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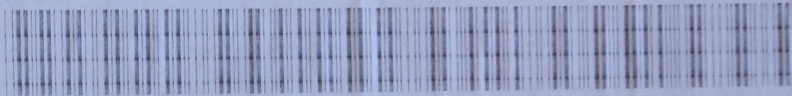
Part A.

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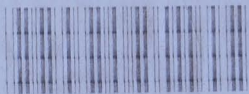
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PO -CH /NL/0057



PART A

MONETARY TARGETS AND THE
MEDIUM TERM FINANCIAL
STRATEGY

Disposal Direction - 25 years

Phillion

20/7/95.

PO -CH /NL/0057

PART A

PART A

S E C R E T



FROM: J O KERR
DATE: 12 January 1984

cc: Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Battishill
Mr Lankester
Mr Ridley
Mr Riley
Mr Sedgwick

MRS LOMAX

MONETARY TARGETS: MTFS PRESENTATION

The Chancellor has noted, and is broadly content with, the draft MTFS passage attached to your minute of 11 January.

A handwritten signature in dark ink, appearing to be "J O Kerr".

J O KERR

33/12/84

SECRET

FROM: RACHEL LOMAX
DATE: 11 JANUARY 1984

1. SIR T BURNS
2. CHANCELLOR

cc: Economic Secretary
Sir P Middleton
Mr Cassell
Mr Battishill
Mr Lankester
Mr Riley
Mr Sedgwick
Mr Ridley

85-43
TARGET RANGES FOR BROAD AND NARROW MONEY

I attach a draft passage for the MTFS showing how option 3 in Mr Cassell's paper on Monetary Targets (6 January) might look in practice. It is based on the comparable passages last year, paras 2.10 and 2.11 of the FSBR.

RL.

RACHEL LOMAX

Good stuff. For Sunday

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DRAFT SECTION FOR MTFS

Money ranges

2.10 As announced in the Budget Speech, there will be two target ranges for monetary growth in 1984-85. The target for broad money is to be set [at the 6-10 per cent indicated in last year's Financial Statement]. The target for narrow money will be [X-Y per cent]. [As usual these ranges apply to the annual rate of growth over the 14 months beginning in February 1984.] Illustrative ranges for the next few years are shown in table 2.2. Precise targets for the later years will be decided nearer the time.

Table 2.2 Ranges for Monetary Growth

	Percentage change during year		
	1984-85	1985-86	1986-87
Broad money - £M3 (and PSL2)			
Narrow money - M0 (and M2)			

2.11 The main measure of broad money for target purposes will remain £M3; the authorities will continue to take account of other indicators of broad money, especially PSL2. The target for narrow money applies to M0; in judging the performance of M0 as an indicator of transactions balances, particular attention will also be paid to the behaviour of M2. The interpretation of monetary conditions will continue to take account of all the available evidence, including the exchange rate. The ranges shown in Table 2.2 have again been constructed on the assumption that there is no major change in the exchange rate from year to year.

SECRET

From: J WILLIAMS

Date: 23 December 1983

NOTE FOR THE RECORD

cc Sir T Burns
Mr Cassell
Mr Lankester
Mrs Lomax
Mr Riley
Mr P Sedgwick
Mr O'Donnell

MONETARY TARGETS

on 22 December Mr Middleton chaired a meeting to discuss the draft paper on monetary targets attached to Mr Cassell's letter of 15 December to Mr George. Sir Terence Burns, Mr Cassell, Mr Monck, Mr O'Donnell, Mr George, Mr Coleby and Mr Allan were present. The meeting also had before it Mr George's letter to Mr Cassell of 21 December. The purpose of this note is to record the conclusions reached at the meeting.

Handling of the paper

2. It was agreed following a brief discussion that it would be more efficient for the Bank and the Treasury to prepare separate papers. Mr Middleton said the Treasury would revise its paper internally and then invite any further Bank comments on it before submission to the Chancellor. Mr George said the Bank would put in their own paper using as a basis his letter of 21 December. It was agreed to aim for a meeting between the Governor and the Chancellor towards the end of the second week of January and that Mr Cassell and Mr George would jointly agree an agenda for the discussion.

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Comments on the substance of the paper

3. Mr George made some general observations on the Treasury paper. The following were among the main points made during discussion:

- (i) Mr George cautioned against reading too much into narrow money as a guide to short term interest rate policy. Sir Terence Burns argued that the messages given by narrow money were more about interest rates than about funding and fiscal policy but at the same time those messages may be no better or clearer than those given by broad money. Both sets of aggregates were important and neither should be excluded as a guide to interest rate policy. Mr George said it was more a question of nuance and defining the balance between the roles of narrow and broad money and ensuring that outside commentators understood the balance and did not come to believe that the narrow aggregates were the only guide to short term interest rate policy.
- (ii) Mr George said the Bank continued to be disturbed at the prospect that Mo might be regarded as a serious indicator of narrow money. After some discussion it was agreed that there was a distinct difference of opinion between the Bank and the Treasury about the role and usefulness of Mo as an indicator or as a target of narrow money.

Options for 1984

4. Finally, the meeting considered the options identified in paragraphs 19 and 20 of the Treasury's paper. Mr George

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said his preference would be to include four rather than two specific indicators within the target ranges. Mr George suggested that for broad money the two indicators might be £M3 and PSL2 and for narrow money M2 and notes and coins. Mr Middleton said he had a preference for option 6 and to say that £M3 and Mo were probably the best two aggregates for target purposes within each grouping. Special attention would be paid to these two indicators, but not exclusive attention, and decisions would be taken in the light of the evidence from all other indicators.

5. It was agreed that only option 1, option 5 and option 6 should be included in the revised paper along with some discussion of the advantages and disadvantages of two as against four specified aggregates.

JW.

J WILLIAMS

SECRET

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

21 December 1983

Rice

F Cassell Esq
H M Treasury
Parliament Street
London SW1P 3AG

Copy to Mr Middleton -
Sir T. Burns
Mr Noel
Mr Lomax
Mr Lister

Dear Frank,

Thank you for your letter of 15 December enclosing a draft paper on Monetary Targets. Given the difficulty that there may be in arranging an early meeting to discuss the draft, we agreed that I should try to set down in this letter our approach to the questions you consider in the paper.

We are, I believe, agreed that, conceptually, narrow money is a relevant indicator alongside broad money of monetary conditions, particularly of the development of "retail transactions". We are also agreed that the issue between us relates to the comparatively limited point of which is the best available statistical measure of narrow money, ie it is not about methods of monetary control. We would be less confident than you are in rejecting M1 at the present stage for this purpose; but we recognise its deficiencies which are likely to increase over time. (We also acknowledge that the public criticisms already made of M1 have diminished its credibility.)

MO

From this starting point we begin by looking at MO, and I am afraid we are still not able to find anything to commend it as an indicator of "retail" money. Conceptually we see no justification for including bankers' till money or bankers' operational balances in such an indicator; and their inclusion adds quite unnecessarily to the volatility of the statistical series. Given these obvious

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disadvantages, we have no convincing explanation as far as we can see for choosing MO as our indicator rather than its principal component, notes and coin with the public, even if it were accepted as sensible to go as narrow as this in the first place.

rk present
The fact is that advocates of MO have seen it as a control variable through which influence might be exerted on the banks' balance sheets as a whole, but that is expressly not the role which either you or we envisaged for it. This matters in our view even though over some period one might expect MO and notes and coin with the public to move quite closely together. It matters because our apparent failure to draw the conceptual distinction between indicator and control variable would raise questions about whether we know what we are doing and create a damaging confusion over whether or not we really intend, covertly, to try to operate on MO as a control variable.

In the terms of your draft paper, this means we agree with many of the points you make concerning the disadvantages of MO in paragraphs 14 and 15, but we would regard them as conclusive arguments against its use as a measure of narrow money

Notes and coin

Lower target
We then go to notes and coin with the public, which, while an improvement on MO, is still conceptually unsatisfactory in that it clearly excludes "retail" deposits. It is perhaps in this sense that you describe it as "sounding primitive"; by the same token it is not likely to carry conviction with outside commentators or markets as a sufficient measure of transactions money. Such scepticism is likely to be all the greater because outside commentators are as aware as we are of a number of financial developments (the increasing use of bank transfers for wage payments; increasing use of plastic cards; increasing numbers of cash dispensers; increasing bank charges for cheque payments, etc) that must necessarily have an uncertain but important effect upon the distribution of transactions money between cash and deposits.

As a result - and the recent econometrics notwithstanding - neither we nor the markets are likely to have much confidence in this component of narrow money as an indicator of monetary conditions over the

relatively short periods necessary for operational purposes. Nor - given its partial nature and the developments likely to affect it - are we persuaded that this component of narrow money will in practice respond predictably to interest rate movements over a period of months. (These comments apply of course equally to M0 quite apart from the disadvantages specific to that aggregate discussed earlier.)

M2

Leaving NIBM1 aside, essentially because of its wide swings and because it too is likely to be distorted by current and prospective financial developments, we are effectively left with M2. I think we - and indeed market commentators - would agree that M2 is conceptually the best measure of transactions money, and is probably less subject to distortion than other measures of narrow money, though of course it has no track record.

Putting these various considerations together we conclude that none of the available measures of narrow money is very satisfactory on its own. Of the two real candidates notes and coin with the public lacks conceptual credibility and we lack statistical experience with M2. If we had to go for a single measure at present we would incline towards M2. But we think it would be much better to acknowledge quite openly that we do not have a satisfactory single measure at this stage and are thus obliged to look at both. (By a somewhat similar process we would favour retaining both the present broad target aggregates.)

Apart from the question of the choice of aggregates, we think the paper for discussion between the Chancellor and Governor should also address directly the question of the respective roles of narrow and broad money in determining policy. We can agree as a practical matter that fiscal and funding policy are of particular relevance to the broader aggregates, and conversely. We can also agree that short-term interest rates must be the primary means of seeking to influence narrow money. But we do not agree that narrow money has now, or will prove to have in future, any kind of primacy as a guide to short-term interest rate policy, which we think must continue to "take account of all the relevant factors, including the exchange rate". In particular, we think lending to the private sector must continue as an important influence on interest-rate policy, and we do not believe that there is any serious or systematic evidence to show that such lending - even

though by no means highly interest-sensitive - is in general perverse with respect to interest rates. (Nor do we have any evidence that it was so, certainly over anything but the very short term, even at the height of the monetary squeeze on companies.) Equally, we do not think that short-term interest rate and funding (ie longer-term interest rate) policy can in practice be very far divorced, as particular emphasis on narrow money as a guide to short-term rates would imply. Nor do we find any support for this special role for narrow money among market commentators.

We are very ready for further discussion on all of this whenever that can be arranged.

Yours sincerely,

Laddie.

PS A meeting has now been arranged for tomorrow afternoon, but I felt it might help us forward if I sent over these comments anyway.

DEC 1983

CONFIDENTIAL

FROM: F CASSELL

6 December 1983

1. MR MIDDLETON
2. CHANCELLOR

cc - Economic Secretary
Sir T Burns
Mr Battishill
Mr Monck
Mr Lankester
Mr Odling-Smee
Mr Sedgwick
Mrs Lomax
Mr Riley
Mr Mowl
Mr Johnston
Mr Ridley

MONETARY TARGETS

C Sir A Walker

This paper sets out some issues still to be resolved on the form of monetary targets for next year's MTFS - in particular what aggregates should we target. I would stress that it is concerned entirely with the form of the targets. The appropriate numbers for the target ranges can be decided later - after Chevening. But it would be very helpful if we could now agree what we want to target.

2. The paper first records the points on which I think we are all agreed (at least within the Treasury) following the discussion of the Strategy papers last summer. It then surveys what other people have said about monetary targets, and particularly about MO, after the Mansion House speech and reports what we have learned from our further research on narrow money since the papers put to you in mid-October. It also looks in more detail at the differences between MO and notes and coin, particularly in the context of operating a target for narrow money. The final section - paragraphs 20-21 sets out what look to be the main options for the next MTFS. These options might provide a framework for discussion.

WHERE WE STAND

3. I think there is general agreement among us all that:
 - i. In assessing monetary conditions it is necessary to look at both broad and narrow money (and other things).

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- ii. £M3 and PSL2 are reasonably good measures of broad money (or liquidity).
 - iii. M1 is not a good measure of narrow money, because of its substantial element of interest-bearing deposits.
 - iv. A better measure of narrow money would be provided by a M2, NIB M1, M0 or notes and coin.
 - v. These narrower aggregates, with the possible exception of M2, should respond unambiguously to changes in interest rates.
 - vi. All are in greater or less degree subject to technological or institutional change.
4. All of us here, I believe, think that some change in the form of the monetary targets is needed. In particular, we need to find better measure of narrow money than M1 and to present the targets in a more even-handed way, as between broad and narrow money (at the moment we target two broad aggregates and one narrow aggregate that has acquired some of the characteristics of broad money).
5. These considerations underlay your speech at the Mansion House, which was very much a "thinking aloud" approach towards reform of targetting in the next MTFS. Much of the monetary part of the speech was concerned with the search for a better measure of narrow money. After pointing to the deficiencies of M1, you looked briefly at M2, ("I think and hope that it will come to play an important part in policy decisions. But its time has not yet come") and then turned to narrower measures:

"Meanwhile there is some recent evidence that other measures of narrow money - particularly measures of non-interest bearing money such as the wide monetary base, M0, and its predominant component, notes and coin with the public - have not been subject to the same distortions as M1."

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A little later in the Speech you said that:

" ... it does appear that MO could have a more important part to play as a key indicator in the growth of narrow money.

Whichever indicators we choose to emphasize, it is unlikely that it would be appropriate to maintain a single range for both broad and narrow aggregates ..."

There was no commitment to targetting MO, but a clear indication that you were looking in that direction. It is this aspect that has been seized on by most of those commenting on the speech.

REACTION TO MANSION HOUSE SPEECH

6. Reaction has been mixed, with the critics (mainly from the City) more vocal than the supporters.

i. The serious press devoted a fair amount of space to explaining the thinking behind your remarks. But the brokers' worries and the December 1982 BEQB article are also widely reported.

ii. Majority opinion in the City is critical, with particularly hostile pieces from Simon and Coates, Capel-Cure Myers (Roger Bootle) and Messel's (Congdon). Hoare Govett (Paul Temperton, ex Bank author of the BEQB article on cash) and Laing and Cruikshank are tersely dismissive. The exceptions are Phillips and Drew (Bill Martin, ex CPRS), with a generally sympathetic and perceptive note, and Greenwell's, who are welcoming but worried about controlling MO "under present arrangements".

iii. There has been little serious comment outside the City, none of it very helpful. Minford has been almost silent, approving the "sensible upgrading" of MO in a single sentence. Beenstock (in 'The Times') was enthusiastic, for the wrong reasons, stressing that MO is "unique because it is directly under the authorities' control ... controllable down to the last penny ... The Chancellor has really stuck

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his neck out this time." The City University (Roy Batchelor), long time MBC advocates, are actually critical, arguing that MO is essentially a means of controlling broad money, and unsuitable as a target in its own right. None of the outside forecasting groups (including the new LBS Financial Outlook) have commented.

