0.852	0.604
1979	262.1	1.327	0.746	0.581
1980	316.9	1.377	0.802	0.575
1981	367.2	1.433	0.808	0.625
1982	455.4	1.635	0.933	0.702
1983	536.5	1.777	1.036	0.741
1984	642.4	2.007	1.143	0.864
1985	711.9	2.014	1.163	0.851
1986 Q1	789.8	2.138	1.293	0.845

7. Table A4.4 shows that from 1979, gross financial wealth has increased by 201 per cent by the first quarter of 1986. Over the same period net financial wealth increased by 225 per cent. As a proportion of money GDP, net financial wealth rose by over 73 per cent and gross financial wealth by over 61 per cent over the same period. Implicit in these figures is a rise in private sector liabilities. These amounted to about 58 per cent of money GDP in 1979 (as against over 60 per cent in 1975) but had increased to 84½ per cent of money GDP by early in 1986.

8. A number of factors are likely to have caused the increase in liabilities relative to GDP:

(i) on the demand side, the rapid rise in net financial wealth is likely to have been a factor. Potential borrowers will have had increased security to offer in guarantee for new loans. Householders in addition will have been able to borrow against the increased equity in their homes that increases in house prices above the general rate of inflation have engendered;

(ii) so far as the supply of borrowing is concerned, it seems indisputable that the ease with which all sectors but especially the personal sector, have been able to borrow has improved. Credit rationing has been much reduced compared to that in 1979. In part, this can be ascribed to specific changes in government policy

designed to introduce more freedom into credit markets - the ending of the Corset and the abolition of hire purchase controls are two major examples. But more generally, increased competition amongst potential lenders has increased the supply of new loans. One effect of this has been to induce the building societies to raise their deposit and lending rates to market levels which itself has reduced rationing and increased the flow of lending;

(iii) symptomatic of the increased competition amongst lenders has been the fall in margins between borrowing and lending rates. Work by the Bank of England over the summer produced a rough quantification of typical rates charged by the banks to various classes of customers and the typical rates. The implicit margins were as shown in table A4.5.

Table A4.5: Typical Spreads between Banks' Deposit and Lending Rates to various Classes of Customers

per cent

	Persons	Industrial Companies	Non-bank Financial Institutions	Total
1975	11.9	4.4	1.2	7.2
1979	14.2	6.6	2.1	9.4
1980	12.2	4.2	1.5	7.6
1981	11.8	3.4	2.2	7.5
1982	10.1	2.6	1.1	6.2
1983	9.7	2.9	1.3	6.1
1984	9.8	3.1	1.7	6.2
1985	9.9	3.1	1.7	6.2
1986 Q1	9.4	1.9	0.8	5.3

Since 1979, there has been a trend reduction in the spreads for all sectors though it has not been a steady or uninterrupted fall. Most of the decline had been completed by 1983. But the implications are clear; for all sectors it is now cheaper than it was to have higher financial assets balanced by higher borrowing.

9. The Portfolio Shares of the Monetary Aggregates. Given the rapid rise in private sector financial assets generally relative to the increase in money GDP, it is not so surprising that broad money should also have risen more rapidly than money GDP. This is the obverse of the observed fall in velocity. Table A4.6 shows the portfolio shares of the various monetary aggregates within private financial wealth.

A4.6: Monetary Aggregates as a Percentage of Gross Financial Wealth

	£M3	PSL2	Institutional Aggregate
1979	23.6	43.5	39.4
1980	23.2	41.2	38.4
1981	22.7	40.1	37.5
1982	20.0	36.4	34.0
1983	18.9	35.0	32.7
1984	17.1	32.7	30.4
1985	17.8	33.7	31.4
1986 Q1	17.0	31.7	29.8

10. The table shows that there has been a sharp decline in the portfolio share of broad money on any of the three definitions considered since 1980. This represents the reversal of a well-established trend from at least the middle of the 1960's towards rising portfolio shares for broad money. This is perhaps the more surprising since the rate of interest receivable on broad money - affected primarily by the rates of interest paid on bank and building society deposits - has probably become more competitive since 1980.

11. The Market Share of Banks and Building Societies: Since 1980 building societies have generally increased their share of deposits against the banks, extending a trend of long standing. Their costs per deposit are typically lower than the banks which may in part explain their expanding share of business. But in 1986-87 the banks have mounted a sharp counter-attack and have won back a significant part of market share.

Table A4.7: Market Shares of Banks and Building Societies Percentage of Combined Sterling Deposits

	Banks	Building Societies
1979	54.8	45.2
1980	56.8	43.3
1981	55.5	44.5
1982	53.3	46.7
1983	52.5	47.5
1984	50.9	49.1
1985	50.5	49.5
1986 Q3	52.6	47.4

12. This change in market share has been reflected in a faster rise to date this year in £M3 than in PSL2, and so a stronger fall in £M3 velocity.

Prospects for the Next Financial Year and Beyond

13. The preceding section has suggested that the fall in velocity generally of the broad money aggregates since 1980 has been associated with a sharp increase in both net and gross financial wealth relative to money GDP. Most of the factors which have supported this shift look set to remain in place for the next year or so but their power may be diminishing. Table A4.8 shows projections of some of the relevant factors taken, for 1987-88 from the projections underlying the Autumn Statement and thereafter from the current MTFS projections.

Table A4.8: Projections of Factors Relevant to Velocity

	1986-87	1987-88	1988 89	1989-90
Company profitability*	9.7	10.0	11.4	11.9
Nominal interest rate**	10.5	10.3	8.5	7.9
Real interest rate***	7.6	6.6	5.2	4.9
Money GDP	5.5	7.1	6.0	5.5

* Percentage rate of return on capital employed

** 3 month interbank rates

*** 3 month interbank rates relative to the change in the GDP deflator

14. The following points seem relevant:

a) company profitability looks set to record some further improvement over the next few years. But the improvement may be comparatively minor compared with that which has already occurred: in 1980-81, on the same measure, profitability was only 3.5 per cent. The expected further improvement may already be discounted in equity prices;

b) at the same time only a limited fall in nominal interest rates is projected, given world conditions. Given the prospects for profits, it seems unlikely that a major rise in assets prices will occur;

c) the decline in real interest rates expected will tend to reduce

the desirability of holding financial assets - though, by historical standards, real rates are projected to remain high.

15. With this background, the increase in private sector net financial wealth may be much closer in future to the rise in money GDP. On the other hand, with increasingly intense competition for lending to the private sector, the immediate prospects may be for a further rise in private gross financial assets which remains in excess of the rate of growth of money GDP.

16. On balance, these considerations suggest that there is only a remote possibility that broad money velocity will not fall further in 1987-88 and in later years. For velocity to remain stable - let alone to resume the increase that characterised most years prior to the 1980s - would require a further fall in the portfolio share of broad money from a level which is already low by past standards. Given the attractive rates of return on liquid assets now available, there must be a possibility that the private sector will attempt to raise the broad money share of its wealth particularly if it is perceived that illiquid assets - gilts or equities - have less to offer than has been the case in recent years.

17. In these circumstances, it seems reasonable to expect that broad money velocity over the MTFS period as a whole will continue to decline at about the average rate of the 1980s overall - around 3 per cent a year. But in 1987-88 at least the further decline could be somewhat greater than this while the private sector prevents a further fall in money's share of the portfolio. A decline closer to the rates in 1986-87 to date, perhaps 6-7 per cent, may be more realistic.

18. The other question at issue - relevant to the velocity behaviour of £M3 against that of PSL2 or the institutional aggregate - is whether the banks will be able to continue to increase their market share at the expense of the building societies. Though they have been strikingly successful in 1986 to date, there must be some doubt whether the banks can maintain their attack. Despite cost savings in recent years, their costs per deposit are still well above those of the building societies. Moreover, banks' profitability remains under pressure in spite of their cost savings because interest spreads have declined. If the changes in building societies' legislation leads, as seems likely, to a movement

away from unsecured lending banks' margins will fall yet further. This suggests that the greater velocity decline in £M3, which has characterised the current financial year will not continue much longer. For 1987-88 and later years, one might therefore expect £M3 velocity to decline no more rapidly than PSL2's or that of the institutional aggregate, or perhaps, as in the past, a little more slowly.

MR 11/25

CONFIDENTIAL

FROM: CATHY RYDING
DATE: 5 January 1987

MR PERETZ

cc: Chief Secretary
Economic Secretary
Financial Secretary
Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mrs Lomax
Mr Odling Smee
Mr Sedgwick
Mr Scholar
Mr Grice
Mr Kelly
Mr Riley
Mr Carr
Mr Ross Goobey

MONETARY POLICY AND THE 1987 MTFS

The Chancellor was most grateful for your minute of 31 December which he found helpful.

2. The Chancellor has commented that he remains interested in NIB M1. He is also interested in a proxy for credit, but to a lesser extent.

CR

CATHY RYDING

RYDING → PERETZ 5/1

013/45

CONFIDENTIAL

FROM: J W GRICE
DATE: 7 JANUARY 1987

CHANCELLOR OF THE EXCHEQUER

cc: Chief Secretary
Economic Secretary
Financial Secretary
Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mrs Lomax
Mr Odling-Smee
Mr Sedgwick
Mr Scholar
Mr Peretz
Mr C W Kelly
Mr Riley
Mr Carr
Mr Ross Goobey
Culpin

MONETARY POLICY AND THE 1987 MTFS

Commenting on Mr Peretz' submission of 31 December, you noted that you remained interested in NIB M1 and to a lesser extent in a credit proxy. You may like to have the attached notes on these issues, ahead of your meeting with us tomorrow.

JWG

J W GRICE

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Non-interest Bearing M1

Non-interest bearing M1 has several claims to be used as a narrow money target aggregate. Like M0:-

(i) it responds unambiguously to interest rates since it is composed entirely of non-interest bearing assets;

(ii) because it is liable to be held only for transactions purposes, it will also respond to fiscal policy insofar as that affects the level and composition of expenditure in the economy;

(iii) a long run of data is available, over the last 11 years.

2. Its proponents would suggest that it has some further advantages compared to M0:-

a) it is likely to provide a more comprehensive measure of transactions balances since it includes the greater part of bank current accounts;

b) it excludes bankers' operational balances which are volatile and in the short term are unlikely to be closely related to transactions.

3. But there are also some significant disadvantages. First, it cannot be regarded as a full measure of transactions demand. In particular, it excludes transactions balances held with the building societies. The extent to which people use building society accounts for transactions purposes has probably been increasing over the years as building societies have offered services like the banks'. This process of evolution may be given a boost by the new building society legislation effective from the beginning of the year. It might look presentationally odd therefore to move to a transaction measure this year which excludes the building societies.

4. A second and perhaps more important problem is that it is difficult to believe that the split of M1 between interest bearing and non-interest bearing components has yet reached an equilibrium. Over the last decade there has been a trend increase in the interest bearing proportion. On the one side, companies have become more aware of the possibilities for holding parts of their transactions balances at interest. On the other, increasing competition has forced the banks to make such facilities more widely available. This rise in the trend has not been steady; not surprisingly, the interest-bearing proportion has increased most rapidly when interest rates have been high and the rise has slowed when rates have fallen. The process has probably not yet been completed. In this case, there would be further changes to non-interest bearing M1 unrelated to any change in transactions in the economy.

5. A final drawback is that the aggregate is liable to be distorted in the short term by shifts into current accounts prior to large new issues or privatisations. This is probably not decisive, since such distortions eventually disappear of their own accord. But it does mean that interpretation of the aggregate's development is obscured for appreciable periods of time.

6. Perhaps for a combination of the above reasons, non-interest bearing M1 has not been a very useful guide to policy in recent years. Chart 1, attached, shows its growth rate over the last two years. It has varied widely over that period - showing negative annual growth in November 1985, growth of over 16 per cent in the year to September 1986 and a sharp decline since - but in a way which is difficult to reconcile with other evidence about monetary conditions. Over a longer time period, its usefulness is also open to question. Chart 2 displays its velocity in relation to money GDP since 1975. There has been a trend rise over that period, as in the case of M0. But the year-to-year variation has been much greater than in the case of the narrower aggregate and it seems likely that its development would continue to be more difficult to predict in future.