7. Parts of the general argument of the Speech have emerged almost unscathed:

i. Most commentators are prepared to accept the case for targetting narrow money as a measure of transactions balances.

ii. More contentious, but still fairly widely accepted, is the proposition that narrow money may be particularly relevant to short term interest rate decisions. Notable dissenters are Roger Bootle and Tim Congdon, who say interest rate decisions should be based on an overall assessment of "financial conditions", consistent with the Government's objectives for inflation.

iii. M1 has no defenders.

iv. Beenstock aside, the message that no move to MBC is being contemplated seems to have got across (though it has not pleased supporters of monetary base at Greenwell's and the City University).

v. MO is widely seen as the main option, but there is some recognition of alternatives. Several commentators (eg the Economist, Greenwell's, Christopher Johnson) refer to "retail" or NIB M1, with varying degrees of conviction. Most (but not all) see notes and coin and MO as synonymous.

8. Criticism of MO is based on three oft-repeated points:

i. Interest rates have little or no direct effect on it, so it will be difficult to control (other than by

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"controlling the economy"). Some commentators challenge the sign of the effect (apparently on statistical grounds; no-one gives a convincing economic explanation of why there should be a perverse effect). The BEQB article - very occasionally supported by a chart - is the sole basis for these assertions. Only Christopher Johnson refers to the small (0.5 per cent) semi-elasticity in the current public version of the Treasury model.

ii. MO has been, and will go on being, heavily affected by structural changes in the use of cash. The velocity trend is high and has risen unexpectedly since the late 70's. So target setting will be difficult. Again, the main source is the BEQB.

iii. The relationship with future inflation is not well established (though there may well be a link with past or current rates of inflation). This appears mainly in the most critical of the brokers, unsupported by statistical evidence other than charts. Some commentators note that the link looks closer since the mid 70's, but suggest that this is fortuitous.

9. There are two widespread misconceptions:

i. that MO would be a fourth target, additional to the existing target variables. This is taken for granted in early articles (some of which complain of a proliferation of targets). On 18 November, Sam Brittan reported that "the present intention is to replace the existing three targets by two: one for so-called "little MO" ... the other will be some measure of broad liquidity". This has been picked up by Congdon, who complains of "uncertainty about the Government's views on monetary policy":

ii. that the chief appeal of MO is as a rationale for cuts in interest rates. In the more superficial places, this is tied simply to the relatively slow growth in MO in recent

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years. More sophisticated commentators argue that technical change will make it easy to underestimate future trends in MO velocity, and hence set a "soft target"; or that the lack of interest sensitivity will mean that MO is not an effective brake on interest rate cuts.

The second point, very fashionable immediately after the Mansion House Speech, is beginning to lose favour as some commentators focus on the probable target range for MO. Serious suggestions are:

3-7 per cent	Minford
4-8 per cent	Greenwell's, Phillips and Drew, Christopher Johnson
5-9 per cent	Laing and Cruikshank

(The Banker notes a 6 per cent trend increase in MO velocity in recent years, but spoils it by concluding that the 7-11 per cent range set for the other aggregates would be uncomfortably tight).

Several people (eg Greenwell's, Henry Kaufman and Phillips and Drew) have argued that with current MO growth well above last year's rate and towards the top of any plausible range, targetting MO is not a soft option.

10. The brokers have not finished with this subject yet. Substantial pieces are still coming in, and at least one commentator (Peter Turner - James Capel) is known to be working on a further major offering. Judging by informal contacts, one question that we may hear more of over the coming weeks is: "If you do not intend to move to MBC, why choose monetary base?" The point has already begun to surface: the Economist noted that operational balances are not included in any other monetary aggregate, and Capel-Cure Myers suggest that MO is a surprising choice if there is no intention to move the MBC. The point of the CUBS article is, of course, to argue that targetting MO makes no sense without a move to MBC. No-one yet appears to have concluded that notes and coin would be a preferable option to MO:

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the focus has rather been on highlighting those objections to M0 that are common to notes and coin (and readily culled from the BEQB article on cash).

FURTHER RESEARCH ON NARROW MONEY

11. We reported to you in the middle of October on our research on narrow money*. Since then we have continued to examine the demand for notes and coin and for M0 and begun the preparation of a Working Paper reporting this research.

12. This further work has been based on an agreed statistical series for M0 - which corrects some mistakes in the Bank's old series that came to light as our research proceeded. We have had further discussions with the Bank, who are still sceptical about some aspects of our work. In addition we have consulted two academics - Professor Hendry of Nuffield College and Dr Bean of the LSE - who occasionally attend our academic panel. They have made some helpful suggestions. Professor Hendry has published work on M1 and is currently undertaking similar research to our own on the effects of financial innovation on the demand for money.

13. Our further work tends to confirm the assessments in the earlier note, including the conclusion that, based on their apparent demand and prediction properties, notes and coin would seem to have a slight edge over M0.

i. There appears to be small but significant interest sensitivity in the demand for both cash and M0. This issue has particularly exercised some commentators since the Mansion House speech. We have now investigated this effect on a run of monthly data that goes back to the early 1960s. This examination indicates that conclusions about interest

* "Research into Narrow Money and its Implication for the Choice of Target Variable" submitted under my minute of 14 October 1983.

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sensitivity do to a certain extent depend on the period used for estimation. While the size of the effect is reasonably constant from the early 1960s, its statistical significance varies. It has not been possible to find any significant interest sensitivity when the equations are fitted to data drawn solely from the early 1970s. There does, however, appear to be some evidence of significant interest sensitivity for notes and coin or MO in the 1960s, and, more impressively, since the mid-1970s. The Bank's economists agree with our findings insofar as they refer to recent years; there is still some disagreement on the nature and implications of the evidence in earlier periods.

ii. Our recent work confirms the importance in explaining the rising trend in the velocity of notes and coin and MO of financial innovation in the means of payments as indicated by a number of measures - such as the greater use of cheques, credit cards and cash dispensers. We have not yet decided which of these measures performs best in explaining the growth of narrow money in purely statistical terms. But whatever the final result of our research we would not want to claim that the chosen measures are doing more than proxy a process of innovation that has taken a number of forms.

iii. The later work, like the earlier, yields better results for notes and coin than for MO. Our greater ability to account for fluctuations in notes and coin compared with total MO reflects the erratic nature of the bankers' balances and, to a lesser extent, till money. Separate work to explain movements in these confirms how difficult it is to model them.

iv. We have also looked further at the high short-term volatility of MO. At least half the volatility in changes in MO appears to be due to noise in bankers' balances. During the last two years this proportion seems to have increased, while the notes and coin series seems to have

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become more predictable. The proportion of the noise in total cash (ie non-bank holdings of notes and coin plus banks' till money) that is due to fluctuations in till money is just under 30 per cent. So once bankers' balances have been excluded from MO there does not appear to be a further major reduction in volatility to be achieved by excluding till money.

While we can take some comfort from the progress of this research, it must be recognised that it cannot point to conclusive evidence. Such research, no matter how successful it may appear to be at the time, can only have a modest role in any justification of targetting a very narrow monetary aggregate. Data revisions or new econometric techniques can all too often upset previous results.

14. There will always be room for legitimate doubts about the extent to which our work "explains" the past, and still more about how far it can be used to forecast the future. It would be unwise to let any public target range for very narrow money rest on our assumptions about future financial innovation and its effect on the demand for cash. It seems best here to stick firmly to the practice of not justifying target ranges by econometrics. But it is important to have reputable published research available so that we are not vulnerable to the charge of adopting targets for monetary aggregates without having studied their past behaviour. The coming working paper will be designed to fulfil that need.

MO OR NOTES OR COIN?

15. The research we have carried out gives notes and coin an edge over MO: the statistical series is less noisy, the demand equations are better specified and have lower standard errors. As against that, MO sounds more like a serious monetary aggregate - it is an "M" - with a good pedigree in monetary theory. Targetting notes and coin sounds primitive. However, MO has some distinctly unattractive features:-

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i. It consists as to 90 per cent of notes and coin in circulation outside the banks and a further 8 per cent is notes and coin held in bank tills. So it is not containing much additional information to notes and coin themselves.

ii. Its non-currency component - bankers' operational balances at the Bank of England - though only small is subject to what look to be sharply erratic movements, which generate a high level of variability in the series. It would be possible, however, to smoothe this by averaging the daily figures for these balances over the banking month. Our experiments with such averaging suggests that it produces a much more stable series (see chart). This, of course, would mean adopting a different means of measuring MO from that used in the past.

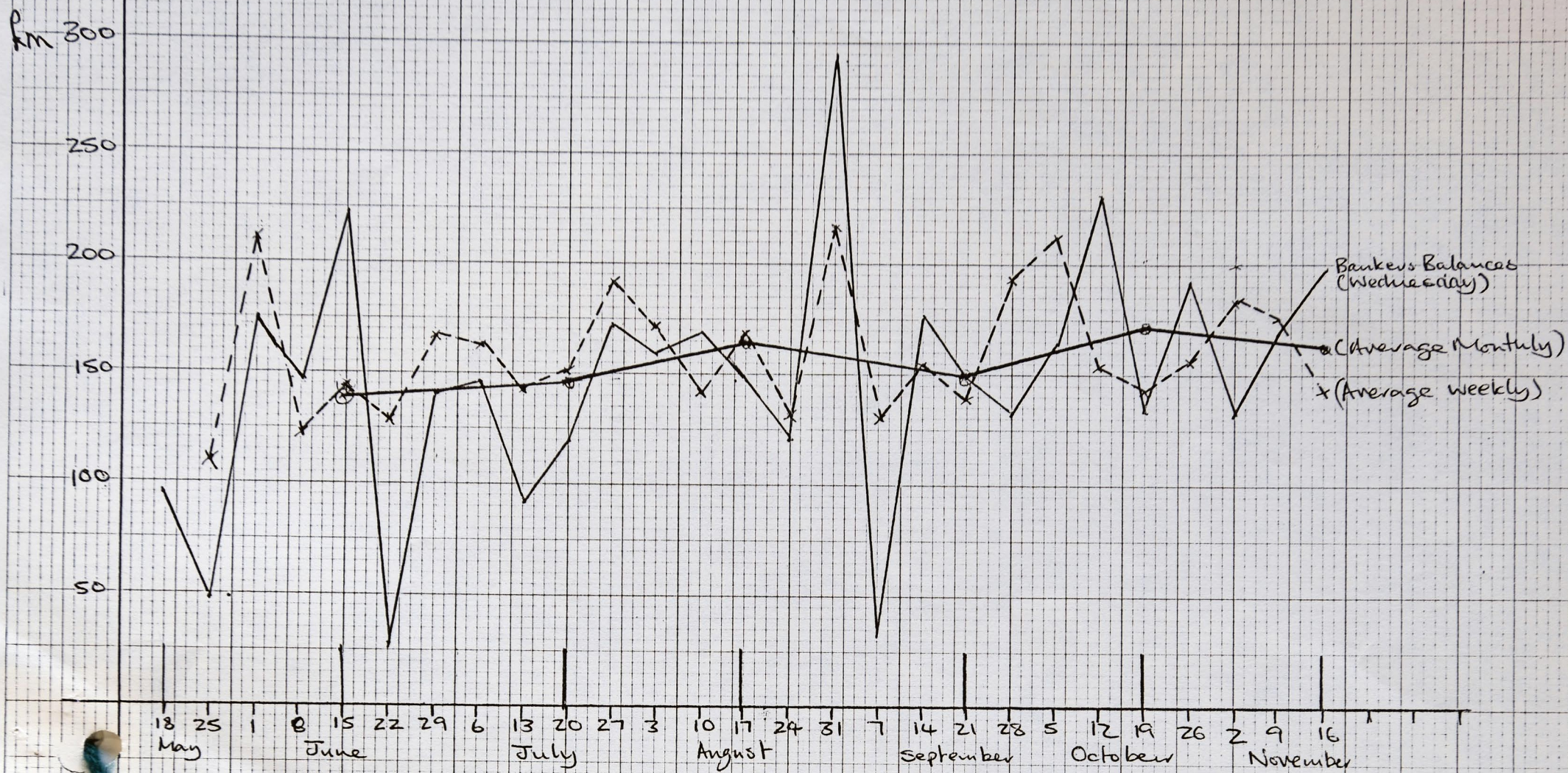
iii. This non-currency component is not part of any monetary aggregate and is of economic significance only if the banks are being controlled by operating on their monetary base.

iv. MO consists entirely of the liabilities of the monetary authorities. This indeed is its great virtue if one is operating a system of monetary base control. But it is not easy to explain why we are choosing this aggregate to target if it is intended not to introduce MBC.

In short, as an indicator it is hard to see what additional information MO contains that is not already contained in the movement of notes and coin. As a target it does not fit cleanly into the hierarchy of ~~Ms~~ and it would have connotations about particular techniques of credit control that could confuse markets about our longer term intentions.

16. In operating a target for MO, or any other aggregate, a key question would be how the markets might react if it moved outside the set range. We would certainly like them to regard a target for MO as no more binding than the targets we have operated for £M3. In that case, they, and we, would tolerate movements

BANKERS' OPERATIONAL BALANCES



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outside the target range if other indicators suggested that monetary conditions in general were consistent with our medium-term objectives for inflation, etc. They might not, however, see it quite that way. The counterparts to MO are much narrower than the counterparts to broad money. £M3 is a joint product of activities by the public sector and activities by the banks. For this reason, it is generally recognised that its movements are partly outside our control. MO, by contrast, is entirely the product of central Government and Bank of England operations. In choosing to target it we would appear (as some commentators have noted) to be going for something that is more directly within our control. Its movements would be closely watched in the City and deviations from the target path would probably generate interest rate expectations more quickly than would deviations in £M3. In time, of course, the market would come to learn that we did not take the target for MO any more seriously than we took a target for £M3. But the learning process could be a fairly confused period. Notes and coin by contrast would be much more readily seen by markets as something we were using as an indicator.