A Credit Proxy

In the past, we have tended to argue - amongst ourselves and in public - that it is money rather than credit which is the key to success in attaining the Government's inflation objectives. The argument has been that credit extension is only the obverse of growth in liquidity. If monetary conditions remain satisfactory, in the sense that any growth in liquidity is willingly held by the private sector so that there is no impetus to inflation, then there would be no reason to be concerned about what was happening to credit.

2. One rationale for looking at a credit measure rather than monetary aggregates would reflect the difficulties inherent in interpreting the available measures of money. Given the distortions caused by financial liberalisation and innovation, it could be argued that a credit measure would provide a better, if imperfect, guide to monetary conditions than the monetary aggregates themselves. This would be quite a different justification from that which might underpin looking at domestic credit expansion. Domestic credit expansion might be relevant when an uncertain prospect for the balance of payments was threatening to cloud the interpretation of the monetary aggregates. It would be particularly relevant in a fixed exchange rate regime. By contrast, the credit measure would be introduced because of the general distortions to the monetary aggregates and regardless of the balance of payments and the exchange rate regime.

3. The United States' experience is interesting in this respect. Because of the distortions which were occurring to the US monetary aggregates, the Federal Reserve accorded monitoring status to bank credit in the late 1970's. But just like monetary aggregates, credit measures are also subject to the effects of financial change. Reacting to the fact that credit was increasingly flowing through channels other than banks, in 1983 the Fed replaced the bank credit aggregate with a much wider one. This broad credit aggregate includes all outstanding debt of the US government, of state and local governments and of

the private non-financial sectors. The private debt embraces corporate bonds, mortgages, bank loans, other consumer debt, commercial paper, bankers' acceptances and other debt instruments. By moving to such a broad definition, the Fed hoped to be able to monitor an aggregate which would be less affected by shifts in the preferences for different financial assets.

4. Technically, it would be possible to construct a similar aggregate for the UK, or, if preferred, a narrower one. The CSO publish in Financial Statistics a table showing the financial assets and liabilities of the non-bank private sector (Table 1, attached) which would form the building blocks. Such a measure could only be quarterly, would be subject to extensive revision and, on the present production timetable, would be available only about 6 months after the end of the quarter to which it referred. These are obviously drawbacks though not necessarily fatal ones; the US measure is also subject to substantial revision and has a production lag of about 2-3 months, though it is available monthly.

5. Perhaps more difficult would be to justify the introduction of a credit proxy. It would not be easy to explain the theoretical basis of looking at credit per se. Presumably it would have to be introduced as an indicator of monetary conditions. But even in this regard there might be difficulties. Given the rapid changes in credit provision now occurring, it would be hard to justify looking at a narrow measure such as bank credit. Like the Fed, we might be driven towards a wide measure. Yet even a wide measure is not insulated from financial change; interpreting the US measure, for example, has been rendered more difficult by the shift since 1984 in the balance of corporate finance away from equity and towards debt. It is interesting that in the US the credit aggregate has not lived up to what was hoped of it. It has probably been more useful in informing debate about prudential issues than as a guide to the operation of monetary policy.

6. If it were necessary to move to very wide financial measures as indicators of monetary conditions, there would also be a question of why we should monitor the behaviour of the private

sector's liabilities rather than its assets. Monitoring the gross financial wealth of the private sector, for example, would have some of the drawbacks of a broad credit aggregate but it might be more in keeping with our existing approach to monetary targets.

NON INTEREST BEARING M1

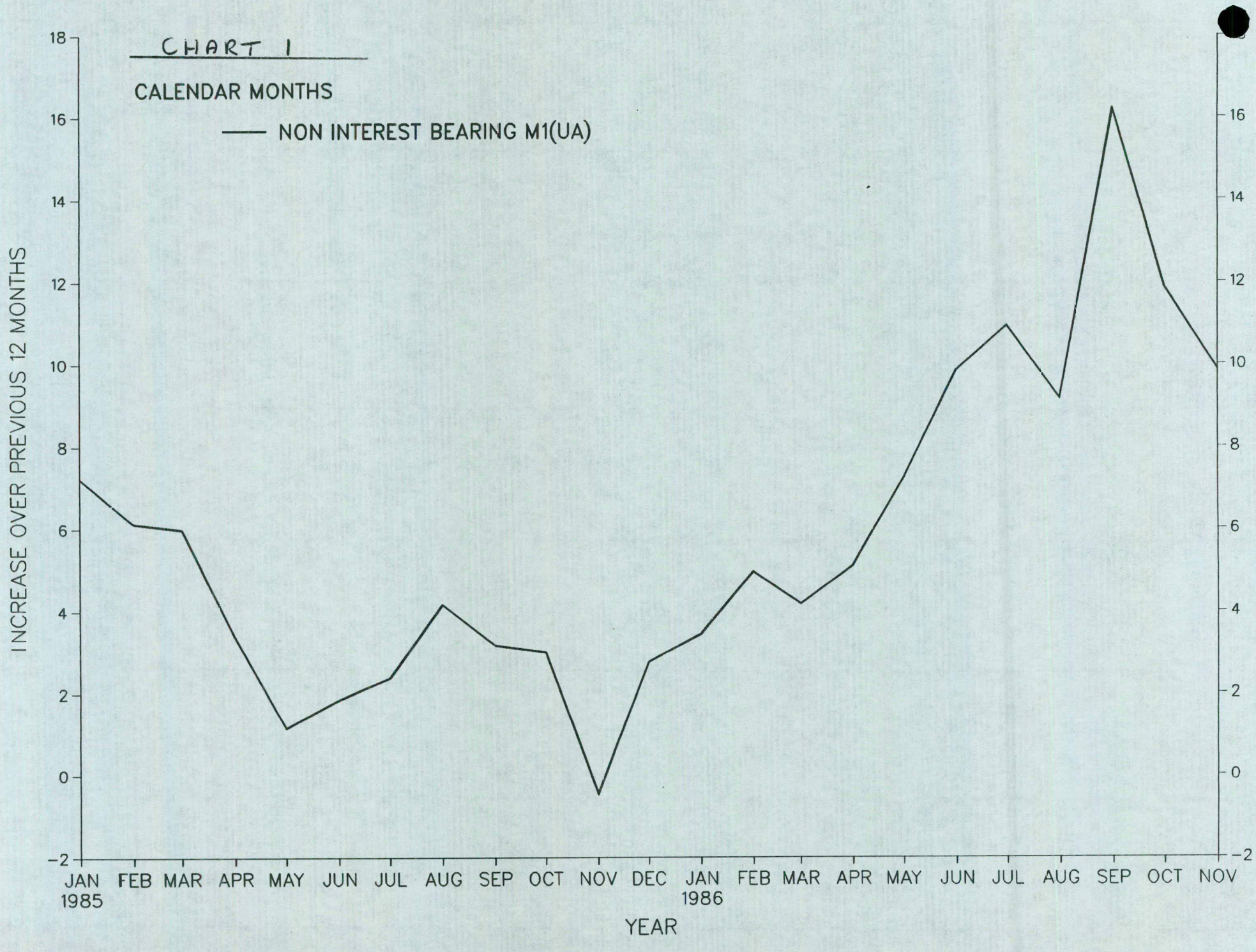
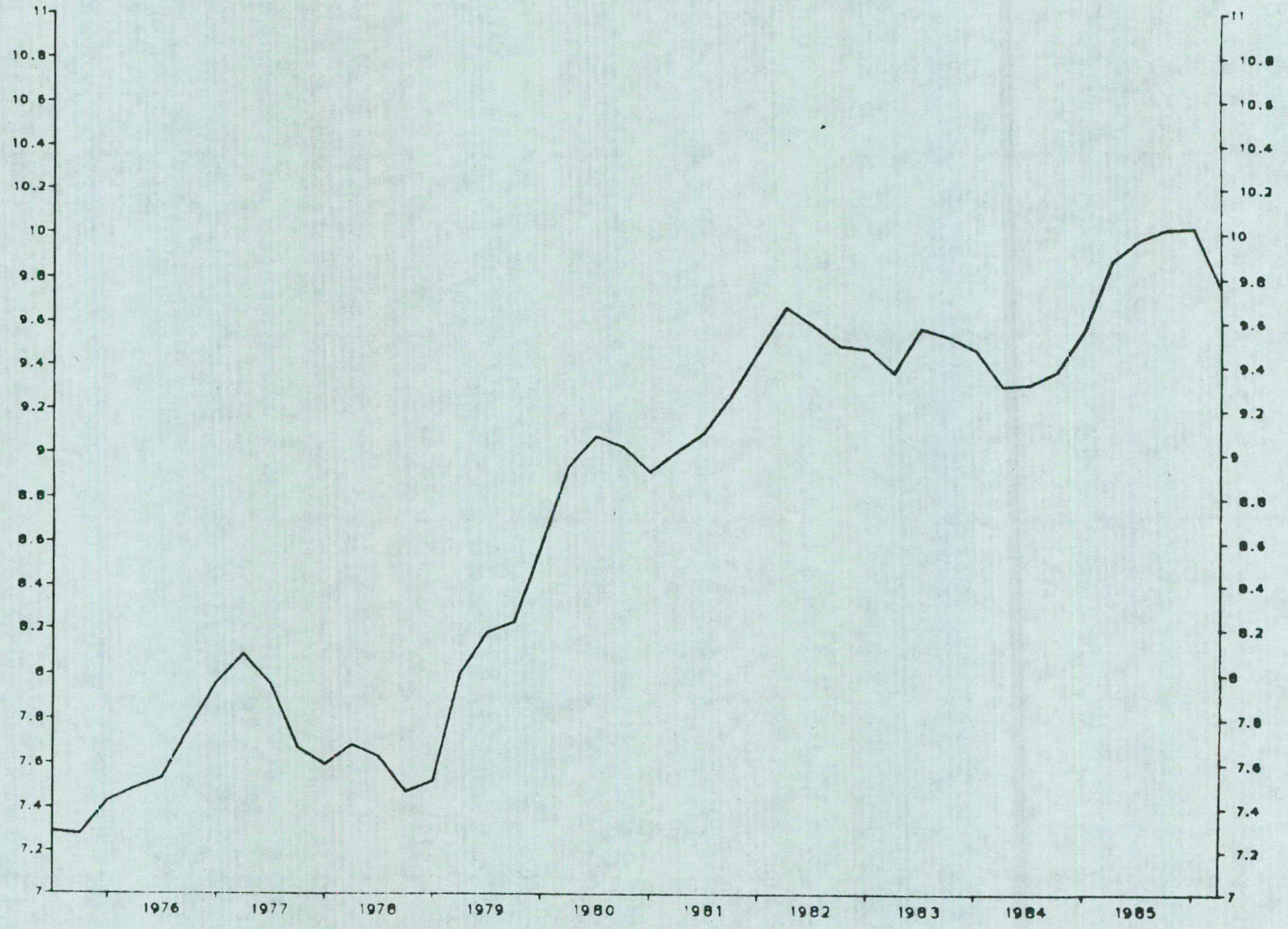