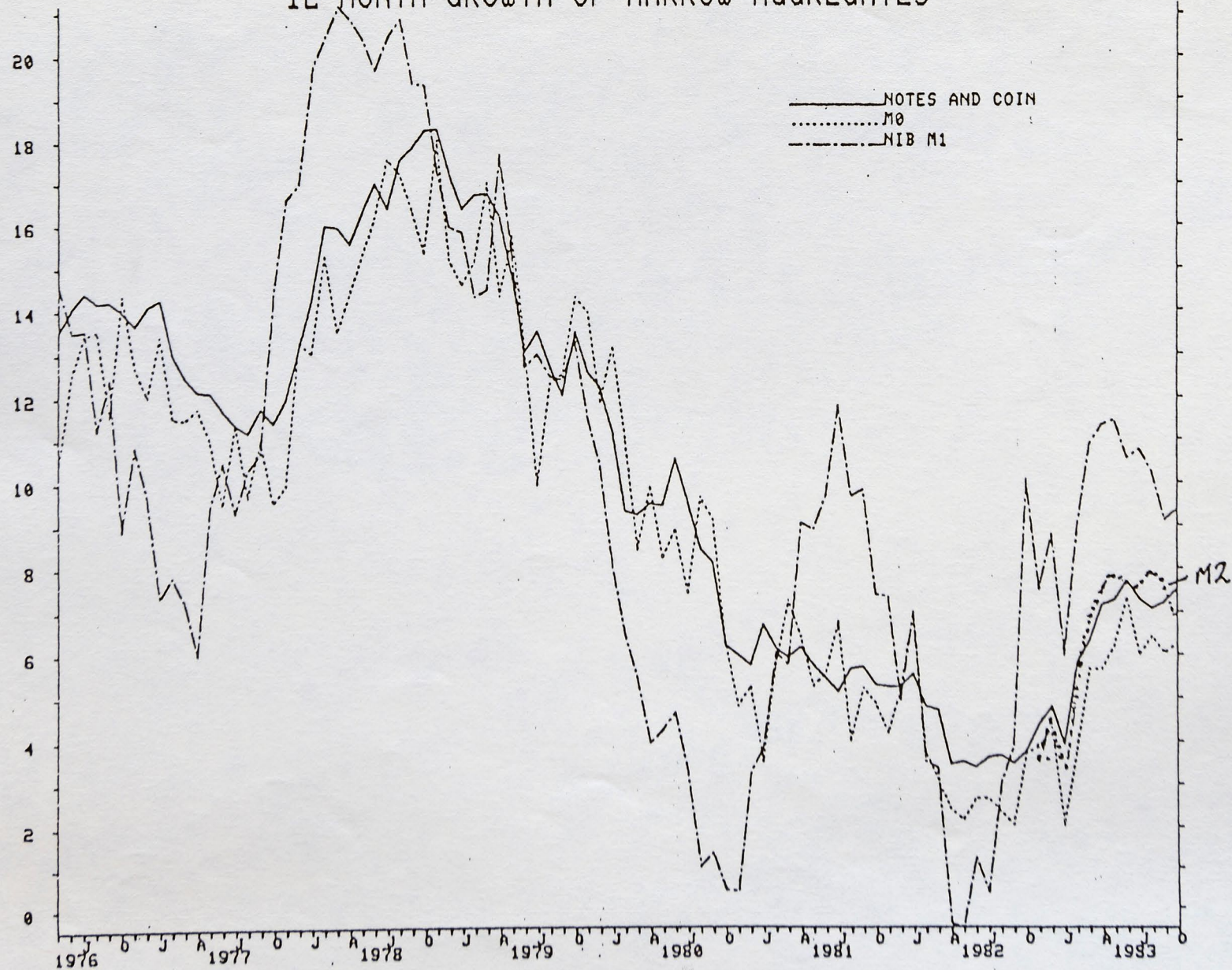
17. However, the choice of narrow aggregate is not simply between MO and notes and coin. The accompanying chart shows the movements in four narrow aggregates: M2, NIB M1, MO and notes and coin. Certain characteristics of each of these stand out clearly:-

The wide swings in NIBMI: it would be difficult to set a target range that included this and any other narrow aggregate.

The smoother path of notes and coin, as compared with MO. The closeness of the movements of M2 to those of notes and coin and MO.

This last feature is encouraging. Unfortunately, we have only a short period to go on, but on the record so far it would seem possible to embrace MO, M1 and M2 in one target range (possibly with an interest rate rider for M2).

12 MONTH GROWTH OF NARROW AGGREGATES



BROAD MONEY

18. Most of this paper has been concerned with narrow money - because that is where the present targets seem most in need of reformulation. However, there is one point about broad money to be stressed. The recent strong growth of building society deposits and advances, and the increasing likenesses between building societies and banks, would make it unwise to do anything that might suggest we were taking less interest in the activities of building societies.

19. This argues for making the definition of broad money very broad (and also for giving greater emphasis in our funding operations to debt sales outside both the banks and the building societies). If we wished to target only one broad aggregate, PSL2 might now be preferable to £M3. However, to cease targeting £M3 would look like a radical change. This argues for a definition of broad money that includes both £M3 and PSL2.

THE OPTIONS FOR 1984

20. For the reasons given at the beginning of this paper, there are strong grounds for wanting to change the form of the monetary targets. We would presumably not want more than two target ranges - one for broad money, the other, and lower, one for narrow money - and we would like them to have equal status. We would also want to stress that in assessing monetary conditions we took account of all the aggregates (whether explicitly targeted or not) and other indicators as well.

21. The options set out below are essentially about how the target ranges are labelled - whether they are defined in terms of specific aggregates, or simply as "broad" and "narrow" money. If the former, it is important that each range contains the same number of aggregates - to convey equal status. There are numerous permutations possible among the various aggregates. To keep the options to a manageable number, we exclude here any containing M1 (because that aggregate does not now fit easily into either broad or narrow money) - this rejects, therefore, the

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combination that most commentators seem to think was suggested at the Mansion House: the existing three targets plus MO. The main remaining options seem to be:-

Two aggregates: Option 1: £M3 (or PSL2) and MO (or notes and coin, NC). Clearcut; even-handed between broad and narrow. But hard to justify ditching target for PSL2 (or £M3); and MO and NC, both have some unattractive features for targetting.

Option 2: £M3 or (PSL2) and NIB M1 (or M2). Replacing M1 by NIB M1, or M2, would get rid of the most glaring deficiency of the present targets. But NIB M1 is highly interest-sensitive (which would complicate the setting of a target range for it), and M2 is still something of an unknown quantity (and not seasonally adjusted). Again, with only one broad and one narrow targetted aggregate the difficulty of justifying the ditching of PSL2 or £M3 would arise.

Four aggregates: Option 3: £M3, PSL2, NIB M1 and MO (or NC). Keeps both broad aggregates. But the swings in NIB M1 are so great that it is difficult to find a range that would both embrace it and another narrow aggregate.

Option 4: £M3, PSL2, MO and NC. Though this includes two broad and two narrow, doubtful if this would be seen as even-handed as between broad and narrow money, given overlap between MO and NC. This grouping would presumably be considered only if we were using the existing "snapshot" measure of MO. It would give the opportunity to stress that we recognized that while MO provided a good measure of narrow money over longer periods

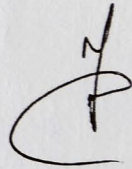
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it was subject to considerable volatility in the short-term and for shorter periods we would accordingly give more weight to the movement in NC.

Option 5: £M3, PSL2, M2 and M0 (or NC).

This grouping has attractions because it includes a wide range of aggregates; but it also has risks, given our limited knowledge of M2.

"Broad" and "narrow" money: Option 6: "Broad money" and "narrow money". Unlike the others, this option would not set target ranges in terms of specified aggregates but one for broad money (which would be said to include £M3 and PSL2) and another for narrow money (which would be said to include M2, M0 and notes and coin). This is less clearcut than the other options, but it avoids many of their disadvantages, and leaves the way open for future evolution - perhaps to a more prominent role for M2.



F CASSELL

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From: P E MIDDLETON
Date: 7 December 1983

CHANCELLOR

cc Economic Secretary
Sir T Burns
Mr Cassell
Mr Battishill
Mr Monck
Mr Lankester
Mr Odling-Smee
Mr P Sedgwick
Mrs Lomax
Mr Riley
Mr Mowl
Mr Johnston
Mr Ridley

*Can I have the
MBC quotes +
Kesteven's about
Mo.*

A. S. A. Walker

MONETARY TARGETS

Mr Cassell's paper below is the one I promised you to enable us to have an early discussion about the options. There is a comprehensive list of permutations in the final paragraph of his minute.

2. In putting this forward, I have two comments - one on substance, one on procedure.

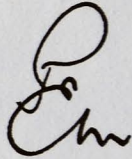
3. My slight quarrel with the substance of Mr Cassell's remarks arises on his para 16. I do not believe that if the Government said that it was targeting Mo but asserted that the authorities were going to run the monetary system in the same way as in the past, there would be the period of confusion to which Mr Cassell refers. Furthermore, I do not think that the ^{possibility} / that such a target might be seen as a step along the road to MBC would necessarily be a bad thing. Not only is our stated policy that we are taking measures which would be consistent with an eventual move to MBC if at some stage we wanted to do it, but we might also find that the increased range of public sector debt we could sell to control Mo would be a positive advantage.

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can, however, expand on this view in discussion.

4. So far as procedure is concerned, we need an early internal discussion. The Treasury, I think, needs to produce a joint paper with the Bank so that the arguments can be set alongside each other and a formal decision taken as to what we target. Meanwhile, you might find it useful to have the internal discussion before your Select Committee appearance, though you will not wish to commit yourself to anything on that occasion. I expect that the Governor will make some anti-Mo noises when he sees you on Friday, but he is unlikely to want to get into the sort of issues raised in Mr Cassell's minute.

5. I would hope that we could have taken decisions in principle before Christmas so that we can take a more positive line in presentation, and have a good basis for preparing the Chevening papers.

A handwritten signature in dark ink, appearing to be 'P E Middleton', written in a cursive style.

P E MIDDLETON

15 DEC 1983

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f—

MONETARY TARGETS: NOTE OF A DISCUSSION
IN THE CHANCELLOR'S OFFICE
AT 10.00 A.M. ON 14 DECEMBER 1983

Present:-

Chancellor	Mr Cassell	Mr Kerr
Mr Middleton	Mr Battishill	Mrs Lomax
Sir T Burns	Mr Monck	Mr Riley
Mr Littler	Mr Lankester	Mr Sedgewick
Sir A Walters	Mr Ridley	

Papers:-

Mr Cassell's minute of 6 December
Mr Middleton's minute of 7 December

Mr Cassell introduced his paper, and expressed his own preference for the last option set out in its paragraph 21. Among measures of narrow money, M1 had no defenders; NIBM1 was too vulnerable to technical change; too little was known about M2; with MO the main problems would be to explain the point of including bankers' balances, and to explain why the authorities would not in practice react on occasion to movements in an aggregate thought to be entirely within their control; while Notes and Coin would be seen as a primitive measure. It might therefore be best to avoid specifying a target range for a particular narrow aggregate, but instead to set one for "narrow money", defining this as including M2, MO and Notes and Coin.

2. Mr Middleton, Sir T Burns, Sir A Walters, and Mr Ridley however thought it necessary to choose a specific narrow target aggregate, though it would of course be possible to refer to the intention to watch others, as indeed we would do. The candidates seemed to be M2, MO and Notes and Coin. M2 had however to be ruled out on the grounds of inadequate past information. As between Notes and Coin and MO, Notes and Coin looked the smoother



series, but taking monthly MO figures as the average of daily figures over the month should remove the difficulty. Further work on this in-month smoothing of MO was in hand.

3. The Chancellor identified the major problem over MO as establishing the rationale for the inclusion of till money and bankers' balances. The former was some 8 times as large as the latter, and also created the greater conceptual difficulty. Bankers' balances were virtually a constant: their inclusion would cause little comment, and their exclusion from the published MO series would seem very odd. A further analysis of the pattern of movement of till money was however required before one could decide whether it would make sense to include it in the chosen target aggregate. Subject to further studies on MO smoothing, and on till money, he would be inclined to show in the MTFS a target range for £M3 and MO, while referring to the intention also to watch PSL2 and M2 (though without specifying target ranges for them). Sir T Burns suggested that the MTFS table might instead show target ranges for "broad" and "narrow" money, with the definitions -along the lines proposed by the Chancellor - being set out in the subsequent prose.

4. It was agreed:-

- a. that further papers on MO smoothing - including a smoothed series going back to 1975 - and on the behaviour of till money should be submitted as soon as possible;
- b. that, subject to (a), a paper on the proposed changes in monetary targeting should be prepared for forwarding to the Bank of England before Christmas;
- c. that a meeting with the Governor and Bank officials, to consider the paper and their reactions to it, should be arranged for early January (ie pre-Chevening); and
- d. that Sir T Burns would submit a draft of the FSB table and explanatory paragraph along the lines he had suggested.

Distribution

Those present

Chief Secretary
Financial Secretary
Minister of State
Economic Secretary

Mr Bailey
Mr Hall

Sir A Walters - No.10

A handwritten signature, likely of J O Kerr, in dark ink.

J O KERR

14 December 1983

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H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-233 3000
Direct Dialling 01-233 5627

F. Cassell
Deputy Secretary

15 December 1983

E A J George Esq
Bank of England
Threadneedle Street
LONDON EC2R 8AH

Dear Eddie,

MONETARY TARGETS

As promised at Peter Middleton's meeting on Tuesday, I attach a draft paper on Monetary Targets, which focusses particularly on narrow money.

This is not in the form that we would want to put to our respective chiefs as background to their coming discussion. It will need substantial reshaping, and possibly some of the material could be consigned to annexes. I would not want to commit all my colleagues here to its arguments. However, I think it useful to get it to you at this stage so that you can see how we are approaching these questions.

The range of options at the end is deliberately wide. I dare say we could slim it down when we look at it together, but it is probably best to start with a fairly long menu.

I hope we can discuss this next week to agree how we should go about producing a paper for the discussion between the Chancellor and the Governor in the New Year - whether the attached could be made into a joint paper that could provide an annotated agenda for the discussion.

✓

F. Cassell

F CASSELL

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DRAFT

MONETARY TARGETS

This paper sets out some issues still to be resolved on the form of monetary targets for next year's MTFS - in particular what aggregates should we target. It is concerned entirely with the form of the targets. The appropriate numbers for the target ranges can be decided ~~later.~~ *separately.*

2. The paper first records the points on which there is general agreement following the discussion of the Strategy papers last summer. It then surveys what other people have said about monetary targets, and particularly about MO, after the Mansion House speech and reports what we have learned from our further research on narrow money since the papers circulated in mid-October. It also looks in more detail at the differences between MO and notes and coin, particularly in the context of operating a target for narrow money. The final section - paragraphs 19-20 - sets out what look to be the main options for the next MTFS. These options might provide a framework for discussion.

WHERE WE STAND

3. There seems to be general agreement that:
- i. In assessing monetary conditions it is necessary to look at both broad and narrow money (and other things).
 - ii. £M3 (and PSL2) are reasonably good measures of broad money (or liquidity).

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gpl

iii. M1 is not a good measure of narrow money, because of its substantial element of "wholesale" interest-bearing deposits.

iv. A better measure of narrow money would be provided by a M2, NIB M1, M0 or notes and coin.

v. These narrower aggregates, with the possible exception of M2, should respond unambiguously to changes in interest rates.

vi. All are in greater or less degree subject to technological or institutional change.

4. Some change in the form of the monetary targets is desirable. In particular, we need to find a better measure of narrow money than M1 and to present the targets in a more even-handed way, as between broad and narrow money (at the moment we target two broad aggregates and one narrow aggregate that has acquired some of the characteristics of broad money).

5. These considerations underlay the Chancellor's speech at the Mansion House, which was very much a "thinking aloud" approach towards reform of targetting in the next MTFS. Much of the monetary part of the speech was concerned with the search for a better measure of narrow money. After pointing to the deficiencies of M1, it looked briefly at M2, ("I think and hope that it will come to play an important part in policy decisions. But its time has not yet come") and then turned to narrower measures:

"Meanwhile there is some recent evidence that other measures of narrow money - particularly measures of non-interest bearing money such as the wide monetary base, M0, and its predominant component, notes and coin with the public - have not been subject to the same distortions as M1."

A little later in the Speech the Chancellor said that:

1. Chequer.
2. Size.
3. Asset demand.

Model

I can't put all this in same target

M1

Asset

Chancellor

B

Broad Money

Narrow

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"... it does appear that MO could have a more important part to play as a key indicator in the growth of narrow money.

Whichever indicators we choose to emphasize, it is unlikely that it would be appropriate to maintain a single range for both broad and narrow aggregates ..."

There was no commitment to targetting MO, but a clear indication of looking in that direction. It is this aspect that has been seized on by most of those commenting on the speech.

REACTION TO MANSION HOUSE SPEECH

6. Reaction has been mixed, with the critics (mainly from the City) more vocal than the supporters.

- i. The serious press devoted a fair amount of space to explaining the thinking behind the Chancellor's remarks. But the brokers' worries and the December 1982 BEQB article are also widely reported.
- ii. Majority opinion in the City is critical, with particularly hostile pieces from Simon and Coates, Capel-Cure Myers (Roger Bootle) and Messel's (Congdon). Hoare Govett (Paul Temperton, ex Bank author of the BEQB article on cash) and Laing and Cruikshank are tersely dismissive. The exceptions are Phillips and Drew (Bill Martin, ex CPRS), with a generally sympathetic and perceptive note, and Greenwell's who are welcoming but worried about controlling MO "under present arrangements".
- iii. There has been little serious comment outside the City, none of it very helpful. Minford has been almost silent, approving the "sensible upgrading" of MO in a single sentence. Beenstock (in 'The Times') was enthusiastic, for the wrong reasons, stressing that MO is "unique because it is directly under the authorities' control ... controllable down to the last penny ... The Chancellor has really stuck

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his neck out this time." The City University (Roy Batchelor), long time MBC advocates, are actually critical, arguing that MO is essentially a means of controlling broad money, and unsuitable as a target in its own right. None of the outside forecasting groups (including the new LBS Financial Outlook) have commented.

7. Parts of the general argument of the Speech have emerged almost unscathed:

i. Most commentators are prepared to accept the case for targetting narrow money as a measure of transactions balances.

ii. More contentious, but still fairly widely accepted, is the proposition that narrow money may be particularly relevant to short term interest rate decisions. Notable dissenters are Roger Bootle and Tim Congdon, who say interest rate decisions should be based on an overall assessment of "financial conditions", consistent with the Government's objectives for inflation.

iii. M1 has no defenders.

iv. Beenstock aside, the message that no move to MBC is being contemplated seems to have got across (though it has not pleased supporters of monetary base at Greenwell's and the City University).

v. MO is widely seen as the main option, but there is some recognition of alternatives. Several commentators (eg the Economist, Greenwell's, Christopher Johnson) refer to "retail" or NIB M1, with varying degrees of conviction. Most (but not all) see notes and coin and MO as synonymous.

8. Criticism of MO is based on three oft-repeated points:

i. Interest rates have little or no direct effect on it, so it will be difficult to control (other than by

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"controlling the economy"). Some commentators challenge the sign of the effect (apparently on statistical grounds; no-one gives a convincing economic explanation of why there should be a perverse effect). The BEQB article - very occasionally supported by a chart - is the sole basis for these assertions. Only Christopher Johnson refers to the small (0.5 per cent) semi-elasticity in the current public version of the Treasury model.

ii. MO has been, and will go on being, heavily affected by structural changes in the use of cash. The velocity trend is high and has risen unexpectedly since the late 70's. So target setting will be difficult. Again, the main source is the BEQB.

iii. The relationship with future inflation is not well established (though there may well be a link with past or current rates of inflation). This appears mainly in the most critical of the brokers, unsupported by statistical evidence other than charts. Some commentators note that the link looks closer since the mid 70's, but suggest that this is fortuitous.

9. There are two widespread misconceptions:

Confusion

i. that MO would be a fourth target, additional to the existing target variables. This is taken for granted in early articles (some of which complain of a proliferation of targets). On 18 November, Sam Brittan reported that "the present intention is to replace the existing three targets by two: one for so-called "little MO" ... the other will be some measure of broad liquidity". This has been picked up by Congdon, who complains of "uncertainty about the Government's views on monetary policy":

ii. that the chief appeal of MO is as a rationale for cuts in interest rates. In the more superficial places, this is tied simply to the relatively slow growth in MO in recent

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years. More sophisticated commentators argue that technical change will make it easy to underestimate future trends in MO velocity, and hence set a "soft target"; or that the lack of interest sensitivity will mean that MO is not an effective brake on interest rate cuts.

The second point, very fashionable immediately after the Mansion House Speech, is beginning to lose favour as some commentators focus on the probable target range for MO. Serious suggestions are:

3-7 per cent	Minford
4-8 per cent	Greenwell's, Phillips and Drew, Christopher Johnson
5-9 per cent	Laing and Cruikshank

(The Banker notes a 6 per cent trend increase in MO velocity in recent years, but spoils it by concluding that the 7-11 per cent range set for the other aggregates would be uncomfortably tight).

Several people (eg Greenwell's, Henry Kaufman and Phillips and Drew) have argued that with current MO growth well above last year's rate and towards the top of any plausible range, targeting MO is not a soft option.

10. The brokers have not finished with this subject yet. Substantial pieces are still coming in, and at least one commentator (Peter Turner - James Capel) is known to be working on a further major offering. Judging by informal contacts, one question that we may hear more of over the coming weeks is: "If you do not intend to move to MBC, why choose monetary base?" The point has already begun to surface: the Economist noted that operational balances are not included in any other monetary aggregate, and Capel-Cure Myers suggest that MO is a surprising choice if there is no intention to move the MBC. The point of the CUBS article is, of course, to argue that targetting MO makes no sense without a move to MBC. No-one yet appears to have concluded that notes and coin would be a preferable option to MO:

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the focus has rather been on highlighting those objections to MO that are common to notes and coin (and readily culled from the BEQB article on cash).

FURTHER RESEARCH ON NARROW MONEY

11. Over recent months Treasury economists have undertaken extensive research on narrow money, examining in particular the demand for notes and coin and for MO. There have been several discussions with the Bank, who are still sceptical about some aspects of the work. In addition we have consulted two academics - Professor Hendry of Nuffield College and Dr Bean of the LSE - who occasionally attend our academic panel. They have made some helpful suggestions.

12. The Treasury's latest work tends to confirm the assessments in the note reporting the earlier work*, including the conclusion that, based on their apparent demand properties, notes and coin would seem to have a slight edge over MO.

i. There appears to be small but significant interest sensitivity in the demand for both cash and MO. This issue has particularly exercised some commentators since the Mansion House speech. We have now investigated this effect on a run of monthly data that goes back to the early 1960s. This examination indicates that conclusions about interest sensitivity do to a certain extent depend on the period used for estimation. While the size of the effect is reasonably constant from the early 1960s, its statistical significance varies. It has not been possible to find any significant interest sensitivity when the equations are fitted to data drawn solely from the early 1970s. There does, however, appear to be some evidence of significant interest sensitivity for notes and coin or MO in the 1960s, and, more

* "Research into Narrow Money and its Implication for the Choice of Target Variable", October 1983.

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impressively, since the mid-1970s. The Bank's economists agree with those findings insofar as they refer to recent years; there is still some disagreement on the nature and implications of the evidence in earlier periods.

ii. The recent work confirms the importance in explaining the rising trend in the velocity of notes and coin and M0 of financial innovation in the means of payments as indicated by a number of measures - such as the greater use of cheques, credit cards and cash dispensers. It is not easy to decide which of these measures performs best in explaining the growth of narrow money in purely statistical terms. But whatever the final result of the research we would not want to claim that the chosen measures are doing more than proxy a process of innovation that has taken a number of forms.

iii. The later work, like the earlier, yields better results for notes and coin than for M0. Our greater ability to account for fluctuations in notes and coin compared with total M0 reflects the erratic nature of the bankers' balances and, to a lesser extent, till money. Separate work to explain movements in these confirms how difficult it is to model them.

iv. We have also looked further at the high short-term volatility of M0. At least half the volatility in changes in M0 appears to be due to noise in bankers' balances. During the last two years this proportion seems to have increased, while the notes and coin series seems to have become more predictable. The proportion of the noise in total cash (ie non-bank holdings of notes and coin plus banks' till money) that is due to fluctuations in till money is just under 30 per cent. So once bankers' balances have been excluded from M0 there does not appear to be a further major reduction in volatility to be achieved by excluding till money.

While we can take some comfort from the progress of this research, it must be recognised that it cannot point to conclusive evidence. Such research, no matter how successful it may appear to be at the time, can only have a modest role in any justification of targetting a very narrow monetary aggregate. Data revisions or new econometric techniques can all too often upset previous results.

13. There will always be room for legitimate doubts about the extent to which such work "explains" the past, and still more about how far it can be used to forecast the future. It would be unwise to let any public target range for very narrow money rest on particular assumptions about future financial innovation and its effect on the demand for cash. It seems best here to stick firmly to the practice of not justifying target ranges by econometrics. But it is important to have reputable published research available so that we are not vulnerable to the charge of adopting targets for monetary aggregates without having studied their past behaviour.

MO OR NOTES OR COIN?

14. The research, as noted above, gives notes and coin an edge over MO: the statistical series is less noisy, the demand equations are better specified and have lower standard errors.

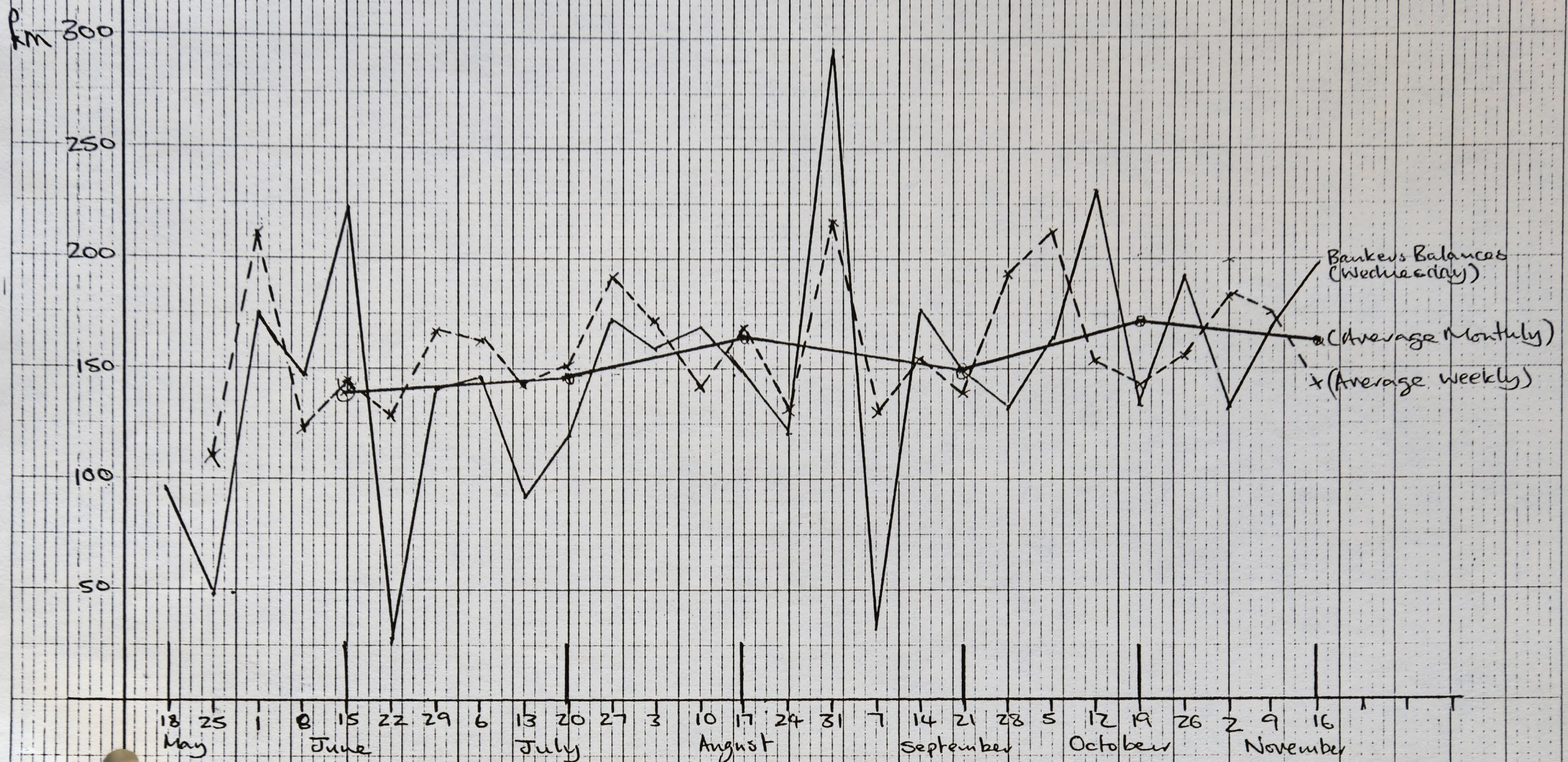
As against that, MO sounds more like a serious monetary aggregate - it is an "M" - with a good pedigree in monetary theory.

Targetting notes and coin sounds primitive. However, MO has some unattractive features:

i. It consists as to 90 per cent of notes and coin in circulation outside the banks and a further 8 per cent is notes and coin held in bank tills. So it is not containing much additional information to notes and coin themselves.

ii. It does not fit cleanly into the structure of monetary aggregates. Two of its components - till money and bankers balances - are bank assets, whereas the other monetary aggregates are built on non-bank holdings of notes and coin and bank liabilities.