CHART 2

NON-INTEREST BEARING M1 VELOCITY



Section 14: Balance sheets

TABLE 1

14.1 Financial assets and liabilities of the non-bank private sector (consolidated)

Holdings at end of period

£ million

		1975	1976	1977	1978	1979	1980	1981	1982	1983
Financial assets										
Money (M3): sterling	ALAA	36,291	39,805	43,530	50,137	56,658	67,201	76,576	91,489	101,656
: other currencies	ALAB	2,939	3,896	4,151	4,799	5,202	6,189	9,872	12,756	16,376
National savings	ALAC	8,035	8,478	9,786	11,337	10,848	12,245	18,351	22,027	25,041
Trustee saving bank balances with National Debt Office	ALEA	-	-	-	-	1,266	1,122	937	-	-
Tax instruments	ALAD	18	22	678	951	1,093	1,377	1,227	2,312	2,283
Treasury bills	ALAE	706	404	747	210	265	232	244	253	280
Local authority temporary deposits and bills	ALAF	2,178	2,332	1,756	1,881	3,218	3,454	2,891	1,830	1,758
Public sector long-term debt	ALAG	22,268	27,580	40,975	41,512	48,329	57,698	59,989	79,378	88,583
UK debenture and loan stock	ALEG	300	300	450	400	450	400	800	1,350	1,300
UK ordinary and preference shares	ALAH	4,280	3,438	4,643	5,440	6,440	9,872	10,945	7,698	8,371
Other domestic loans	ALEH	353	293	367	1,609	1,608	1,585	1,552	1,297	1,287
Domestic trade and other credit	ALAJ	4,900	6,000	7,150	7,800	8,900	9,000	11,250	12,000	13,200
Other domestic assets	ALEI	319	272	220	226	242	259	292	335	394
Overseas assets(1)	ALAL	29,013	36,600	37,446	43,179	49,680	58,507	78,255	105,083	127,609
Accruals of taxes, rates and interest	ALAM	223	391	560	639	829	1,338	1,354	1,984	2,217
Total assets: gross financial wealth	ALAN	111,823	129,811	152,459	170,120	195,028	230,479	274,535	339,792	390,355
Liabilities										
Bank lending: sterling	ALAO	23,211	26,201	29,549	34,079	42,031	51,150	57,658	68,222	77,216
: other currencies	ALAP	5,610	6,975	7,394	8,036	8,270	8,792	13,471	19,937	24,604
Issue Department holdings of bills,etc(2)	ALEE	5	330	26	10	25	420	2,939	7,620	6,901
Building society wholesale borrowing	ALEJ	-	-	-	-	-	12	66	209	1,170
UK ordinary and preference shares	ALAQ	2,770	3,631	3,411	4,112	4,884	5,627	7,814	7,368	10,001
Public sector loans for house purchase	ALAR	3,437	3,564	3,586	3,552	3,925	4,681	5,303	6,209	5,924
Bank loans for house purchase	ALEB	1,320	1,400	1,520	1,790	2,380	2,880	5,143	10,751	14,845
Other public sector loans	ALAS	1,039	1,249	1,400	1,319	1,294	1,149	1,066	1,097	1,149
Domestic trade and other credit	ALAU	4,500	5,500	6,000	6,950	8,950	9,250	10,500	11,000	12,150
Other domestic liabilities	ALEK	478	371	336	439	360	311	317	383	414
Overseas liabilities(1)	ALAW	19,630	22,621	27,184	29,255	35,189	39,620	46,237	53,387	58,510
Accruals of taxes, rates and interest	ALAX	3,095	3,518	3,898	4,670	7,738	8,846	11,905	10,891	11,740†
Total liabilities	ALAY	65,095	75,360	84,304	94,212	115,046	132,738	162,419	197,074	224,624†
Net financial wealth	ALAZ	46,728	54,451	68,155	75,908	79,982	97,741	112,116	142,718	165,731†

		1984			1985				1986	
		2nd qtr	3rd qtr	4th qtr	1st qtr	2nd qtr	3rd qtr	4th qtr	1st qtr	2nd qtr
Financial assets										
Money (M3): sterling	ALAA	105,532	107,764	111,953	114,074	118,013†	122,950	126,971	133,125	140,019
: other currencies	ALAB	16,506	17,489	20,958	19,094†	19,462	19,695	20,124	20,776	22,502
National savings	ALAC	26,619	27,723	28,447	29,123	29,862	30,479	30,939	31,226	31,885
Tax instruments	ALAD	2,163	1,950	2,775	2,804	2,896	2,885	3,267	2,995	3,505
Treasury bills	ALAE	536	469	281	301	319	336	210	260	241†
Local authority temporary deposits and bills	ALAF	2,231	2,541	2,310†	2,370	2,298	2,146	1,791	1,685	1,436
Public sector long-term debt	ALAG	89,012	92,503	95,368†	97,718	100,125	102,683	104,548	114,609	112,824
UK debenture and loan stock	ALEG	1,450	1,350	1,200	1,400	1,670	1,540	950†	750	650
UK ordinary and preference shares	ALAH	8,450	8,550	8,729	9,200	9,150	10,450	12,283†	11,250	11,500
Other domestic loans	ALEH	1,280	1,280	1,280	1,271	1,269	1,269	1,269	1,235	1,234†
Domestic trade and other credit	ALAJ	13,350	13,800	12,500	12,400	12,550	12,650	12,750	12,400	12,600†
Other domestic assets	ALEI	443	476	510	543	563	583	603	621	641†
Overseas assets(1)	ALAL	140,451	157,683	170,829	170,027†	165,606	161,481	170,767	185,893	193,893
Accruals of taxes, rates and interest	ALAM	1,808	2,089	2,747	1,622	2,213†	2,504	3,525	2,360	2,923
Total assets: gross financial wealth	ALAN	409,831	435,667	459,887†	461,947	465,996	471,661	480,007	519,105	535,853
Liabilities										
Bank lending: sterling	ALAO	83,778	84,575	87,742	96,947	100,320†	102,365	102,340	110,541	115,797
: other currencies	ALAP	29,910	33,507	37,778	38,537	37,540	34,677	34,554†	36,607	37,293
Issue Department holdings of bills,etc(2)	ALEE	7,166	9,169	9,953	7,309	7,197	7,578	10,961	8,818	7,409†
Building society wholesale borrowing	ALEJ	1,143	1,583	1,905	1,892	1,817†	1,863	1,987	1,814	2,008
UK ordinary and preference shares	ALAQ	9,794	10,213	19,720	20,295	18,706	19,822	20,402	22,109	20,355†
Public sector loans for house purchase	ALAR	5,822	5,751	5,686	5,495†	5,359	5,246	5,106	4,951	4,808
Bank loans for house purchase	ALEB	15,755	16,224	16,888	17,406	18,195†	19,819	20,981	21,565	22,712
Other public sector loans	ALAS	1,202	1,169	1,273	1,239	1,217	1,261	1,420†	1,304	1,673
Domestic trade and other credit	ALAU	11,850	11,600	10,050	10,600	10,050	9,950	10,850	11,150	10,700†
Other domestic liabilities	ALEK	882	972	3,809	3,842†	3,940	4,106	4,665	5,115	5,263
Overseas liabilities(1)	ALAW	58,137†	62,935	65,794	67,574	69,055	70,160	73,281	76,748	78,575
Accruals of taxes, rates and interest	ALAX	10,802†	11,769	13,093	9,978	11,021	12,158	13,898	11,182	11,925
Total liabilities	ALAY	236,241†	249,467	273,691	281,114	284,423	289,005	300,445	311,904	318,518
Net financial wealth	ALAZ	173,590†	186,200	186,196	180,833	181,573	182,646	189,552	207,281	217,335

1. From the beginning of 1983, estimates are no longer available for certain components of these items. After that date,the values of these components are included indistinguishably in domestic trade and other credit.
2. Holdings of commercial bills & shipbuilding credit paper.

Source: Central Statistical Office

ps1/57A

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NOTE OF A MEETING AT NO.11 DOWNING STREET
AT 3.00 PM ON THURSDAY, 8 JANUARY 1987

Those present

Chancellor
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Peretz
Mr Culpin
Mr Kelly
Mr Riley
Mr Ross Goobey

MONETARY POLICY AND THE 1987 MTFS

The meeting considered the questions set out in paragraph 3 of Mr Peretz' note of 31 December.

New options

2. The Chancellor said he saw some attractions in NIB M1, since it might have greater credibility than M0, given the doubts expressed - especially by the Bank of England - that M0's extreme narrowness made it difficult to take seriously. But he accepted the advice in Mr Grice's note of 7 January that NIB M1 did not seem to provide a practical guide to policy, partly because the split between interest bearing and non-interest bearing components of M1 had probably not yet reached equilibrium. He thought it would be worth keeping in play as a tactical device in discussions with the Bank, so that if the Bank rejected it, they would be that much more committed to M0.

3. The Chancellor said he had been interested in a credit proxy as a round-about way of assessing monetary conditions. But he was again persuaded by the arguments in Mr Grice's minute that this was not something to be pursued now.

Options to be ruled out

4. It was agreed that no targets at all, more explicit exchange rate targets, and DCE could all be ruled out. Mr Peretz noted that even the IMF had changed their minds on dropping monetary targets altogether.

Targetting M0

5. Everyone agreed that we should continue to target M0. There were arguments for saying we should not publish ranges for later years; other countries did not. But it was not clear we would gain much. Mr Culpin felt that if all we published were ranges for M0 one year ahead, that would mean dropping (a) broad money; and (b) the medium-term from the MTFS; would a gain in flexibility be worth that? Sir T Burns felt a gain in "flexibility" was probably a bad thing, and he would rather keep ranges for M0 for the future. The Chancellor agreed, and thought there was a strong case for business as usual, retaining ranges for future years.

Broad money

6. The Chancellor thought the options were to retain the status quo and target £M3 again, or to abandon targetting broad money altogether. He did not see any convincing case for going to a different broad money target. There were problems even with the "new institutional aggregate": if we did target it, people would expect us to be guided much more strongly by movements in it. He thought the most promising option was to adopt a formal target for M0 only, but to take account of the growth of broad money on much the same basis as we took account of movements in the exchange rate - ie option (g) in paragraph 8 of the paper attached to Mr Peretz' note. He saw no attractions in having a "monitoring range" in place of a target.

7. Mr Cassell said that decisions on funding were important here. There were some attractions in saying we would look equally at all

measures of broad money, but that was not consistent with a funding policy based on selling gilts to the non-bank sector, including building societies. The Chancellor wondered whether we might not move to a new definition of full funding which excluded sales to building societies; he had many fewer reservations about changing the funding rule (following the Building Societies Act) than to introducing new targets. Mr Cassell said this would be straightforward.

8. Sir P Middleton thought this could be a useful change. We could publish figures for both £M3 and £M3* (ie including building society deposits) and change our funding rule accordingly. There was general agreement that this approach seemed attractive.

Attitude of the Bank

9. There was some discussion about the likely attitude of the Bank. Their position would probably be, at least initially, to place more weight on money GDP and dispense with targets altogether. But there were some indications that they were moving towards accepting targets for M0 - though they might perhaps prefer a "monitoring range" to a target. The Chancellor commented that it was essential to persuade or manoeuvre the Bank into accepting greater responsibility for defending M0 targets.

Next steps

10. It was agreed that the next steps should be for the Treasury and Bank to prepare an agreed paper for discussion with the Chancellor and Governor. The options which should be included in the paper should be broadly as in paragraph 8 of the paper attached to Mr Peretz' minute, except that option (c) - DCE - should be dropped, as should option (e) - a different wide aggregate - unless the Bank insisted on putting it back in. The aim should be to hold a meeting at the end of the week beginning 19 January.

ACSA

A C S ALLAN

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Distribution

Those present
PS/CST
PS/FST
PS/EST
PS/MST
Sir G Littler
Mrs Lomax
Mr Odling-Smee
Mr Sedgwick
Mr Scholar
Mr Carr

PS Chancellor PLP
12/2

CHIEF SECRETARY - INTERVIEW ON STRENGTH OF THE ECONOMY

Transcript from: ITV Channel 4, 7-8 PM News, 8 January 1987

INTERVIEWER: (PETER SISSONS) ... SO WHAT ABOUT THE STATE OF THE ECONOMY, IS IT IN CRISIS AS LABOUR SAYS AND MANY OF THE UNEMPLOYED MAY FEEL OR DO THE OPTIMISTS IN THE CITY OFFER A BETTER ASSESSMENT? TO ANSWER FOR THE GOVERNMENT WE'RE NOW JOINED BY JOHN MACGREGOR WHO'S THE CHIEF SECRETARY TO THE TREASURY. COULD YOU DEAL FIRST WITH LABOUR'S PRINCIPAL ALLEGATION THAT YOU AND THE CHANCELLOR ARE WORKING ON A PRE-ELECTION BUDGET IN AN ATTEMPT TO BUY VOTES WITH THE PRIME MINISTER FORCED BY ECONOMIC CRISIS TO CUT AND RUN IN MAY OR JUNE?