BANKERS' OPERATIONAL BALANCES



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iii. Its non-currency component - bankers' operational balances at the Bank of England - though only small is subject to what look to be sharply erratic movements, which generate a high level of variability in the series. It would be possible, however, to smoothe this by averaging the daily figures for these balances over the banking month. Our experiments with such averaging suggests that it produces a much more stable series (see chart).

iv. This non-currency component is not part of any monetary aggregate and is of economic significance only if the banks are being controlled by operating on their monetary base.

v. MO consists entirely of the liabilities of the monetary authorities. This indeed is its great virtue if one is operating a system of monetary base control. But it is not easy to explain why we are choosing this aggregate to target if it is intended not to introduce MBC.

The problem of short-term volatility can probably be dealt with by calculating MO as a daily average for the month. There is indeed much to be said for that. This series would then differ from notes and coin mainly because it included till money. If changes in till money are related to changes in non-bank holdings of notes and coin it may be helpful to look at the two together. If so, MO (smoothed) would have some additional information over notes and coin, even though it does not fit cleanly into the hierarchy of Ms and, as a target, would have connotations about particular techniques of credit control that could confuse markets about our longer term intentions.

15. In operating a target for MO, or any other aggregate, a key question would be how the markets might react if it moved outside the set range. We would certainly like them to regard a target for MO as no more binding than the targets we have operated for £M3. In that case, they, and we, would tolerate movements outside the target range if other indicators suggested that monetary conditions in general were consistent with our medium-term objectives for inflation, etc. They might not, however, see it quite that way. The counterparts to MO are much narrower than

12 MONTH GROWTH OF NARROW AGGREGATES

Y-axis: 0, 2, 4, 6, 8, 10, 12, 14, 16, 18, 20

X-axis: 1976, 1977, 1978, 1979, 1980, 1981, 1982, 1983

Legend:

- NOTES AND COIN (solid line)
- M0 (dotted line)
- M1 (dashed line)

Handwritten label: M2 (pointing to the solid line)

CM2

the counterparts to broad money. £M3 is a joint product of activities by the public sector and activities by the banks. For this reason, it is generally recognised that its movements are partly outside our control. M0, by contrast, is entirely the product of central Government and Bank of England operations. In choosing to target it we would appear (as some commentators have noted) to be going for something that is more directly within our control. Its movements would be closely watched in the City and deviations from the target path might generate interest rate expectations more quickly than would deviations in £M3. In time, of course, the market would come to learn that we did not take the target for M0 any more seriously than we took a target for £M3. But the learning process could be a fairly confused period. Notes and coin by contrast would be much more readily seen as something we were using as an indicator.

I don't agree

16. However, the choice of narrow aggregate is not simply between M0 and notes and coin. The accompanying chart shows the movements in four narrow aggregates: M2, NIB M1, M0 and notes and coin. Certain characteristics of each of these stand out clearly:-

The wide swings in NIBMI: it would be difficult to set a target range that included this and any other narrow aggregate.

The smoother path of notes and coin, as compared with M0.

The closeness of the movements of M2 to those of notes and coin and M0.

This last feature is encouraging. Unfortunately, we have only a short period to go on, but on the record so far it would seem possible to embrace M0, M1 and M2 in one target range (possibly with an interest rate rider for M2).

BROAD MONEY

17. Most of this paper has been concerned with narrow money - because that is where the present targets seem most in need of

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reformulation. However, there is one point about broad money to be stressed. The recent strong growth of building society deposits and advances, and the increasing likenesses between building societies and banks, would make it unwise to do anything that might suggest we were taking less interest in the activities of building societies.

18. This argues for making the definition of broad money very broad (and also for giving greater emphasis in our funding operations to debt sales outside both the banks and the building societies). If we wished to target only one broad aggregate, PSL2 might now be preferable to £M3. But to cease targetting £M3 would look like a radical change. However we express the target for broad money it will be important to make clear that we remain interested in the growth of building society deposits.

THE OPTIONS FOR 1984

19. For the reasons given at the beginning of this paper, there are strong grounds for wanting to change the form of the monetary targets. We would presumably not want more than two target ranges - one for broad money, the other, and lower, one for narrow money - and we would like them to have equal status. We would also want to stress that in assessing monetary conditions we took account of all the aggregates (whether explicitly targeted or not) and other indicators as well.

large | 20. The options set out below are essentially about how the target ranges are labelled - whether they are defined in terms of specific aggregates, or simply as "broad" and "narrow" money. If the former, it is important that each range contains the same number of aggregates - to convey equal status. There are numerous permutations possible among the various aggregates. To keep the options to a manageable number, any containing M1 have been excluded (because that aggregate does not now fit easily into either broad or narrow money) - this rejects, therefore, the combination that most commentators seem to think was suggested at the Mansion House: the existing three targets plus M0. The main remaining options seem to be:

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Two aggregates: Option 1: £M3 (or PSL2) and MO (or notes and coin, NC). Clearcut; even-handed between broad and narrow. But hard to justify ditching target for PSL2 (or £M3); and MO and NC, both have some unattractive features for targetting. Essential to emphasise that we would be monitoring other aggregates as well as those specifically targetted.

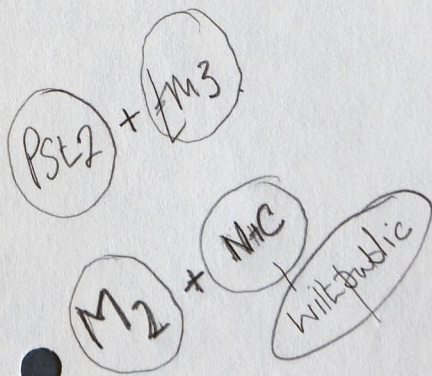
Option 2: £M3 or (PSL2) and NIB M1 (or M2). Replacing M1 by NIB M1, or M2, would get rid of the most glaring deficiency of the present targets. But NIB M1 is highly interest-sensitive (which would complicate the setting of a target range for it), and M2 is still something of an unknown quantity (and not seasonally adjusted). Again, essential to emphasise that we would be monitoring other aggregates as well.

2

Four aggregates: Option 3: £M3, PSL2, NIB M1 and MO (or NC). Keeps both broad aggregates. But complicated. And the swings in NIB M1 are so great that it is difficult to find a range that would both embrace it and another narrow aggregate.

Option 4: £M3, PSL2, MO and NC. Though this includes two broad and two narrow, doubtful if this would be seen as even-handed as between broad and narrow money, given overlap between MO and NC. This grouping would presumably be considered only if we were using the existing "snapshot" measure of MO. It would give the opportunity to stress that we recognized that while MO provided a good measure of narrow money over longer periods it was subject to considerable volatility in the short-term and for shorter periods we would accordingly give more weight to the movement in NC.

2 or 4



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Option 5: £M3, PSL2, M2 and M0 (or NC).

This grouping has attractions because it includes a wide range of aggregates. But it is complicated and also has risks, given our limited knowledge of M2.

"Broad" and "narrow"
money:

Option 6: "Broad money" and "narrow money".

Unlike the others, this option would not set target ranges in terms of specified aggregates but one for broad money (which would be said to include £M3 and PSL2) and another for narrow money (which would be said to include M2, M0 and notes and coin). This is less clearcut than the other options. But it avoids many of their disadvantages, and leaves the way open for future evolution.

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FROM: F CASSELL

22 December 1983

MR MIDDLETON

cc - Sir T Burns
Mr Monck
Mr Lankester
Mrs Lomax o.r.
Mr O'Donnell

MONETARY TARGETS: MEETING WITH THE BANK

The main objectives at this afternoon's meeting with Eddie George are first to make him feel fully involved in the discussions leading up to the meeting between the Governor and the Chancellor on monetary targets and, secondly, if necessary, to get his agreement to the Bank doing more work on the production of a smoothed MO series.

2. On the first objective, the best approach might be to ask Eddie how far he would see the draft that I sent him on 15 December providing the basis for a joint paper for the Chancellor/Governor meeting. He has now sent over a letter with some - fairly predictable - general comments of his own. The Bank's views could be incorporated in a joint paper without great difficulty, but at some cost in cumbersomeness.

3. You will presumably want to ask him about the options at the end of the paper. These can - and should - be narrowed down for the next version, and include explicitly one for MO (M2)/£M3 (PSL2). It might be helpful to explore how far Eddie would be willing to go along with the presentation in the draft MTFS passage prepared by Mrs Lomax; I attach a spare copy of this in case you would like to show it to him.

4. On the question of figures, I think we have got a reasonable amount of smoothing from the weekly series and that it would be hard to justify the additional work that would be entailed for the Bank in producing at this stage a daily averaged series.

CONFIDENTIAL

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Is it best for
us to do paper
+ you to comment

110

CONFIDENTIAL

5. We need to do two more pieces of work ourselves:-

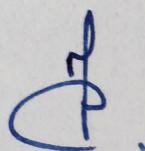
i. To seasonally adjust the weekly figures for bankers' balances.

ii. To produce daily averages of total notes and coin.

On ii. we have enough raw data from the Bank. On i. we have weekly averages back to November 1976; this is just about adequate, but ideally we would like a longer back-run.

6. I suggest that you say to Eddie that we seem to have got quite a way with weekly smoothing and would not at this stage want to inflict on the Bank the labour of providing daily averages. However, there does seem to be a seasonality in the weekly figures for bankers' balances and it would be helpful in estimating this if the Bank could provide weekly figures for a few years before 1976.

7. On the whole, I think the material in Mrs Lomax's note to you yesterday, together with the bits of further work mentioned above give us sufficient to report back to the Chancellor. However, if we do want to press the Bank for further work it is essential that we do so at this afternoon's meeting; it is clear that they will not undertake it without Eddie's approval.



F CASSELL

SECRET

DRAFT SECTION FOR MTFS

Money ranges

2.10 As announced in the Budget Speech, there will be two target ranges for monetary growth in 1984-85. The target for broad money is to be set at the 6-10 per cent indicated in last year's Financial Statement. The target for narrow money will be [4-8 per cent]. As usual these ranges apply to the annual rate of growth over the 14 months beginning in February 1984. Illustrative ranges for the next few years are shown in table 2.2. Precise targets for the later years will be decided nearer the time.

Table 2.2 Ranges for Monetary Growth

	Percentage change during year				
	1984-85	1985-86	1986-87	1987-88	1988-89
Broad money	6-10	5-9	[4-8]	[3-7]	[2-6]
Narrow money	[4-8]	[3-7]	[2-6]	[1-5]	[0-4]

2.11 The main measure of broad money for target purposes remains £M3. The authorities will continue to take account of other indicators of broad money, especially PSL2, in the expectation that they will grow within the range set for £M3. The target for narrow money applies to Mo, and its principal component notes and coin. In judging the performance of Mo as an indicator of transactions balances, particular attention will also be paid to the behaviour of M2, which has recently grown closely in line with Mo. Lower interest rates as

inflation falls could for a time lead to a more rapid rise in the more interest sensitive measures of narrow money, such as the non-interest bearing component of M1. The interpretation of monetary conditions will continue to take account of the available evidence, including the exchange rate. The ranges shown in Table 2.2 have again been constructed on the assumption that there is no major change in the exchange rate from year to year.

From: P E MIDDLETON
Date: 23 December 1983

CHANCELLOR

MONEY

Over the last two days I have spoken to the Governor, held a long meeting with the Bank - and had a private word with Eddie George this afternoon.

2. Procedurally we have agreed that:

- (i) You and the Governor to meet to discuss target aggregates at the end of the second week in January ie before Chevening.
- (ii) The Treasury will get a paper to the Bank at the end of the first week in January.
- (iii) The Bank will comment on our paper in a separate note for your meeting with the Governor, though there will be many points in our note on which we know there will be no disagreement.

3. This timing is determined by the absence of Eddie George from the Bank in the first week of January. It will not hold up the work which Terry Burns is doing on the MTFs for Chevening; he will operate on the assumption that broad money is indicated by $\pounds M3$ and narrow money by M_0 .

4. The Governor - and the Bank when we met their officials yesterday - were totally hostile to any reference to the monetary base. This is because they distrust it as an indicator and fear that it will result in the Government being drawn quickly towards MBC whatever is said or believed at the outset.

5. But the Bank (i) accept there must be two targets

(broad and narrow);
(ii) accept that they should have equal
weight (an important concession).

6. If you leave on one side the batty Cassell suggestion, that we should have targets for broad and narrow without saying exactly what this means in terms of particular aggregates, I think we have narrowed it down to two options:

(a)	Broad	£M3 and PSL2;
	Narrow	M2 and Notes and Coin with the public.

This is the Bank's preferred option:

(b)	Broad	£M3;
	Narrow	Mo

with a reference to PSL2 and M2 in the text to show that we took account of Building Society influence on both wide and narrow aggregates.

This is our preferred option.

7. Given 4 this is not a vast difference. Eddie George came to see me on a purely personal basis this afternoon to say that he recognised that you could have your own way so far as the Red Book was concerned. But he personally, and the rest of the Bank, would not go along with a single aggregate - especially Mo - for narrow money. And he thought it was dangerous to have a single aggregate for broad money. There would be bound to be a public sense of difference if we went down the £M3 Mo route, and it might react on the way policy was conducted which he thought was very satisfactory at present.

8. I should add that he did not say any of this in a threatening tone. And one has to recognise that if the Bank do get into the frame of mind he describes it could adversely affect the presentation and operation of policy.

9. He went on to say that he had thought further since yesterday's discussion with us. He was genuinely more concerned about having two aggregates reflecting broad and two reflecting narrow money rather than precisely which they were. He would settle and give wholehearted support to a range for narrow money which included Mo if it could also include M2. This could be explained by saying that they normally moved together, but we were not totally certain about the future behaviour of either for different reasons, so it made sense to include each as a check on the other.

10. This narrows the gap still further. Wholehearted Bank support in this area is worth having, especially as they seem so paranoid about our alternative, so I think we should pause to consider the George offer. If we go along with it the text submitted by Sir T Burns (Mrs Lomax's minute of 20 December) would need only minor changes.

11. We think we have enough information for the time being to take the work on Mo far enough to deal with the volatility point. And of course the more we come together on the policy, the more the Bank will work with us to get the practical issues concerning Mo settled.

P E MIDDLETON

STRICTLY CONFIDENTIAL



FROM: J O KERR

DATE: 29 December 1983

MR MIDDLETON

MONEY

The Chancellor was grateful for your report of 23 December, following your discussions with Mr George. He has minuted:-

"I continue to prefer the two-target-aggregate presentation to the four-target-aggregate presentation, for a number of reasons; but the latest George offer is the first time the Bank have come forward with anything worth serious consideration."

He envisages an early meeting with you and Sir T Burns, after the holiday. We shall be setting one up for around 9 January. (I assume that the paper we send to the Bank will be putting forward the Chancellor's - and your - preferred option ie. the second in your paragraph 6, and that if there were to be any further move in the George direction, it would be signalled at the proposed meeting with the Governor, rather than on paper and in advance of that meeting.)

2. The Chancellor has also noted that the question of the appropriate new target period, to be announced in the FSBR, needs to be discussed; and that options other than the standard "14 months from February" period need to be considered. I of course mentioned his interest in a minute before Christmas to Mrs Lomax; but he has now stressed that the question needs to be addressed irrespective of whether the Central Unit study now under way results in a recommendation to move to a calendar year PSBR.

for ^{mon} J O KERR

From: P E MIDDLETON
Date: 3 January 1984

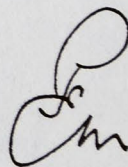
MR CASSELL

CC Sir T Burns
Mr Littler

MONETARY TARGETS

... I attach a few drafting comments on the paper. We ought to show it to the Chancellor again before we show it to the Bank which in practice means by Thursday night.

2. I am pretty sure that the Chancellor will want to see a more positive steer in favour of his preferred option, if there is to be a compromise it will come later in the discussion with the Governor. But we must leave room in the paper for a compromise in the paper - hence my suggested list of options. I particularly want the £M3/PSL2 - Mo/M2 option to be there.



P E MIDDLETON

3.

- (i) In assessing monetary conditions it is necessary to look at both broad and narrow money.
- (ii) Whatever numbers are targetted, it will also be necessary to take into account other monetary indicators, including the exchange rate in assessing monetary conditions.
- (iii) We cannot continue with the present arrangement in which there is one target range embracing both broad and narrow money. Last year was exceptional. Their different characteristics indicate different target ranges for broad and narrow money.
- (iv) M1 is an unsatisfactory measure of narrow money because of its substantial element of whole sale, 'interest bearing' deposits.
- (v) £M3 (and PSL2) continue to be reasonable measures of broad money.
- (vi) All monetary aggregates are subject to technological or institutional change.

4 A.

Some changes in the form of monetary targets are necessary. The opportunity is therefore available to re-think the presentation of policy. There is no suggestion that the present process of arriving at interest rate decisions - or of market operations to support them - should be altered. These considerations underlay the Chancellor's speech at the Mansion House in October.

5 B.

There are ^{four} ~~three~~ issues for decision:

- (a) Should we move to two target ranges, one for broad and one for narrow money. If so,
- (b) which aggregates are suitable for target purposes;

- (c) should each target range refer to one monetary aggregate or to more than one;
- (d) what should be said about non-targetted indicators of monetary conditions.

q. 6

The Target for Broad Money

At present broad money for MTFS purposes is referred to as £M3 (and PSL2) - 1983-84 FSBR para 211. It is agreed that £M3 should remain a target aggregate for broad money. PSL2 does not, in practice receive much attention, nor does it add much to the explanatory power of £M3. It is therefore for consideration whether it should cease to be referred to for target purposes and, instead, included among the other measures of liquidity which are taken into account in assessing monetary conditions. The main problem in removing it - even in its present bracketed form - is that it might be taken to mean that we are taking less interest in the activities of building societies. This is not a message we should wish to convey given the present very strong growth of building society deposits.

7 The Target for Narrow Money

M1 needs to be replaced for target purposes for two reasons. First, it has a substantial and growing interest bearing component, which means that like much of £M3 it can be held as an income earning asset. Second, it contains a large proportion of wholesome money and so cannot be said to be a very good indicator of the transactions function of money. The choice of narrow aggregate is not easy. In principle there are two candidates:

- (i) M2 which has been specially designed to measure retail transactions, but which nonetheless contains a considerable interest bearing element.
- (ii) Various non-interest bearing measures which might provide a good guide to transactions which avoiding the complication of having a complex interest bearing demand. These are NIBM1, Mo or notes and coin.

8. ^{The difficulty with} ~~In practice~~ M2 ^{that has} ~~is not a contender because~~ it has not been in existence long enough - certainly not for use on its own. At the Mansion House the Chancellor said of M2:

"I think and hope that it will come to play an important part in policy decisions. But its time has not yet come".

So the Chancellor went on to say

"Meanwhile, there is some recent evidence that other measures of narrow money - particularly measures of non-interest bearing money such as the wide monetary base, Mo, and its predominant component, notes and coin with the public - have not been subject to the same distortions as M1."

9. A little later in the Speech the Chancellor said that:

"... it does appear that Mo could have a more important part to play as a key indicator in the growth of narrow money.

Whichever indicators we choose to emphasize, it is unlikely that it would be appropriate to maintain a single range for both broad and narrow aggregates ..."

There was no commitment to targetting Mo, but a clear indication of looking in that direction. It is this aspect that has been seized on by most of those commenting on the Speech.

Reaction to the Speech

4. FC.

Recent Research

4. FC.

5. Of the three aggregates, NIBM, seems to be too volatile and has no advantages over the smoother series for Mo and notes and coin. A choice between Mo and notes and coin revises complex issues because Mo is one of the aggregates on which a monetary base control regime could be based.

6. The Government's position on monetary base control is:

- (a) It has no present intention of moving to monetary base control. This was made clear again in the Mansion House Speech and is the agreed position.
- (b) We are still in the business of taking 'steps which are desirable in their own right' and which 'would be considered with a gradual evolution towards a monetary base system and will help

Mo or Weston

14. Mo in its weekly average version and notes and coin give much the same signals. In choosing between them the relevant considerations seem to be:

as FC 14

adjusted for recent research
+ the answer on the role of
+ real money.

15. So far as the markets are concerned, there might be a period of adjustment as they accustom themselves to two aggregates with equal weight. But this should not prove difficult provided they do not believe policy is being relaxed. Policy will in fact be conducted in the same way as in the past; we have simply given a sharper expression to what we are doing.

16. There is a problem in targeting Mo which arises because some will think that, whatever we say, we shall have moved to monetary base control. There might also be pressure to move more quickly in the direction of monetary base control. These problems arise so long as Mo is given a place in the constellation of monetary indicators which we monitor. So long as we continue to take a range of monetary indicators into account - and indeed have two targets - it is difficult to see that any serious misunderstanding of our intentions could arise.

17. Conclude with 3 options:

(a) Two aggregates

(i) £M3 and Mo

(ii) £M3 and notes and coin

(b) Four aggregates

(i) £M3 + PSL2 and Mo and M2

(ii) £M3 + PSL2 and notes + coin + M2

(c) Wide + narrow.

us to judge how far such a system would contribute
towards our medium term objectives'

Sir G Howe 24 November 1980.

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FROM: F CASSELL

5 January 1984

1. SIR P MIDDLETON
2. CHANCELLOR

cc - Sir T Burns
Mr Littler
Mr Battishill
Mr Monck
Mr Lankester
Mrs Lomax

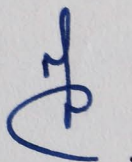
bf 12/1

MONETARY TARGETS

I attach a draft of the Treasury paper for your meeting with the Governor next week. The Bank are planning to put in a short paper of their own, saying where they disagree with ours.

The paper follows the general lines of the one discussed at your meeting with Treasury officials on 14 December but reflects the discussion at that meeting, and subsequently. The range of options has been narrowed to three, and the section on outsiders' views updated. The sections on research and on the comparison of MO and notes and coin have been revised to take in the results of later work - on the effects of smoothing bankers' balances and the significance of till money. Mrs Lomax is preparing a separate submission reporting the results of this work more fully.

We have agreed that we will let the Bank have our paper by the end of this week, so that they can prepare theirs, and let us see it, in good time for the meeting. You have agreed also that a copy of the paper should go to No 10.



F CASSELL

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MONETARY TARGETS

This paper sets out some issues still to be resolved on the form of monetary targets for the next MTFS - in particular what aggregates should we target. It is concerned entirely with the form of the targets. The appropriate numbers for the target ranges can be decided later.

2. The paper first records the points on which there is general agreement following the discussion of the Strategy papers last summer and identifies four main issues for decision. It then surveys what other people have said about monetary targets, and particularly about MO, after the Mansion House speech and reports what we have learned from our further research on narrow money since the papers circulated in mid-October. It also looks in more detail at the differences between MO and notes and coin, particularly in the context of operating a target for narrow money. The final section - paragraphs 24-25 - sets out what look to be the main options for the next MTFS.

WHERE WE STAND

3. There seems to be general agreement that:

i. In assessing monetary conditions it is necessary to look at both broad and narrow money.

ii. Whatever numbers are targetted, it will also be necessary to take into account other monetary indicators, including the exchange rate, in assessing monetary conditions.

iii. We cannot continue with the present arrangement in which there is one target range embracing both broad and narrow money. Last year was exceptional. Their different characteristics indicate different target ranges for broad and narrow money.

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iv. M1 is an unsatisfactory measure of narrow money because of its substantial element of wholesale, interest-bearing deposits.

v. £M3 (and PSL2) continue to be reasonable measures of broad money.

vi. All monetary aggregates are subject to technological or institutional change.

4. Some changes in the form of monetary targets are necessary. The opportunity is therefore available to re-think the presentation of policy. There is no suggestion that the present process of arriving at interest rate decisions - or of market operations to support them - should be altered. These considerations underlay the Chancellor's speech at the Mansion House in October.

5. There are four issues for decision:

a. Should we move to two target ranges, one for broad and one for narrow money. If so,

b. Which aggregates are suitable for target purposes;

c. Should each target range refer to one monetary aggregate or to more than one;

d. What should be said about non-targetted indicators of monetary conditions.

The Target for Broad Money

6. At present broad money for MTFs purposes is referred to as "£M3 (and PSL2)" - 1983-84 FSBR paragraph 2.11. It is agreed that £M3 should remain a target aggregate for broad money. PSL2 does not, in practice receive much public attention, nor so far has it added much to the explanatory power of £M3. It is therefore for consideration whether it should cease to be referred to for target purposes and, instead, included among the

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other measures of liquidity which are taken into account in assessing monetary conditions. The main problem in removing it - even in its present bracketed form - is that it might be taken to mean that we are taking less interest in the activities of building societies. This is not a message we should wish to convey given the present very strong growth of building society deposits.

The Target for Narrow Money

7. M1 needs to be replaced for target purposes for two reasons. First, it has a substantial and growing interest-bearing component, which means that like much of £M3 it can be held as an income earning asset. Second, it contains a large proportion of wholesale money and so cannot be said to be a very good indicator of the transactions function of money. The choice of narrow aggregate is not easy. In principle there are two candidates:

i. M2, which has been specially designed to measure retail transactions, but which nonetheless contains a considerable interest-bearing element.

ii. Various non-interest-bearing measures which might provide a good guide to transactions while avoiding the complication of having a complex interest-bearing element. These are NIBM1, M0 or notes and coin.

8. The difficulty with M2 is that it has not been in existence long enough - certainly not for use on its own. At the Mansion House the Chancellor said of M2:

"I think and hope that it will come to play an important part in policy decisions. But its time has not yet come."

So the Chancellor went on to say:

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"Meanwhile, there is some recent evidence that other measures of narrow money - particularly measures of non-interest bearing money such as the wide monetary base, M0, and its predominant component, notes and coin with the public - have not been subject to the same distortions as M1."

9. A little later in his speech the Chancellor said that:

"... it does appear that M0 could have a more important part to play as a key indicator in the growth of narrow money.

Whichever indicators we choose to emphasize, it is unlikely that it would be appropriate to maintain a single range for both broad and narrow aggregates ..."

There was no commitment to targetting M0, but a clear indication of looking in that direction. It is this aspect that has been seized on by most of those commenting on the speech.

REACTION TO MANSION HOUSE SPEECH

10. Reaction has been mixed, with the critics (mainly from the City) more vocal than the supporters.

i. The serious press devoted a fair amount of space to explaining the thinking behind the Chancellor's remarks. But the brokers' worries and the December 1982 BEQB article are also widely reported. More recently, the Treasury EPR article on Narrow Money has attracted some further coverage and comment (the latter mainly in the FT, including a fairly even handed article from Sam Brittan - aside from the usual plug for money GDP).

ii. Majority opinion in the City is critical, with particularly hostile pieces from Simon and Coates, Capel-Cure Myers (Roger Bootle) and Messel's (Congdon). Hoare Govett (Paul Temperton, ex Bank author of the BEQB article on cash) and Laing and Cruickshank are tersely dismissive, while Grievson-Grant, on the basis of the present Chancellor's

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sceptical remarks about narrow money in his 1981 Zurich speech, suggest that perhaps he "will not take MO as seriously as one might think at first sight". The exceptions are Phillips and Drew (Bill Martin, ex CPRS), with a generally sympathetic and perceptive note, and Greenwell's who were welcoming but worried about controlling MO "under present arrangements" (Greenwell's December Bulletin, however, strikes a less grudging note, prompted by the EPR article).

iii. There has been little serious comment outside the City, none of it very helpful. Minford has been almost silent, approving the "sensible upgrading" of MO in a single sentence. Beenstock (in 'The Times') was enthusiastic, for the wrong reasons, stressing that MO is "unique because it is directly under the authorities' control ... controllable down to the last penny ... The Chancellor has really stuck his neck out this time." The City University (Roy Batchelor), long time MBC advocates, are actually critical, arguing that MO is essentially a means of controlling broad money, and unsuitable as a target in its own right. None of the outside forecasting groups (including the new LBS Financial Outlook) have commented.

11. Parts of the general argument of the Speech have emerged almost unscathed:

i. Most commentators are prepared to accept the case for targetting narrow money as a measure of transactions balances.

ii. M1 has no defenders.

iii. Beenstock aside, the message that no move to MBC is being contemplated seems to have got across (though it has not pleased supporters of monetary base at Greenwell's and the City University).

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iv. MO is widely seen as the main option, but there is some recognition of alternatives. Several commentators (eg the Economist, Greenwell's, Christopher Johnson) refer to "retail" or NIB M1, with varying degrees of conviction. M2 comes in for favourable mention, but the view that it is too new to act as a target aggregate is not seriously questioned. Most (but not all) see notes and coin and MO as synonymous.

12. The proposition that some measure of narrow money may be particularly relevant to short-term interest rate decisions is more contentious. Notable dissenters from this view are Roger Bootle and Tim Congdon, who say interest rate decisions should be based on an overall assessment of "financial conditions", consistent with the Government's objectives for inflation. Criticism of MO itself is based on three oft-repeated points:

i. Interest rates have little or no direct effect on it, so it will be difficult to control (other than by "controlling the economy"). Some commentators challenge the sign of the effect (apparently on statistical grounds; no-one gives a convincing economic explanation of why there should be a perverse effect). The BEQB article - very occasionally supported by a chart - is the sole basis for these assertions. Only Christopher Johnson refers to the small (0.5 per cent) semi-elasticity in the current public version of the Treasury model. Greenwell's are the most explicit in drawing the conclusion that the lack of interest-sensitivity means that there is no reason to associate MO in any special way with short-term interest rates.

ii. MO has been, and will go on being, heavily affected by structural changes in the use of cash. The velocity trend is high and has risen unexpectedly since the late 70s. So target setting will be difficult. Again, the main source is the BEQB. Some commentators add, presumably also on the basis of the Bank's work on the demand for cash, that at best MO provides a very limited snapshot of current monetary conditions, being chiefly related to personal sector behaviour.