CHIEF SEC: Well I think the only crisis actually is in Labour's own economic policies and they're producing this election scare because they're scared of an election. And the plain fact is that it's not just the City who think that the economy is strong. I think all the indicators - and it really was nonsense for Neil Kinnock to say that we're talking the economy down - all the indicators are that over the last 5 years we've had persistent economic growth on a scale we haven't experienced for some time, better than many of our competitors.

INTERVIEWER: We're still producing less than in 1979?

CHIEF SEC: But we went through a very severe recession and a period when we we had to do the shake out of overmanning under the Labour Government and all sorts of things during that period. In the last 5 years it's been very persistent. We're projecting that for next year.

INTERVIEWER: We've still lost 1 in 4 manufacturing jobs?

CHIEF SEC: But manufacturing has actually in the last 5 years maintained its share of world markets, which it hasn't done for ages. And I think, as was made clear at ""NEDC yesterday, the opportunities for manufacturing in exports now are very very tremendous. So we have been doing the restructuring of the economy. We've had to run down the older industries. We've had to cope with the modern high tech and the British

rail exhibition, the example we saw just now, is a very good example of it where the older type of railway engine is no longer required and the modern doesn't need the maintenance. We've had to cope with all of that. But the basic point is that the economy is strong and we're moving with balanced growth into this year.

INTERVIEWER: The balance of payments isn't strong is it? Labour accuse the Government of ignoring the balance of payments, ignoring the imports that are being sucked in, they say it's happening because of a short term credit expansion which you don't dare to stop?

CHIEF SEC: I don't think that's actually at all why it's been happening. First of all, we've had very strong balance of payments surpluses over the past 5 years which is the background to this. Secondly, the present deficit that we're expecting this year in the balance of payments is as a proportion of our national income very small compared to what we were experiencing under Labour. What's actually happened is that we've had to adjust to the change in the oil patterns over the last year and that has obviously affected our balance of payments for a period and the sterling has had to adjust to that. Now as the prospects for British exports grow and as the markets, the world markets, start to re-adjust to the oil position I believe that we will see us dealing with that problem. So it's not a crisis, not a crisis at all.

INTERVIEWER: There's a lot of agreement, and I heard it on your own Back Benches, that we have this short term credit led expansion that will have to be stopped sooner or later and you are ignoring it?

CHIEF SEC: Not at all because, as I say, it's a balanced growth and sometimes the Labour Party actually believe that the growth isn't strong enough. It's a balanced growth and I don't believe that the City would have reacted in the way it has, and it certainly isn't only in the City. Because I think what is also very interesting is that we've very had very substantial endorsement of our policies and of the present economic

situation from the CBI and from various other industrial and trade organisations. Now they are all making their assessment and it's an assessment that accords very much with our own view and not at all with the Labour Party's view.

CHIEF SEC: How do you react to Neil Kinnock's tax promise that he will restore any cut in the basic rate made by Nigel Lawson this spring?

CHIF SEC: I think it's very interesting actually. I mean it's very interesting how little they've been prepared to say about their tax policies and their economic policies following the Bishops Stortford 2 days. Roy Hattersley was asked about this over the weekend and I think has had a pretty universal panning since then by all the commentators for what he's been saying about tax. The plain fact is that they are still coming forward with very high public expenditure programmes way beyond what we're doing, way beyond what we believe the economy can afford. And that can only be financed by very big increases in taxes across the board, income taxes right across the board on people on very modest incomes. And their figures simply do not begin to add up. And I think that most of the economic commentators see that. And that's why there's so much scepticism about Labour's economic policies.

INTERVIEWER: Is it still your intention to cut the basic rate in the next Budget?

CHIEF SEC: You wouldn't expect me today to predict what the the Chancellor might wish to do in the Budget. Obviously at this stage I don't know. It would be quite wrong for me to say anything about that.

INTERVIEWER: Well Mr Hattersley's point is that if you don't do it in the next Budget he says the promises of tax cuts are unsustainable and untrue?

CHIEF SEC: I think the proof of the pudding will be in the eating. Mr Hattersley's made a lot of predictions about economic crisis over the last few years and he's always been proved wrong.

22/3069

PERETZ CH/EX 23/1

CONFIDENTIAL

FROM: DAVID PERETZ
23 January 1987

CHANCELLOR —

cc Chief Secretary
Economic Secretary
Financial Secretary
Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mrs Lomax
Mr Sedgwick
Mr Scholar
Mr Grice
Mr Kelly
Mr Riley
Mr Culpin
Mr Carr
Mr Ross Goobey

MONETARY POLICY AND THE 1987 MTFS

I have sent forward separately the paper, and annotated agenda for next Thursday's meeting with the Governor.

2. You will recognise most of the paper, though we have reordered and shortened it a little - and there are one or two new points. The points that emerged in my discussion with the Bank of England are:

(i) They appear to accept that we should continue to target MO. I do not think they feel as comfortable with MO as paragraphs 23-27 of the paper imply, but they did not seek to change the drafting or to add anything.

(ii) I doubt whether they want either a target or a "monitoring range" for broad money. But they have introduced a new option, described in paragraph 31 of the note, which would involve publishing a "forecast" or "projection" for broad money.

3. It will probably be sensible to take the Bank through the

whole list of issues in the annotated agenda. But I suggest you might spend time in particular on:-

(a) What can be done to improve the credibility of MO. (Need for the authorities to speak with one voice.)

(b) The idea of showing a broad money forecast or projection. The arguments against strike me as a good deal more weighty and convincing than those for. Apart from those mentioned, if we gave a forecast for £M3 in the FSBR Part 3, we would also be asked to give a forecast for MO. I am not quite clear how seriously the Bank regard this suggestion. You may need to try to flush them out.

(c) The questions about which measure of broad money to highlight; whether to publish the new "institutional aggregate"; and whether or not to make a parallel change in the funding rule. This is clearly the year to make a switch, with the coming into force of new building society powers. I have a suspicion that the Bank may try to suggest shelving this issue as one that does not need early decision, and as a less "central" issue. I hope nevertheless we can make some progress on it. It affects both the drafting of references to broad money in the MTFS; and the form of future publication of the money figures (something which on past experience we will have to spend some time on with the Bank before we can agree on the revised format, which we really should have settled by Budget time).

D L C PERETZ

24/3069

CONFIDENTIAL

FROM: DAVID PERETZ
23 January 1987

CHANCELLOR

cc Chief Secretary
Economic Secretary
Financial Secretary
Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mrs Lomax
Mr Sedgwick
Mr Scholar
Mr Grice
Mr Kelly
Mr Riley
Mr Culpin
Mr Carr
Mr Ross Goobey

MONETARY POLICY AND THE 1987 MTFS

I attach a list of issues for discussion at your meeting with the Governor on 29 January, and a background paper. The list of issues is agreed with the Bank. The paper has been discussed with the Bank and includes a number of Bank suggestions. We are agreed that it covers all the necessary background.

D L C PERETZ

cc: Bank of England

Governor
Deputy Governor
Mr George
Mr Flemming
Mr Coleby

31/3068

CONFIDENTIAL

MONETARY POLICY IN 1987 MTFS: ISSUES

(i) **Have we identified all the potential options?**

Paragraph 8

(ii) **Are there any options we can rule out, firmly.**

- An exchange rate guidline outside the ERM (paragraphs 13-20).

- A target for broad money

(iii) **Do we want to continue to target MO?**

Would it make sense to switch to targetting nib M1 (paras 23-24)?

- Is a target for MO better than no target at all (paragraphs 9-12 and 25-26)?

- Can we target only MO?

- What can we do to improve the credibility of an MO target?

- Publish illustrative ranges again for later MTFS years? (paragraph 27).

(iv) **Target; monitoring range; projection; or nothing for broad money?**

Do we think the idea of a "monitoring range" has any advantages over retaining a target? Would it be better to have no range, but to say we continue to take account of the behaviour of broad money in much the same way as we take account of the exchange rate? Would publishing a "projection" for broad money be helpful, or the reverse? (Paragraphs 28-32)

(v) **What if any measure of broad money should we emphasise?**

Case for switching to PSL2 or a new bank plus building society aggregate, now that building societies have their new powers? Similar case for a change to funding rule? Implications for monthly money figures announcement? (Paragraphs 33-41).

CONFIDENTIAL

MONETARY POLICY IN THE 1987 MTFS

Introduction

This paper reviews the options for monetary targets for 1986-88, and the related material on monetary policy to be included in the 1987 MTFS. It is designed to provide background for a preliminary discussion.

Work carried out last year

2. Extensive work on the choice of target aggregate was carried out during the second half of 1985. Many of the conclusions reached then still appear to hold good. Annex 1 displays the advantages and drawbacks, as potential targets, of the main monetary aggregates.

3. Among the **narrow aggregates**, M0 looked then, and still looks, the best aggregate to choose for target status. Although in principle there would be attractions in adopting a wider transactions aggregate, such as M1, its behaviour continues to be distorted by the growth in interest bearing sight deposits. The same factor distorts the behaviour of non interest bearing M1.

4. If we are to continue to give any special status to a single **broad aggregate**, as last year the choice probably lies between £M3, PSL2 and a new building society/bank institutional aggregate (in effect £M3 extended to embrace building societies as well as banks).

5. The conclusions of last year's work were that it was doubtful whether the behaviour of any of the broad aggregates was sufficiently stable or predictable for target status. And there was the further point that there was no evidence that they would react to changes in interest rates within the target period; so that following the end of over-funding there was no instrument left with which to meet any target set. If any broad aggregate were to be given target status, it was concluded that a wider

aggregate such as PSL2 or a new institutional aggregate would have considerable advantage over £M3.

6. In the event it was decided to continue to target £M3 (but to raise its target range substantially), largely because of the market's familiarity with that aggregate. It was accepted that this decision might have to be looked at again before the 1987 MTFS, by when the building societies' new powers would be in operation. Although the range for £M3 continued to be described as a "target", it was made clear in the 1986 MTFS that were it to overshoot it would not necessarily be possible to get it back within its target range during the year, but that monetary conditions could be tightened in other ways.

7. Experience since March this year has confirmed the drawbacks of £M3 as a target aggregate. The fall in its velocity, which seemed to be speeding up a year ago, has accelerated sharply since. And it has continued to prove a good deal more volatile than the broader aggregates, as banks have gained market share at the expense of building societies, and building societies have switched to holding a greater proportion of their liquidity in the form of bank deposits.

Possible Options for 1987 MTFS

8. It may be worth considering the following options as possibilities for the 1987 MTFS. Some are clearly more realistic than others, and some are included mainly for expository purposes.

(a) We could abandon formal monetary targets altogether, and reaffirm that decisions on interest rates will continue to be made taking all the monetary evidence into account, with the aim of keeping clear downward pressure on inflation and securing the desired medium term path for money GDP.

(b) With or without abandoning monetary targets, we could seek to give the exchange rate a more explicit role. Apart from the ERM, one possibility might be to publish

a "monitoring zone" for the effective index.

(c) We could follow last year's pattern, and fix formal targets once again for both MO (with or without illustrative ranges for later MTFS years) and £M3.

(d) We could have a formal target for MO (with or without illustrative ranges for later years), but some looser range, which we might describe as a "guideline" or "monitoring range" for one or other of the broader aggregates.