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iii. The relationship with future inflation and growth is not well established (though there may well be a link with past or current rates of inflation). This appears mainly in the most critical of the brokers, unsupported by statistical evidence other than charts. Some commentators note that the link looks closer since the mid 70s, but suggest that this is fortuitous.

13. There are two widespread misconceptions:

i. That M0 would be a fourth target, additional to the existing target variables. This is taken for granted in early articles (some of which complain of a proliferation of targets). On 18 November, Sam Brittan reported that "the present intention is to replace the existing three targets by two: one for so-called "little M0" ... the other will be some measure of broad liquidity". This has been picked up by Congdon, who complains of "uncertainty about the Government's views on monetary policy":

ii. That the chief appeal of M0 is as a rationale for cuts in interest rates. In the more superficial places, this is tied simply to the relatively slow growth in M0 in recent years. More sophisticated commentators argue that technical change will make it easy to underestimate future trends in M0 velocity, and hence set a "soft target"; or that the lack of interest sensitivity will mean that M0 is not an effective brake on interest rate cuts.

The second point, very fashionable immediately after the Mansion House speech, is beginning to lose favour as some commentators focus on the probable target range for M0. Serious suggestions are:

3-7 per cent	Minford
4-8 per cent	Greenwell's, Phillips & Drew, Christopher Johnson
5-9 per cent	Laing and Cruickshank

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(The Banker notes a 6 per cent trend increase in MO velocity in recent years, but spoils it by concluding that the 7-11 per cent range set for the other aggregates would be uncomfortably tight). Sam Brittan says the likely range for 1984-85 is 3-7 per cent or 4-8 per cent.

Several people (eg Greenwell's, Henry Kaufman and Phillips and Drew) have argued that with current MO growth well above last year's rate and towards the top of any plausible range, targetting MO is not a soft option.

14. The brokers have not finished with this subject yet. Judging by informal contacts, one question that we may hear more of over the coming weeks is: "If you do not intend to move to MBC, why choose the monetary base?" The point has already begun to surface: the Economist noted that operational balances are not included in any other monetary aggregate, and Capel-Cure Myers suggest that MO is a surprising choice if there is no intention to move the MBC. The Lex Column on 19 December commented that "by linking notes and coin with bankers' deposits and till money, MO raises the spectre of monetary base control". The point of the CUBS article is, of course, to argue that targetting MO makes no sense without a move to MBC. No-one yet appears to have concluded that notes and coin would be a preferable option to MO: the focus has rather been on highlighting those objections to MO that are common to notes and coin (and readily culled from the BEQB article on cash).

FURTHER RESEARCH ON NARROW MONEY

15. Over recent months Treasury economists have undertaken extensive research on narrow money, including the demand for notes and coin and for MO. There have been several discussions with the Bank, who are still sceptical about some aspects of the work. In addition we have consulted two academics - Professor Hendry of Nuffield College and Dr Bean of the LSE - who occasionally attend our academic panel. They have made some helpful suggestions which we have now largely taken on board.

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16. The Treasury's latest work tends to confirm the assessments in the note reporting the earlier work*, including the conclusion that, based on their apparent demand properties, notes and coin would seem to have a slight edge over MO and both have a fairly clear advantage over NIB M1 (the demand for which seems to be rather poorly determined and probably distorted by the growth of interest-bearing sight deposits in recent years).

i. There appears to be small but significant interest sensitivity in the demand for both cash and MO. This issue has particularly exercised some commentators since the Mansion House speech. We have now investigated this effect on a run of monthly data that goes back to the early 1960s. This examination indicates that conclusions about interest sensitivity do to a certain extent depend on the period used for estimation. A significant, though fairly small, interest rate effect is only well established in data since the mid-1970s. (The Bank's economists agree with this finding.) The role of interest rates in earlier periods - on which we are still working - is more uncertain.

ii. The recent work confirms the importance of financial innovation in explaining the rising trend in the velocity of notes and coin and MO. The rising proportion of the population holding bank and building society accounts seems to have been particularly important. (The Bank's work suggests this too.)

iii. The later work, like the earlier, yields better results for notes and coin than for MO. Our greater ability to account for fluctuations in notes and coin compared with total MO reflects the erratic nature of the bankers' balances and, to a lesser extent, till money. Separate work to explain movements in these confirms how difficult it is to model them.

* "Research into Narrow Money and its Implication for the Choice of Target Variable", October 1983

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iv. We have also looked further at the high short-term volatility of M0. About half the volatility in changes in M0 appears to be due to noise in bankers' balances. The proportion of the noise in total cash (ie non-bank holdings of notes and coin plus banks' till money) that is due to fluctuations in till money is small. So once bankers' balances have been excluded from M0 there does not appear to be a further significant reduction in volatility to be achieved by excluding till money.

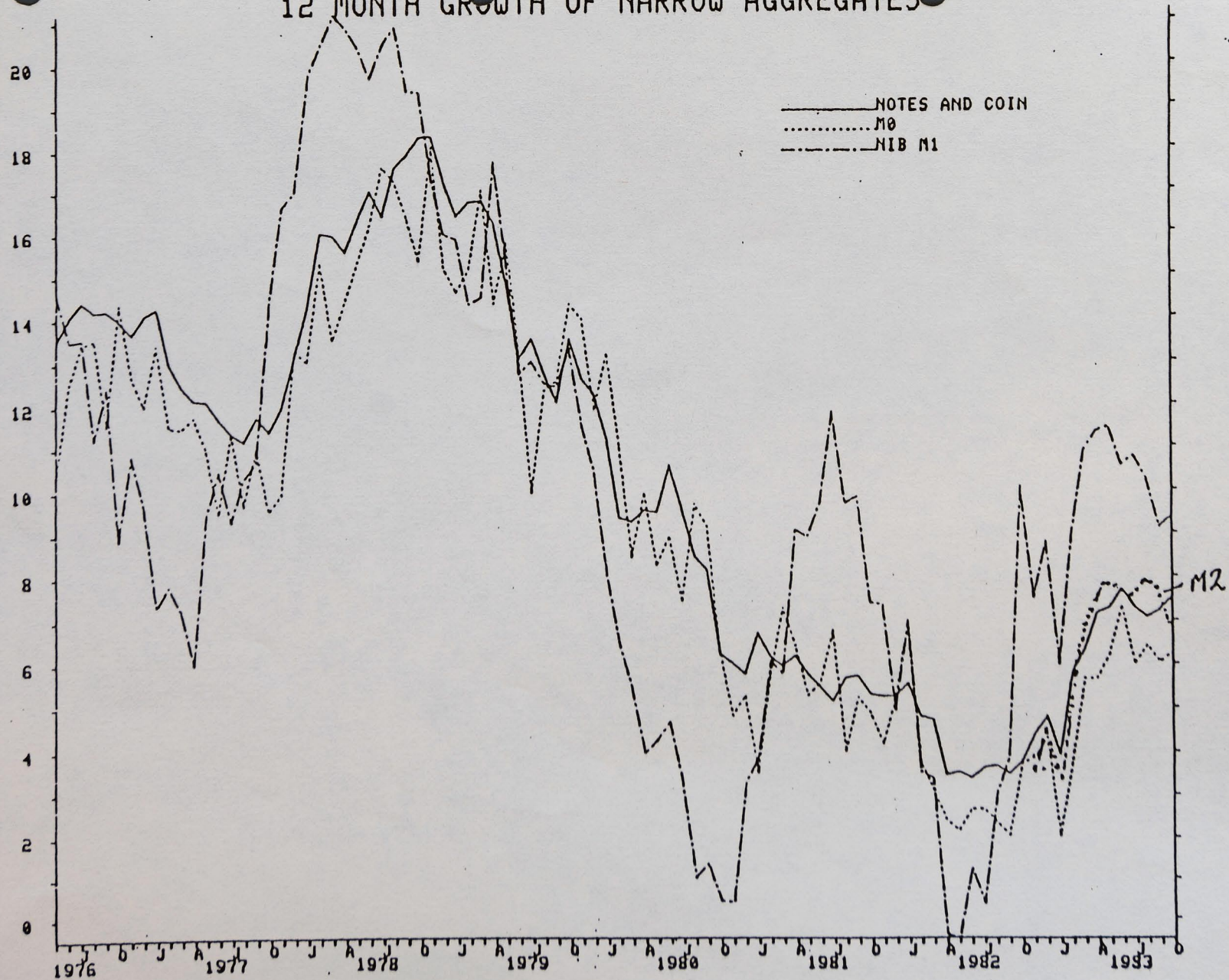
While we can take some comfort from the progress of this research, it must be recognised that it cannot point to conclusive evidence. Such research, no matter how successful it may appear to be at the time, can only have a modest role in any justification of targetting a very narrow monetary aggregate. Data revisions or new econometric techniques can all too often upset previous results.

17. There will always be room for legitimate doubts about the extent to which such work "explains" the past, and still more about how far it can be used to forecast the future. It would be unwise to let any public target range for very narrow money rest on particular assumptions about future financial innovation and its effect on the demand for cash. It seems best here to stick firmly to the practice of not justifying target ranges by econometrics. But it is important to have reputable published research available so that we are not vulnerable to the charge of adopting targets for monetary aggregates without having studied their past behaviour.

M0 or Notes and Coin

18. The chart on the next page shows the movements since 1976 in the three narrow aggregates that consist entirely of non-interest-bearing money (and also, for its brief life, of M2). As will be seen NIB M1 is subject to very wide swings (probably reflecting its high interest sensitivity), and seems to have no advantage over the smoother series for M0 and notes and coin.

12 MONTH GROWTH OF NARROW AGGREGATES



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19. A choice between M0 and notes and coin revises complex issues because M0 is one of the aggregates on which a monetary base control regime could be based.

20. The Government's position on monetary base control is:

a. It has no present intention of moving to monetary base control. This was made clear again in the Mansion House speech and is the agreed position.

b. We are still in the business of taking 'steps which are desirable in their own right' and which 'would be consistent with a gradual evolution towards a monetary base system and will help us to judge how far such a system would contribute towards our medium-term objectives' (Sir G Howe, 24 November 1980).

21. The research, as noted above, gives notes and coin an edge over M0: the statistical series is less noisy, the demand equations are better specified and have lower standard errors. As against that, M0 sounds more like a serious monetary aggregate - it is an "M" - with a good pedigree in monetary theory. Targetting notes and coin sounds primitive. However, M0 has some unattractive features:

i. It consists as to 90 per cent of notes and coin in circulation outside the banks and a further 8 per cent is notes and coin held in bank tills. It is difficult to argue that either till money or bankers' balances contribute much - if any - additional information about monetary conditions.

ii. It does not fit cleanly into the structure of monetary aggregates. Two of its components - till money and bankers' balances - are bank assets, whereas the other monetary aggregates are built on non-bank holdings of notes and coin and bank liabilities.

iii. This non-currency component - bankers' operational balances at the Bank of England - though only small is subject to what look to be sharply erratic movements, which

BANKERS' OPERATIONAL DEPOSITS

Y-axis: -250, -200, -150, -100, -50, 0, 50, 100, 150, 200, 250, 300, 350

X-axis: 1978, 1979, 1980, 1981, 1982, 1983

Legend: — WEEKLY, - - - MONTHLY

WEEKLY
MONTHLY

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generate a high level of variability in the series. It would be possible, however, to smooth this by averaging the weekly or even daily figures for these balances over the banking month. Our experiments with weekly averaging suggest that it produces a much more stable series (see chart).

iv. This non-currency component would only be of economic significance if the banks are being controlled by operating on their monetary base.

v. MO consists entirely of the liabilities of the monetary authorities. This indeed is its great virtue if one is operating a system of monetary base control. But it is not easy to explain why we are choosing this aggregate to target if it is intended not to introduce MBC.

The problem of short-term volatility can probably be dealt with by calculating MO as a weekly or daily average for the month. There is indeed much to be said for that. This series would then differ from notes and coin mainly because it included till money. On statistical grounds, there is little to choose between total notes and coin and currency in circulation with the public. The two series move closely together and are virtually indistinguishable in terms of volatility and predictability; if little is gained from including till money, little is lost either. The fact that the series for total notes and coin is, in principle, better measured, suggests some presumption in favour of looking at the total. (While the monetary authorities know how much currency they have coined in total, the split between the public's holdings and till money has to be estimated from banking sector returns. Within month information about this split is only available from the smaller sample of banks that report weekly.)

22. So far as the markets are concerned, there might be a period of adjustment as they accustom themselves to narrow and broad aggregates with equal weight. But this should not prove difficult provided they do not believe policy is being relaxed.

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Policy will in fact be conducted in the same way as in the past; we have simply given a sharper expression to what we are doing.

23. There is a problem in targetting M0 which arises because some will think that, whatever we say, we shall have moved to monetary base control. There might also be pressure to move more quickly in the direction of monetary base control. These problems arise so long as M0 is given a place in the constellation of monetary indicators which we monitor. So long as we continue to take a range of monetary indicators into account - and indeed have two targets - it is difficult to see that any serious misunderstanding of our intentions could arise.

THE OPTIONS FOR 1984

24. For the reasons given at the beginning of this paper, there are strong grounds for wanting to change the form of the monetary targets. We would presumably not want more than two target ranges - one for broad money, the other, and lower, one for narrow money - and we would like them to have equal status. We would also want to stress that in assessing monetary conditions we took account of all the aggregates (whether explicitly targeted or not) and other indicators as well.

25. The three options set out below are essentially about how the target ranges are labelled - whether they are defined in terms of specific aggregates, or simply as "broad" and "narrow" money. If the former, it is important that each range contains the same number of aggregates - to convey equal status.

OPTION 1: Two Aggregates

a. £M3 and M0

b. £M3 and notes and coin (NC)

Comments:- Clearcut; even-handed between broad and narrow. But hard to justify ditching target for PSL2; and M0 and NC, both have some unattractive features for targetting. Essential to emphasise

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that we would be monitoring other aggregates as well as those specifically targetted.

OPTION 2: Four Aggregates

- a. £M3 + PSL2 and M0 + M2
- b. £M3 + PSL2 and NC + M2

Comments:- This grouping has attractions because it includes a wide range of aggregates. But it is complicated and also has risks, given our limited knowledge of M2.

OPTION 3: "Broad money" and "narrow money".

Unlike the others, this option would not set target ranges in terms of specified aggregates but one for broad money (which would be said to include £M3 and PSL2) and another for narrow money (which would be said to include M2, M0 and notes and coin). Less clearcut than the other options. But avoids many of their disadvantages, and leaves the way open for future evolution.