(e) We could adopt a formal target for MO only (with or without illustrative ranges for later years), "taking account of" the growth of broad money but with no mechanical rule - on very much the same formula as we use at present for movements in the exchange rate. We would still need to consider which measure(s) of broad money we should focus on.

Abandon targets altogether?

9. In the course of this year's IMF Article IV consultations, the IMF team suggested at one stage that the best approach for next year's MTFS would be to **abandon formal targets altogether**. They also suggested that at the same time we should give slightly increased status to the path for money GDP: making it clear that this path is an objective, set after taking account of expected rate of growth of productive capacity in the economy, not merely a forecast.

10. The arguments for abandoning monetary targets altogether would be that:-

(i) the behaviour of all the monetary aggregates is now too uncertain for target purposes; and

(ii) the Government has an established counter inflationary track record, so that the need for clear external guidelines is less than it was.

11. Against that there would be severe presentational disadvantages. It could all too easily be portrayed as a sharp break in policy, which would add unhelpfully to uncertainties at a time when the market is in any event likely to become more unsettled as the date of the next election gets closer. Although we have established a counter inflationary track record, it is debateable whether it is sufficiently firmly set to let us do without any external guideline at all. Even the Germans see the need to maintain a monetary target, despite doubts somewhat similar to our own about the behaviour of their chosen target aggregate. (In fact we understand the IMF staff have now changed their minds, and will be recommending in their final report that we should retain one or more monetary targets.) Even so, the judgement clearly turns on whether we have sufficient faith in the behaviour of any of the potential target aggregates. If the uncertainties are too great, then abandoning targets altogether could be the lesser evil.

12. Attaching enhanced status to the money GDP path is to some degree a separate issue. It is of course not a new idea, and the difficulties of using it as an operational target are well known. The current behaviour of money GDP tends not to be a useful guide to policy, first becuase it is not known until sometime after the event. And second because changes in policy affect the future path of money GDP not its current level. But there might be ways in which the MTFS projection for money GDP could be given more of the character of an objective than it has had heretofore (see para 31 below).

An exchange rate guideline?

13. We have felt (and argued publicly) that it would be wrong to establish an **exchange rate target** for sterling, outside the EMS, for two reasons. First, the exchange rate, taken by itself, is not always a good indicator of monetary conditions; it can be affected by external events as well as domestic ones, and, domestically, by supply side factors as well as demand ones. A movement in oil prices, for example, or a shift in productive potential (such as would be caused by an oil price or other terms of trade change) ought to be allowed to feed through to the exchange rate. Though it would influence monetary conditions

through its effect on inflation, it would not directly tell us very much about them. It is for this reason that we have argued that movements in the exchange rate need to be put into context, and interpreted alongside the other indicators.

14. Second, we have argued that if we were to adopt an exchange rate target, it would be foolish to do so other than in the context of a formal exchange rate system, shared by other countries, and supported by a coordinated approach to economic management and intervention. In market terms an explicit target is an open invitation to speculators to test the authorities' resolve. We would be much better placed to deal with this as part of an agreed international arrangement, such as the exchange rate mechanism of the EMS.

15. If we were to move away from this position and adopt a more formal target by ourselves this could only be because:-

(i) we had so little faith in the other monetary indicators that the disadvantages of an exchange rate target seemed relatively less important, and outweighed by the advantages of a clear explicit discipline; or

(ii) (a slightly different point) because we had persuaded ourselves that we wanted a more stable exchange rate, and that announcing a target or target range might help to achieve that; and

(iii) we had concluded for other reasons that we did not want to join the ERM.

16. As to the form such a target or guideline would take, it is a little difficult to see logically where there is to stop between an explicit and precise target (ie joining the ERM) and our present position. But we might, for example, think in terms of some kind of "monitoring" zone, establishing a presumption that if the rate moved outside the zone then clear contradictory evidence would be required from other indicators if there were not to be a shift in interest rates.

17. The most obvious way of expressing this would be in terms of the ERI, which would also have the advantage of familiarity. Alternatively, we could think in terms of an oil-adjusted ERI, or perhaps construct some different index altogether, more directly related to inflation. Whatever aggregate was used would clearly need to be published.

18. Presentationally, the main difficulty in operating a regime of this kind might be in explaining why it was preferred to joining the ERM - particularly given what we have said in the past about the disadvantages of setting an independent target. The answer would have to be expressed in terms of allowing us greater discretion to take account of other indicators. But the more we ran that line, the less credible the arrangement would be as providing a firm grounding for the operation of monetary policy. It would be assumed by many that we were not joining the ERM for political reasons.

19. Operationally, one of the main difficulties would be that any exchange rate index would be available more or less continuously. We would therefore have to be ready to respond on a similar basis. However much we described it as a zone with soft edges, the market would try to test our resolve - and we would quickly have to decide whether or not to defend the limits. The result, could, paradoxically, be to increase market instability rather than reduce it.

20. Some of these problems would be resolved if there were any prospect of an early **international move to some kind of exchange rate target zone arrangement** - say between G5 countries. But this seems unlikely. The US-Japan understanding appears to contain little of substance in terms of agreement about what if any action would be taken if the $/Yen rate were to change substantially. And there seems little prospect of the Germans agreeing to any wider arrangement.

Target Monetary Aggregates

21. Option (b), then, can probably be categorised as interesting,

but not very practicable, with a range of real and presentational difficulties. Option (a) has similar drawbacks: but a final judgement must depend also on our assessment of the options that involve continuing to target one or more monetary aggregates (Options (c)-(e)).

22. The ideal target monetary aggregate would have a combination of the following features:

- a reasonably stable or predictable relationship with money GDP over time

- some lag in that relationship, with movements in the target aggregate preceding those in money GDP, or at least providing guidance about the contemporaneous behaviour of money GDP before the GDP data is available.

- it should respond to interest rates, with higher rates leading to lower growth within a reasonable period.

- it should also react in the right direction to changes in fiscal policy, at given interest rates

- we should not expect its velocity trend to be affected within the target period by institutional or technological change

- we should be prepared to act on it, and it should carry credibility with the financial markets.

Narrow money

23. In principle there would be a case for choosing an aggregate that embraced all balances held for transactions purposes. However the growth of interest bearing sight deposits has affected the behaviour of both M1 and non-interest bearing M1, making them hard to use for target purposes (see Chart 2 and 3). So of the possible target narrow aggregates, MO still probably comes the closest to meeting the criteria. (See Annex 1).

24. The difficulty is that MO is so narrow - consisting almost entirely of notes and coin - as to raise questions about its credibility: it is thought to be vulnerable to unpredictable innovation, even though this has so far proved not to be the case. Hitherto this has led us to wish to supplement a target for MO with a target for broad money as well, despite the difficulties we have encountered with £M3. It also raises the question of whether, despite the draw backs, it is worth reconsidering the case for targetting the wider transactions measure, n.i.b. M1. Annex 2 discusses the potential advantages and problems. The main difficulties are the extreme variability of this aggregate, and its very high sensitivity to interest rates changes.

25. Assuming we stick with MO as the narrow target aggregate, it is worth noting a number of particular properties of MO that could have implications for the choice target range or the way that policy is operated, or both.

(a) The **velocity trend has been stable** relative to that exhibited by other monetary aggregates;

(b) it has some **desirable forward looking properties.** First, it provides information about the current behaviour of money GDP before the GDP data itself becomes available. Second, it tends to respond to factors such as interest rates before money GDP does so. This makes it a useful leading indicator.

(c) It is affected by **fiscal policy** as well as interest rates. Again, this is a desirable characteristic.

(d) Its **velocity appears to change,** a little, with the level of interest rates (with lower rates leading to faster MO growth for a given money GDP); and also with the composition of money GDP (with MO particularly sensitive to the growth of non-durable consumer spending). This second characteristic, is not necessarily a drawback, since we are probably not

indifferent to the composition of money GDP. If the investment component of GDP were greater we might be able to accept a faster growth in total money GDP, with the same ultimate inflation objectives, since the economy would be building up productive capacity for the future; and if growth seemed to be concentrated in consumption, then arguably that should lead us to try to tighten policy even if that meant temporarily undershooting the MTFS money GDP path.

26. More generally, although MO has shown a more stable velocity trend than the other aggregates, it still falls some way short of meeting the criteria set out in paragraph 22. In principle that could be an argument for having no target range at all - on the basis that given the history of monetary targeting it would now be less damaging to the credibility to have no policy guideline than one that we might want to breach. But:-

(i) MO would not, presumably, be used as the sole guide to policy. As hitherto, we would also look at the other evidence, including the exchange rate in particular. We would continue to say that a move outside the range would only create a presumption of a move in interest rates, which would be subject to the other evidence.

(ii) a wide range creates some scope to take account of short term shifts in velocity. And we have, hitherto, had a wide range (4 percentage points, while the Germans have just widened their range for Central Bank Money to 3 percentage points (3-6%), to take account of uncertainties about its behaviour). In practice however there may be less scope in one direction and more in the other for such variations if the range is wrongly centred when the target is set.

27. If we felt velocity was likely to change sharply from year to year that might constitute an argument against continuing to give indicative ranges for MO for the later MTFS years, even

if we continue with a target for year 1. It is always difficult, presentationally, to choose a target range for year 1 different from the illustrative range displayed the previous year for year 2. This would mean leaving the money GDP path as the only indicator of the Government's medium term policy commitment. Arguably, this would be sufficient. The issue is largely a presentational one. The real question is whether we can do without the buttress of a path for MO displayed for the whole MTFS period - particularly if this year other important changes are to be made to the MTFS presentation.

Broad Money: target, monitoring range, projection or "taking into account"

28. The Governor's Loughborough lecture has set the scene for dropping broad money targets altogether, if we wish to do so. Charts 4-6 show clearly that velocity, of all the broad aggregates, has been anything but stable - or predictable. These uncertainties together with their slow and possibly perverse response to interest rate movements, suggest that there is little case for giving any of the broad aggregates full target status. At most, as at present; any range would have to be regarded as in practice a guideline, in the sense that we would accept that if there was a move outside the range, it is unlikely that an interest rate move would return the aggregate to the range within the target period. (No change here from what is said about £M3 in the 1986 MTFS.)

29. One possibility would be to go further and change the terminology from target to "guideline" or "monitoring range". We might strengthen the message by saying that if the guidelines were breached action would only be taken if there were some supporting evidence. (This would be a change from the 1986 MTFS presentation.) This approach could be argued to have the advantage of going some way to reflect the spirit in which we actually look at movements in broad money - while avoiding going so far as to abandon entirely the practice of publishing a range for the year ahead. The likely result, though, whatever the terminology is that whatever we called the range we would in practice be stuck with all the operational problems of a target

range - and in that case we might just as well have stuck to the familiar terminology of a "target".

30. So it might be better to go further still, and publish no range at all for broad money. The questions then become how to describe the way in which we would continue to "take account" of the behaviour of broad money in setting interest rates; and which, if any, particular measure of broad money we should seek to highlight.

31. As with the exchange rate we would presumably say there was no mechanistic rule for taking account of broad money. It could be argued that it would nevertheless be useful to expose a forecast or projection of broad money that would be consistent with the money GDP path, spelling out the assumptions on which the figure was based. One possibility might be simply to publish the figures in the official financial forecast, describing the judgements or assumptions about financial behaviour which led to them. Another would be to provide figures based on explicit projection of recent velocity trends. In either case the figures could relate to a specified monetary aggregate (or aggregates) or be more loosely expressed in terms of "broad money" without specifying any particular measure." The arguments for this are that it would give the market a base against which to judge how we would "take into account" movements in broad money; and the arguments against are the reverse: that we would not ourselves find it particularly useful to judge the message from the broad aggregates against the base of such a projection; and that to publish it would mislead the markets.

32. The alternative is, as with the exchange rate, to have no figure at all. We might include in the MTFS some discussion of factors - including recent velocity trends - that might be expected to affect the growth of different measures of broad money without necessarily having any implications for policy.

Which measure of broad money?

33. If we were to have a target or "monitoring range", there would be a question of which measure or measures of broad money

to choose. Even without a published range, we would need to consider what if any measure or measures to highlight in the published figures, though this would be a less central issue. At present we highlight £M3, because it is the target aggregate, by publishing it together with MO in the "provisional" money supply figures.

34. There are three possible runners as "main" broad aggregate:-

(i) **£M3**

(ii) **PSL2**

(iii) a new **"institutional aggregate"** - like £M3 but extended to place building societies within the monetary sector.

35. **£M3** has the advantages of familiarity, and long runs of published figures. It is also consistent with the present funding rule. Against this its velocity has been even more volatile then broader aggregates, reflecting shifts in funds between banks and building societies. In the current financial year, after a run of years when the banks had been losing deposits share to the building societies, they contrived to increase their competitiveness and increase market share. At the same time the building societies have been adding to their holdings of bank deposits, while running down other forms of liquidity. These developments, which have only limited implications for monetary conditions generally, would not have affected aggregates including building society liabilities but did inflate growth in £M3. This distortion may be worth perhaps 3 per cent or so of the current annual growth rate.

36. The building societies legislation, which comes into force on 1 January 1987, is expected to accelerate the process of building societies' behaving as banks. This gives further weight to the argument for focussing on a wider aggregate than £M3.

37. One possibility would be to emphasise **PSL2**, instead. It

has had target status in the past so that it is not wholly unfamiliar to the financial markets. But there are some difficulties. It is not just a straightforward extension of £M3 to including building society liabilities as well as those of the banks. It also includes non-bank, non-building society private sector holdings of CTDs, of local authority temporary debt and of some National Savings products, such as Invac and premium bonds. One consequence is that PSL2 is more complex than £M3 to understand or interpret. A further difficulty may be the very fact that it has been targetted before and then dropped. Some might argue that an aggregate which had been found unsuitable as a target in the past could not be expected to be any better in future.

38. Some of these difficulties would be avoided by emphasising a new banks plus building societies **"institutional aggregate"**, in effect taking the change in building society powers to mark a point at which it no longer made sense to distinguish between liabilities of banks and building societies in the operation of monetary policy.

39. The same considerations would suggest a change in our **funding rule.** If banks and building societies are so alike it is hard to see why borrowing from societies should count as funding when borrowing from banks does not. Presentationally it might help to link the change to a more rigorous funding rule with a shift to emphasising a wider monetary aggregate. Again there would be an advantage in this respect in the "institutional aggregate" over PSL2, for a funding rule consistent with PSL2 would be a complicated affair - with CTDs, local authority temporary debt and some national savings instruments no longer counting as funding - and a good deal harder to explain.

40. A wider aggregate than £M3 would of course still be subject to the consequences of financial innovation and liberalisation. Its velocity could turn out to be as difficult to predict as that of £M3. And although the institutional aggregate has other advantages over PSL2, one awkwardness is that there is no published series and it would be necessary to construct and publish back figures.

41. As noted above, even without a target or monitoring range there would be a question about which if any measure of broad money to highlight. It would have some bearing both on the terms in which, in the MTFS, we describe how we take account of broad money; and the choice of aggregates to be published in the "provisional" money figures. In both contexts there would seem a good case for drawing attention to an expanded version of £M3, to include building societies, perhaps along side the traditional £M3 measure; and for linking this change to a change to a more rigorous funding rule, treating borrowing from building societies in the same way as borrowing from banks. This course would raise a number of questions about the form of the provisionals press notice, for example what if any counterparts to show, which we ought to have resolved before the MTFS is published.

Conclusion

42. Leaving aside the more radical, and probably less realistic, options, it looks as if we may be faced with a choice between:-

(i) a **target range for MO**, with or without illustrative ranges for later MTFS years; combined with

(ii) for **broad money** either a **target or monitoring range**, or simply a suitable statement about our intention to continue to **take account** of its behaviour (with an option of exposing some kind of "forecast" or "projected" figure for broad money);

(iii) with for broad money a choice between highlighting one or more of **£M3, PSL2** or a new **bank/building society institutional aggregate** (acknowledging the building societies' new powers, and the case for a more rigorous funding rule);

(iv) and with the description of how we take account of other factors, in particular the exchange rate, set out in familiar terms.

43. Discussion of what any target or monitoring ranges should be is best left until the MTFS arithmetic is more advanced, and until figures are available other decisions will clearly need to be provisional.

MOVEMENT

CHART 1

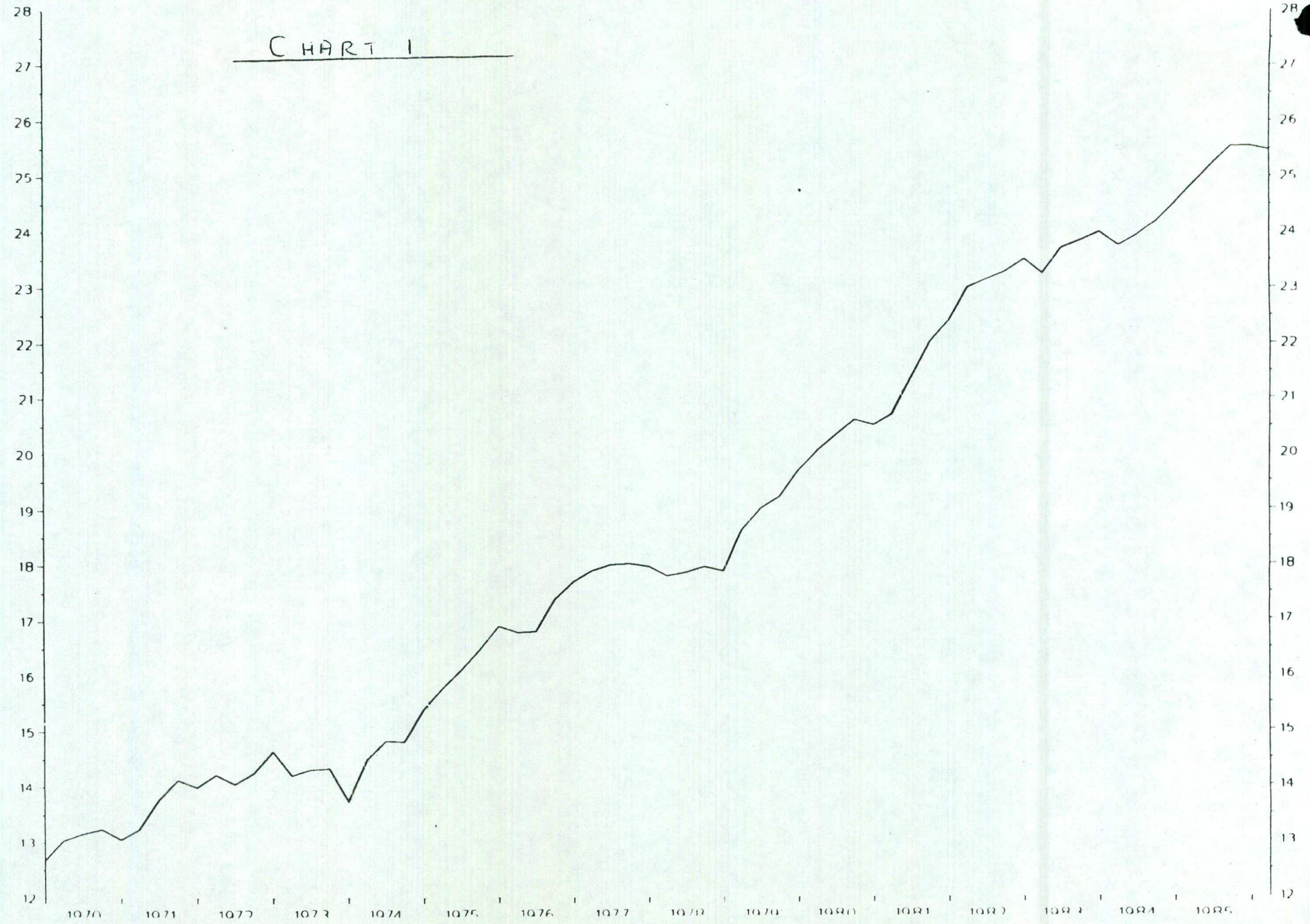


CHART 2

NON-INTEREST BEARING M1 VELOCITY

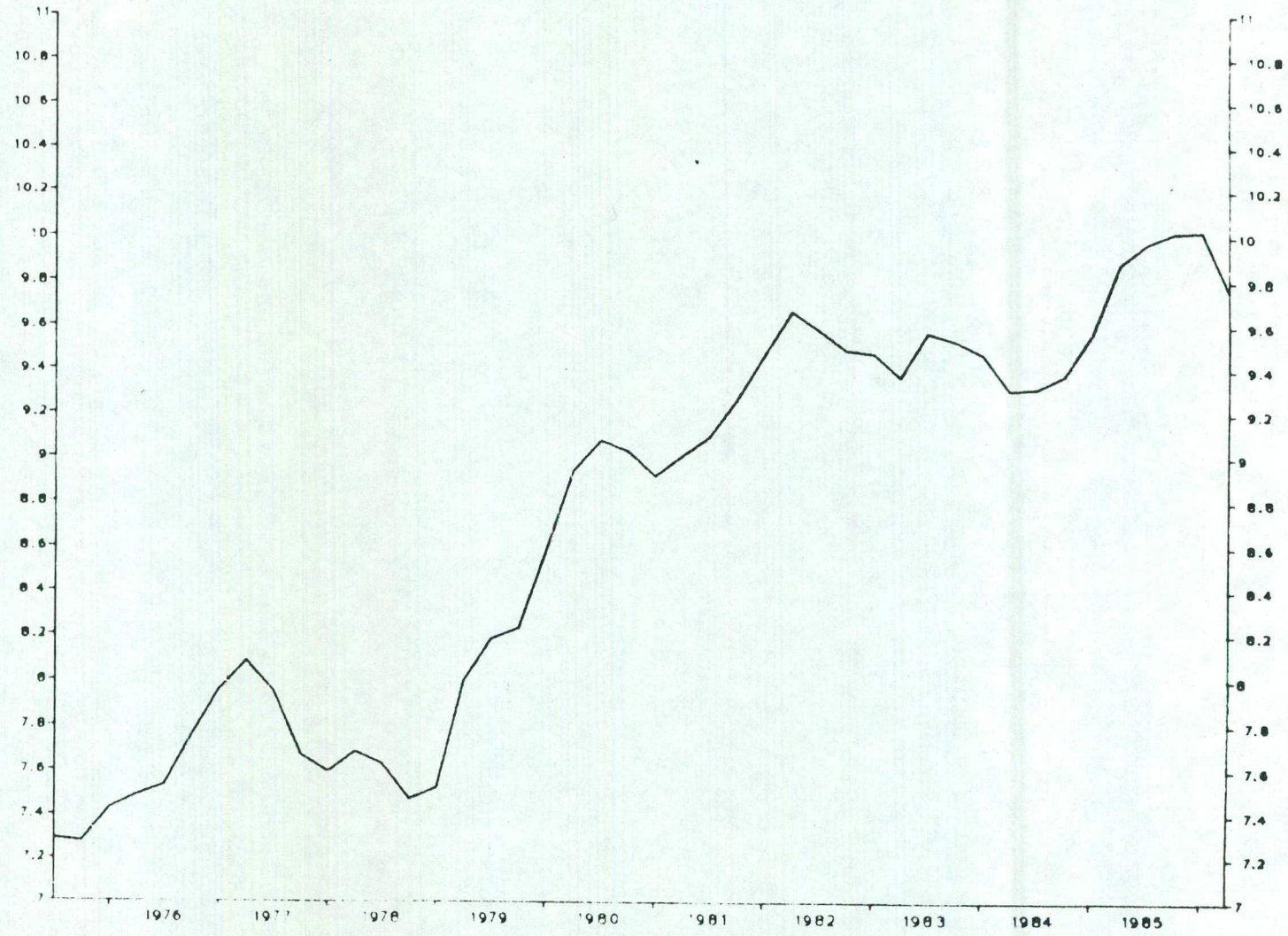
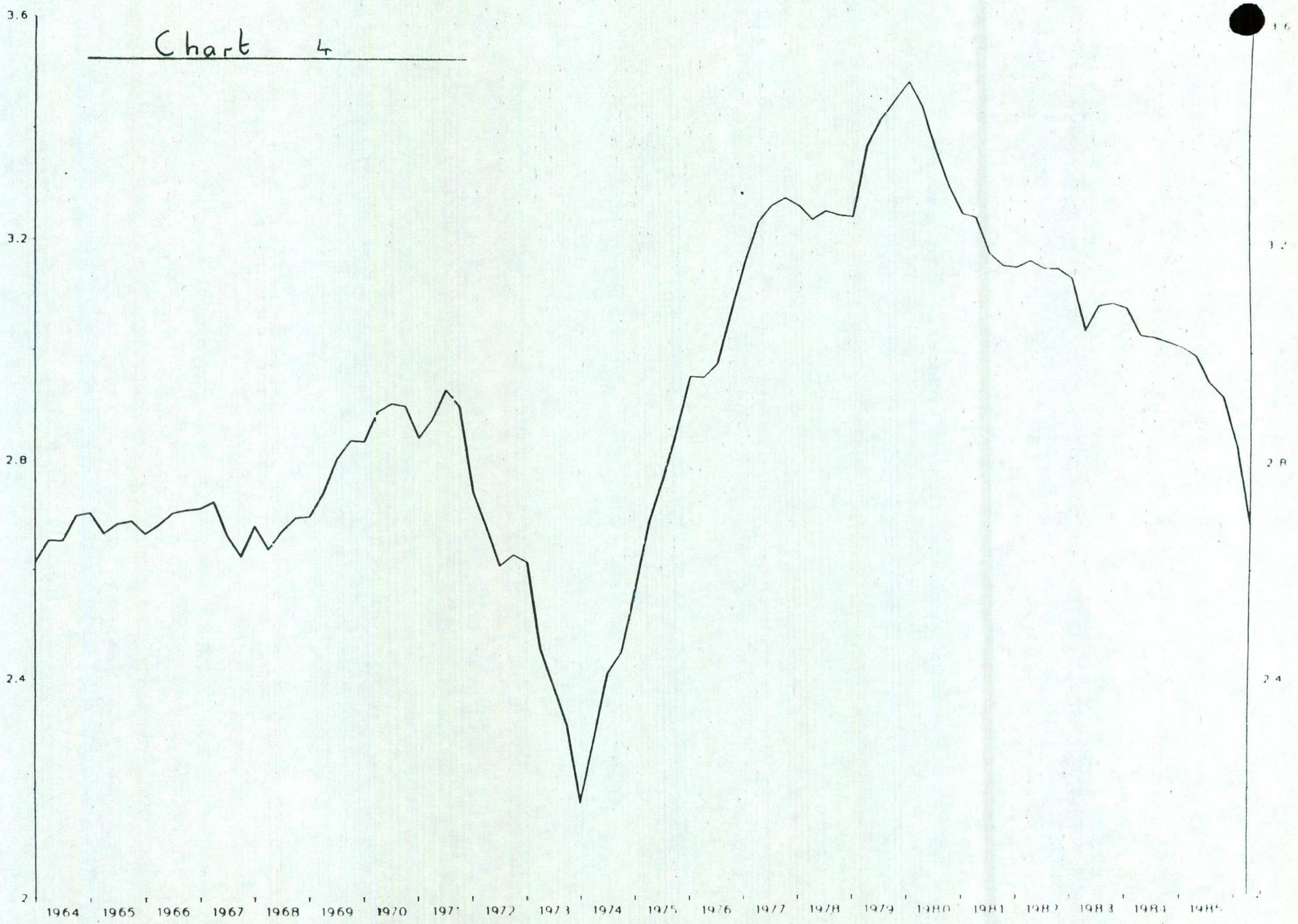


CHART 3

M1 VELOCITY

STERLING M3 VELOCITY

Chart 4

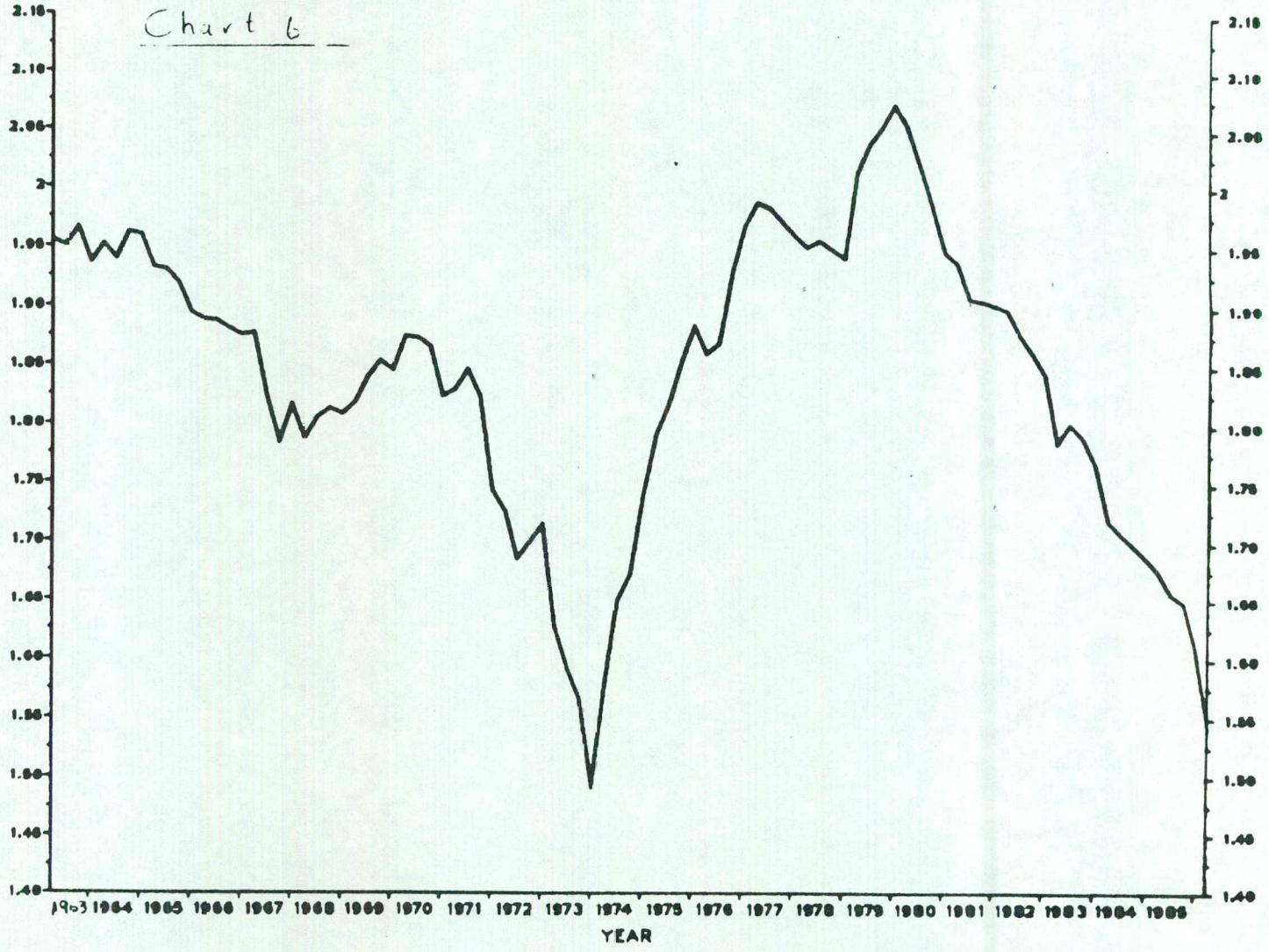


PSI 2 VELOCITY

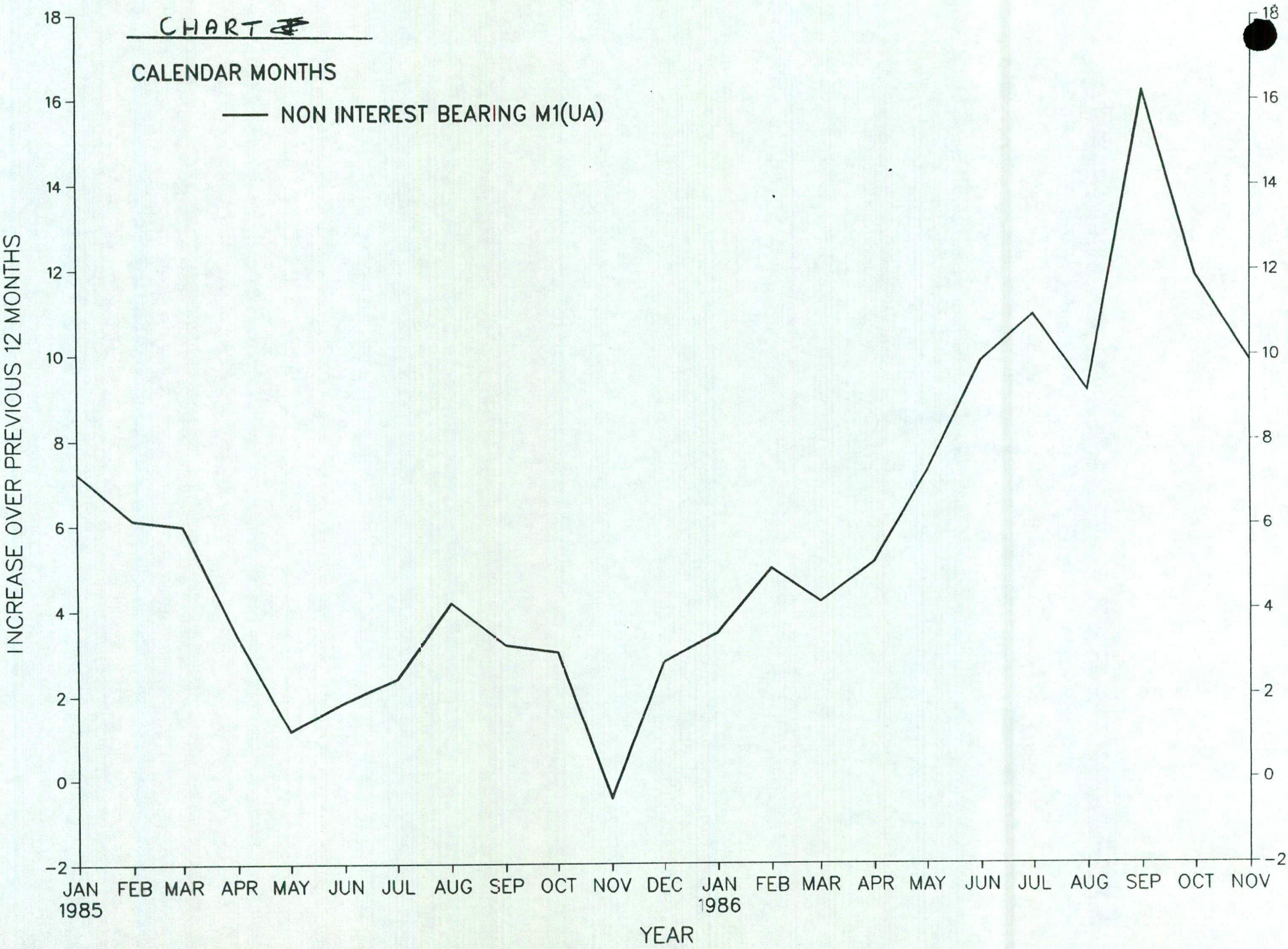
Chart 5

VELOCITY OF INSTITUTIONAL AGGREGATE

Chart 6



NON INTEREST BEARING M1



ANNEX 1

SUMMARY OF ADVANTAGES AND DISADVANTAGES OF THE MAIN AGGREGATES AS TARGETS

	Advantages	Disadvantages
MO	- Current target aggregate	- Lacks credibility at present, because excludes the bulk of transactions balances; and because thought to be subject to unpredictable innovation.
	- Relatively stable velocity trend over a long period.	
	- No interest bearing element, so unambiguous response to interest rates (though timing and scale uncertain).	- The small bankers' balances component fluctuates erratically. (But an aggregate consisting only of notes and coin would lose some the other advantages of MO).
	- Well established concept, defined in terms of the authorities' monetary liabilities.	
	- Data available quickly, and for a long run.	

	Advantages	Disadvantages
NIB M1	- A comprehensive measure of of non-interest bearing transactions balances. Therefore should have more credibility than MO.	- Growth distorted, downwards, because of continued rise in use of interest bearing current accounts, which is not a steady or predictable process.
M1	- A comprehensive measure of money realisable on demand [other than building society deposits.]	- Growth biased, upwards, by continued growth in interest bearing current accounts, through substitution out of time deposits. So ambiguous response to interest rates.
	- Previously used as a target aggregated (but dropped for reasons that remain valid).	- Includes large amount of interest bearing wholesale deposits.
M2	- Specifically designed as a measure of retail transactions balances at banks and building societies.	- Little known about long run characteristics, with only 4 years' data. - Development of "instant access" facilities means M2 now contains a large portion of building society deposits almost certainly held for savings rather than transactions purposes. - Data unreliable at present, subject to mis-reporting and revision.

	Advantages	Disadvantages
£M3	- Counterparts analysis links monetary and fiscal policy.	- Excludes building society accounts even though big societies becoming more like banks.
	- Familiar to market commentators.	- Contains large interest bearing element and so may react perversely to interest rate changes.
	- Includes all residents' sterling bank deposits so unaffected by switches between types of bank deposits.	- Velocity not predictable.
		- Didn't predict recent downturn in inflation.
PSL2	- Includes building societies which are becoming more like banks.	- Interest response may be perverse.
	- Unaffected by switches between building societies and bank accounts.	- Poor predictor of inflation since 1980.
	- Has been a target aggregate.	- Affected by financial innovation/ liberalisation, both hard to predict (eg effect of forthcoming legislation).
	- Includes all building society deposits regardless of maturity.	- Adoption would require changes in funding definition.
INSTITUTIONAL AGGREGATE	- Similar advantages to PSL2.	- Similar disadvantages to PSL2.
	- Easy to understand; excluding small items included in PSL2, unrelated to bank/building society deposits and not generally likely to be regarded as money.	

	Advantages	Disadvantages
DCE	- Links with £M3 and with balance of payments - Has been given target status in past	- Similar disadvantages to £M3 - No published series at present - Diminished usefulness with a floating exchange rate - Since abolition of exchange controls, could be unreliable.

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ANNEX 2

Non-interest Bearing M1

Non-interest bearing M1 has several claims to be used as a narrow money target aggregate. Like M0:-

(i) it responds unambiguously to interest rates since it is composed entirely of non-interest bearing assets;

(ii) because it is liable to be held only for transactions purposes, it will also respond to fiscal policy insofar as that affects the level and composition of expenditure in the economy;

(iii) a long run of data is available, over the last 11 years.

2. Its proponents would suggest that it has some further advantages compared to M0:-

a) it is likely to provide a more comprehensive measure of transactions balances since it includes the greater part of bank current accounts;

b) it excludes bankers' operational balances which are volatile and in the short term are unlikely to be closely related to transactions.

3. But there are also some significant disadvantages. First, it cannot be regarded as a full measure of transactions demand. In particular, it excludes transactions balances held with the building societies. The extent to which people use building society accounts for transactions purposes has probably been increasing over the years as building societies have offered services like the banks'. This process of evolution may be given a boost by the new building society legislation effective from the beginning of the year. It might look presentationally odd therefore to move to a transaction measure this year which excludes the building societies.

4. A second and perhaps more important problem is that it is difficult to believe that the split of M1 between interest bearing and non-interest bearing components has yet reached an equilibrium. Over the last decade there has been a trend increase in the interest bearing proportion. On the one side, companies have become more aware of the possibilities for holding parts of their transactions balances at interest. On the other, increasing competition has forced the banks to make such facilities more widely available. This rise in the trend has not been steady; not surprisingly, the interest-bearing proportion has increased most rapidly when interest rates have been high and the rise has slowed when rates have fallen. The process has probably not yet been completed. In this case, there would be further changes to non-interest bearing M1 unrelated to any change in transactions in the economy.

5. A final drawback is that the aggregate is liable to be distorted in the short term by shifts into current accounts prior to large new issues or privatisations. This is probably not decisive, since such distortions eventually disappear of their own accord. But it does mean that interpretation of the aggregate's development is obscured for appreciable periods of time.

6. Perhaps for a combination of the above reasons, non-interest bearing M1 has not been a very useful guide to policy in recent years. The attached chart shows its growth rate over the last two years. It has varied widely over that period - showing negative annual growth in November 1985, growth of over 16 per cent in the year to September 1986 and a sharp decline since - but in a way which is difficult to reconcile with other evidence about monetary conditions. Over a longer time period, its usefulness is also open to question. Chart 2 displays its velocity in relation to money GDP since 1975. There has been a trend rise over that period, as in the case of M0. But the year-to-year variation has been much greater than in the case of the narrower aggregate and it seems likely that its development would continue to be more difficult to predict in future.

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NOTE OF A MEETING IN THE CHANCELLOR'S ROOM, HM TREASURY AT 5.00 PM ON WEDNESDAY, 29 JANUARY

Those present

Chancellor
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Peretz
Mr Grice
Mr Kelly
Mr Riley
Mr Ross Goobey

Governor
Deputy Governor
Mr George
Mr Flemming
Mr Coleby

MONETARY POLICY AND THE 1987 MTFS

The meeting discussed the list of issues set out in Mr Peretz' note of 23 January.

2. It was agreed that the option of seeking to give the exchange rate a more explicit role could be ruled out. The Chancellor commented that the Governor's Loughborough lecture had set out in very convincing terms the case against a target for broad money. The Governor accepted that there was no case for broad money targets if that carried the connotation of an intention to hit the targets or to take action if it looked like they were not being hit; all agreed that was impracticable. But he thought further discussion was needed about the possibility of ranges or projections.

MTFS
MTG
29/1

Narrow money

3. The Chancellor thought there was conceptually a better case for targetting NIB M1 than M0. But there were problems over targetting NIB M1 at a time when the balance between interest bearing and non-interest bearing current accounts did not seemed to have settled down yet. We had rejected targets for NIB M1 in the past, and he thought those arguments were probably still valid.

4. The Governor said he shared the Chancellor's sympathy for NIB M1; he thought it would be attractive to be able to say we were looking at spending money in a wider sense than the very narrow definition of M0. But the velocity of NIB M1 was unstable, and he did not believe it was possible to target it. Sir P Middleton agreed; an additional problem was the extreme interest rate sensitivity of NIB M1.

5. The Chancellor said that in these circumstances, the choice was between targetting M0 or having no targets at all. He felt that to have no targets at all would be very difficult. The Governor agreed. The Chancellor noted the choice was then between showing a target for 1987 alone, or adding to it - as in previous year - illustrative ranges for the future years. He thought the latter was preferable, and the Governor agreed.

6. Mr George was somewhat concerned that having a target for M0 alone might imply that movements in M0 would be of even greater significance to monetary policy. He was not sure that M0 could bear that sort of weight. The Governor noted that it was possible we might be over the top of the target range at the start of the year, even though we might expect growth to fall back within the range later in the year. A major issue was how we would react to growth in M0 outside its target range, and in particular whether this would be an automatic interest rate trigger. He wondered whether we should refer to an M0 "target" or an M0 "monitoring range", in the sense that if it went outside the range we would be that much more alert to the need to take action, but would not treat it as an automatic trigger.

7. Sir P Middleton thought it was important to maintain the continuity of policy. Monetary targets existed within the general context of monetary policy: we took account of other factors, including the exchange rate in particular. He did not think we should increase the status of monetary targets, in the sense of

greater automaticity; but equally, if we down-graded their importance, we would inevitably be forced much more towards an exchange rate target.

8. The Chancellor agreed. He thought that changing to "monitoring ranges" from "targets" would lead to pressure to explain a change in stance, where none existed. Even though we might in retrospect have preferred "monitoring range" if we were starting afresh, it was very difficult to make a change now.

9. He did, however, feel that it was very important to increase the credibility of M0. There were problems arising from its narrow composition, but it seemed clearly in our interests to get it taken more seriously in the markets. The Economic Secretary noted that the greatest help to credibility would be if changes in M0 were seen to have an influence on the authorities' actions. Mr George said he was worried about putting too much weight on M0 in explaining our actions. The Chancellor accepted there worries, but felt it would be essential that the authorities should speak with one voice: any differences were always picked up and exploited.

Broad money

10. The Chancellor said there seemed to be two ways we could treat broad money in the future: we could say we were taking it into account, in much the same way as we now referred to movements in the exchange rate; or we could publish a projection. The Governor said he thought that simply saying we were taking broad money into account might create the impression we were not giving it as much weight as before; in these circumstances a projection might be useful. But he fully took the Economic Secretary's point that any change was difficult and needed justification.

11. Mr George thought that a statement along the lines that the trends which had caused broad money to grow fast last year were still present, and we once again expected broad money to grow

faster than money GDP this year. This would be a helpful indication of the broad trend we expected, and would be better than a simple statement that we intended to take the growth of broad money into account. Sir T Burns said he did not see any problem with a statement of this sort, and indeed he thought it could be useful. But he would not wish to see it strengthened by quoting an explicit projection or range. The Chancellor agreed; he would be grateful if officials could produce draft forms of words for the MTFS.

Choice of broad money measure

12. The Chancellor thought the choice of broad money measure was linked in to the definition of funding. There was a case for saying that with the new Building Societies Act now in force, sales of gilts to building societies should not count as funding. Mr Cassell noted this issue was linked in turn with what aggregates should be published in the provisional press notice: the proposed new funding rule would imply we should switch the focus to the new "institutional aggregate". Mr Coleby noted that it was only M0 and £M3 that could be published on the present timetable; to include PSL2 and/or the new institutional aggregate would take several more days.

13. Mr George was concerned that any delays in publication would increase the risks of leaks, since the banks would have the information themselves. He did not regard it as a major issue whether or not we changed the funding rule: indeed, switching to funding outside the building societies could imply a loosening, not a tightening of policy: the building societies had been net sellers of gilts over the last year and might continue to be, given the new proposals on capital adequacy.

14. The Chancellor said he did not feel particularly strongly on this point, but thought that if we were to make a change it should be done this year, since it could be easily linked to the coming

into force of the Building Societies Act. Sir P Middleton said that another possibility was to redefine the monetary sector so as to bring building societies within it, and to continue to call the aggregate £M3.

15. The Chancellor said he would be grateful for further advice from Bank and Treasury officials on this option. He was marginally in favour of making the change and broadening the monetary sector, but he would be worried if this was seen as a dodge to enable us to sell fewer gilts.

Next steps

16. The Chancellor noted that a further meeting would be needed shortly on the numbers themselves.

ACSA.

A C S ALLAN

Distribution

Those present
PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
Sir G Littler
Mrs Lomax
Mr Sedgwick
Mr Scholar
Mr Culpin
Mr Carr
Mr Cropper
Mr Tyrie