HM Treasury
5 January 1984

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FROM: MISS M O'MARA
DATE: 6 JANUARY 1984

MR CASSELL

cc Sir P Middleton
Sir T Burns
Mr Littler
Mr Battishill
Mr Monck
Mr Lankester
Mrs Lomax

MONETARY TARGETS

As I told you on the telephone, the Chancellor has read the paper attached to your minute of 5 January and has commented that although it is drafted with admirable clarity, he is not very happy with its flavour. He is particularly concerned about the concluding section and would like Option 3 to be re-written completely. At present, he believes it resembles far too closely Option 6 in your paper of 6 December which he has pointed out was unequivocally rejected at the meeting he held on 14 December. He would like the present Option 3 to be replaced by a compromise between Option 1 and 2, ie:

- (i) MO (M2)
- (ii) EM3 (PSL2).

He has commented that the FSBK could still follow the suggestion put forward by Sir T Burns. He has also asked that the paper should state more clearly the dangers of holding to the status quo.

2. The Chancellor had the following detailed drafting comments:-

Paragraph 10 (i): Delete entirely. Sub-paragraphs (ii) and (iii) should no longer be numbered.

Paragraph 10 (ii) line 3: Amend to ".... Messels (Tim Congdon). Hoare Govett (Paul Temperton, ex-Bank author of the December 1982 BEQB article ...".

Paragraph 10 (ii) line 7: Amend to "...allegedly

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sceptical remarks".

Paragraph 10 (ii) final sentence: Amend to "... (Greenwells' December Bulletin, however, strikes a less grudging note, prompted by the recent Treasury EPR article on narrow money)."

Paragraph 10 (iii) line 1: Amend to "There has been little serious academic comment." and delete "outside the City, none of it very helpful."

Paragraph 12 (ii) line 3: Amend to ".... and has risen sharply since ...".

Paragraph 13 (i) line 1: Amend to "That MO would necessarily be a fourth target"

Paragraph 13 (i) line 4: Amend to "... of targets). However, on 18 November, Samuel Brittan".

Paragraph 13 (i) final sentence: Delete.

Paragraph 16 line 4: Amend to "... have a very slight edge...".

Paragraph 16 (iii) line 1: Amend to "... yields slightly better results....".

Paragraph 16 (iv): The term "noise" should be placed in inverted commas.

Paragraph 21 line 1: Amend to "... notes and coin a slight edge...".

Paragraph 21 (iii): The Chancellor has commented that daily averaging would presumably produce a still

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smoother series.

Paragraph 23 line 3: Amend to ".... might also be some pressure ...".

Paragraph 25 line 2: Delete " - whether they are defined in terms of specific aggregates, or simply as "broad" and "narrow" money. If the former,".

Paragraph 25 Option 1, Comments, line 3: Amend to "... and both MO and NC have some unattractive...".

Subject to these amendments, the Chancellor is content that the paper should be sent to the Bank, given the time constraints. We shall send the revised version to No 10 on Monday.

MOM

MISS M O'MARA

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FROM: (F CASSELL)
6 January 1984

PRINCIPAL PRIVATE SECRETARY

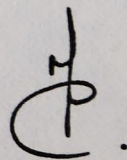
cc - Economic Secretary
Sir P Middleton
Sir T Burns
Mr Littler
Mr Battishill
Mr Monck
Mr Lankester
Mrs Lomax
Mr Sedgwick
Mr Ridley

MONETARY TARGETS

I attach the Treasury paper for the Chancellor's meeting with the Governor next week.

This version, which has now gone to the Bank, takes in the changes requested by the Chancellor on the earlier draft.

I attach also a second copy, for you to send to No 10.



F CASSELL

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MONETARY TARGETS

This paper sets out some issues still to be resolved on the form of monetary targets for the next MTFS - in particular what aggregates should we target. It is concerned entirely with the form of the targets. The appropriate numbers for the target ranges can be decided later.

2. The paper first records the points on which there is general agreement following the discussion of the Strategy papers last summer and identifies four main issues for decision. It then surveys what other people have said about monetary targets, and particularly about MO, after the Mansion House speech and reports what we have learned from our further research on narrow money since the papers circulated in mid-October. It also looks in more detail at the differences between MO and notes and coin, particularly in the context of operating a target for narrow money. The final section - paragraphs 26-27 - sets out what look to be the main options for the next MTFS.

WHERE WE STAND

3. There seems to be general agreement that:

i. In assessing monetary conditions it is necessary to look at both broad and narrow money.

ii. Whatever numbers are targetted, it will also be necessary to take into account other monetary indicators, including the exchange rate, in assessing monetary conditions.

iii. We cannot continue with the present arrangement in which there is one target range embracing both broad and narrow money. Last year was exceptional. Their different characteristics indicate different target ranges for broad and narrow money.

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- iv. M1 is an unsatisfactory measure of narrow money because of its substantial element of wholesale, interest-bearing deposits.
 - v. £M3 (and PSL2) continue to be reasonable measures of broad money.
 - vi. All monetary aggregates are subject to technological or institutional change.
4. Some changes in the form of monetary targets are necessary. The opportunity is therefore available to re-think the presentation of policy. There is no suggestion that the present process of arriving at interest rate decisions - or of market operations to support them - should be altered. These considerations underlay the Chancellor's speech at the Mansion House in October.
5. There are four issues for decision:
- a. Should we move to two target ranges, one for broad and one for narrow money. If so,
 - b. Which aggregates are suitable for target purposes;
 - c. Should each target range refer to one monetary aggregate or to more than one;
 - d. What should be said about non-targetted indicators of monetary conditions.

The Target for Broad Money

6. At present broad money for MTFPS purposes is referred to as "£M3 (and PSL2)" - 1983-84 FSBP paragraph 2.11. It is agreed that £M3 should remain a target aggregate for broad money. PSL2 does not, in practice receive much public attention, nor so far has it added much to the explanatory power of £M3. It is therefore for consideration whether it should cease to be referred to for target purposes and, instead, included among the

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other measures of liquidity which are taken into account in assessing monetary conditions. The main problem in removing it - even in its present bracketed form - is that it might be taken to mean that we are taking less interest in the activities of building societies. This is not a message we should wish to convey given the present very strong growth of building society deposits.

The Target for Narrow Money

7. M1 needs to be replaced for target purposes for two reasons. First, it has a substantial and growing interest-bearing component, which means that like much of £M3 it can be held as an income earning asset. Second, it contains a large proportion of wholesale money and so cannot be said to be a very good indicator of the transactions function of money. The choice of narrow aggregate is not easy. In principle there are two candidates:

i. M2, which has been specially designed to measure retail transactions, but which nonetheless contains a considerable interest-bearing element.

ii. Various non-interest-bearing measures which might provide a good guide to transactions while avoiding the complication of having a complex interest-bearing element. These are NIBM1, M0 or notes and coin.

8. The difficulty with M2 is that it has not been in existence long enough - certainly not for use on its own. At the Mansion House the Chancellor said of M2:

"I think and hope that it will come to play an important part in policy decisions. But its time has not yet come."

So the Chancellor went on to say:

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"Meanwhile, there is some recent evidence that other measures of narrow money - particularly measures of non-interest bearing money such as the wide monetary base, M0, and its predominant component, notes and coin with the public - have not been subject to the same distortions as M1."

9. A little later in his speech the Chancellor said that:

"... It does appear that M0 could have a more important part to play as a key indicator in the growth of narrow money.

Whichever indicators we choose to emphasize, it is unlikely that it would be appropriate to maintain a single range for both broad and narrow aggregates ..."

There was no commitment to targetting M0, but a clear indication of looking in that direction. It is this aspect that has been seized on by most of those commenting on the speech.

REACTION TO MANSION HOUSE SPEECH

10. Reaction has been mixed, with the critics (mainly from the City) more vocal than the supporters.

11. Majority opinion in the City is critical, with particularly hostile pieces from Simon and Coates, Capel-Cure Myers (Roger Bootle) and Messel's (Tim Congdon). Hoare Govett (Paul Temperton, ex Bank author of the December 1982 BEQB article on cash) and Laing and Cruickshank are tersely dismissive, while Grievson-Grant, on the basis of the present Chancellor's allegedly sceptical remarks about narrow money in his 1981 Zurich speech, suggest that perhaps he "will not take M0 as seriously as one might think at first sight". The exceptions are Phillips and Drew (Bill Martin, ex CPRS), with a generally sympathetic and perceptive note, and Greenwell's who were welcoming but worried about controlling M0 "under present arrangements" (Greenwell's December Bulletin, however,

strikes a less grudging note, prompted by the recent Treasury EPR article on narrow money).

12. There has been little serious academic comment. Minford has been almost silent, approving the "sensible upgrading" of M0 in a single sentence. Beenstock (in 'The Times') was enthusiastic, for the wrong reasons, stressing that M0 is "unique because it is directly under the authorities' control ... controllable down to the last penny ... The Chancellor has really stuck his neck out this time." The City University (Roy Batchelor), long time MBC advocates, are actually critical, arguing that M0 is essentially a means of controlling broad money, and unsuitable as a target in its own right. None of the outside forecasting groups (including the new LBS Financial Outlook) have commented.

13. Parts of the general argument of the speech have emerged almost unscathed:

i. Most commentators are prepared to accept the case for targetting narrow money as a measure of transactions balances.

ii. M1 has no defenders.

iii. Beenstock aside, the message that no move to MBC is being contemplated seems to have got across (though it has not pleased supporters of monetary base at Greenwell's and the City University).

iv. M0 is widely seen as the main option, but there is some recognition of alternatives. Several commentators (eg the Economist, Greenwell's, Christopher Johnson) refer to "retail" or NIB M1, with varying degrees of

conviction. M2 comes in for favourable mention, but the view that it is too new to act as a target aggregate is not seriously questioned. Most (but not all) see notes and coin and M0 as synonymous.

14. The proposition that some measure of narrow money may be particularly relevant to short-term interest rate decisions is more contentious. Notable dissenters from this view are Roger Bootle and Tim Congdon, who say interest rate decisions should be based on an overall assessment of "financial conditions", consistent with the Government's objectives for inflation. Criticism of M0 itself is based on three oft-repeated points:

i. Interest rates have little or no direct effect on it, so it will be difficult to control (other than by "controlling the economy"). Some commentators challenge the sign of the effect (apparently on statistical grounds; no-one gives a convincing economic explanation of why there should be a perverse effect). The BEQB article - very occasionally supported by a chart - is the sole basis for these assertions. Only Christopher Johnson refers to the small (0.5 per cent) semi-elasticity in the current public version of the Treasury model. Greenwell's are the most explicit in drawing the conclusion that the lack of interest-sensitivity means that there is no reason to associate M0 in any special way with short-term interest rates.

ii. M0 has been, and will go on being, heavily affected by structural changes in the use of cash. The velocity trend is high and has risen sharply since the late 70s. So target setting will be difficult. Again, the main source is the BEQB. Some commentators add, presumably also on the basis of the Bank's work on the demand for cash, that at best M0 provides a very limited snapshot of current monetary conditions, being chiefly related to personal sector behaviour.

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iii. The relationship with future inflation and growth is not well established (though there may well be a link with past or current rates of inflation). This appears mainly in the most critical of the brokers, unsupported by statistical evidence other than charts. Some commentators note that the link looks closer since the mid-70s, but suggest that this is fortuitous.

15. There are two widespread misconceptions:

i. That MO would necessarily be a fourth target, additional to the existing target variables. This is taken for granted in early articles (some of which complain of a proliferation of targets). However, on 18 November, Samuel Brittan reported that "the present intention is to replace the existing three targets by two: one for so-called "little MO" ... the other will be some measure of broad liquidity".

ii. That the chief appeal of MO is as a rationale for cuts in interest rates. In the more superficial places, this is tied simply to the relatively slow growth in MO in recent years. More sophisticated commentators argue that technical change will make it easy to underestimate future trends in MO velocity, and hence set a "soft target"; or that the lack of interest sensitivity will mean that MO is not an effective brake on interest rate cuts.

The second point, very fashionable immediately after the Mansion House speech, is beginning to lose favour as some commentators focus on the probable target range for MO. Serious suggestions are:

3-7 per cent	Minford
4-8 per cent	Greenwell's, Phillips & Drew, Christopher Johnson
5-9 per cent	Laing and Cruickshank

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(The Banker notes a 6 per cent trend increase in MO velocity in recent years, but spoils it by concluding that the 7-11 per cent range set for the other aggregates would be uncomfortably tight). Sam Brittan says the likely range for 1984-85 is 3-7 per cent or 4-8 per cent.

Several people (eg Greenwell's, Henry Kaufman and Phillips and Drew) have argued that with current MO growth well above last year's rate and towards the top of any plausible range, targetting MO is not a soft option.

16. The brokers have not finished with this subject yet. Judging by informal contacts, one question that we may hear more of over the coming weeks is: "If you do not intend to move to MBC, why choose the monetary base?" The point has already begun to surface: the Economist noted that operational balances are not included in any other monetary aggregate, and Capel-Cure Myers suggest that MO is a surprising choice if there is no intention to move to MBC. The Lex Column on 19 December commented that "by linking notes and coin with bankers' deposits and till money, MO raises the spectre of monetary base control". The point of the CUBS article is, of course, to argue that targetting MO makes no sense without a move to MBC. No-one yet appears to have concluded that notes and coin would be a preferable option to MO: the focus has rather been on highlighting those objections to MO that are common to notes and coin (and readily culled from the BEQB article on cash).

FURTHER RESEARCH ON NARROW MONEY

17. Over recent months Treasury economists have undertaken extensive research on narrow money, including the demand for notes and coin and for MO. There have been several discussions with the Bank, who are still sceptical about some aspects of the work. In addition we have consulted two academics - Professor Hendry of Nuffield College and Dr Bean of the LSE - who occasionally attend our academic panel. They have made some helpful suggestions which we have now largely taken on board.

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18. The Treasury's latest work tends to confirm the assessments in the note reporting the earlier work*, including the conclusion that, based on their apparent demand properties, notes and coin would seem to have a very slight edge over MO and both have a fairly clear advantage over NIB M1 (the demand for which seems to be rather poorly determined and probably distorted by the growth of interest-bearing sight deposits in recent years).

i. There appears to be small but significant interest sensitivity in the demand for both cash and MO. This issue has particularly exercised some commentators since the Mansion House speech. We have now investigated this effect on a run of monthly data that goes back to the early 1960s. This examination indicates that conclusions about interest sensitivity do to a certain extent depend on the period used for estimation. A significant, though fairly small, interest rate effect is only well established in data since the mid-1970s. (The Bank's economists agree with this finding.) The role of interest rates in earlier periods - on which we are still working - is more uncertain.

ii. The recent work confirms the importance of financial innovation in explaining the rising trend in the velocity of notes and coin and MO. The rising proportion of the population holding bank and building society accounts seems to have been particularly important. (The Bank's work suggests this too.)

iii. The later work, like the earlier, yields slightly better results for notes and coin than for MO. Our greater ability to account for fluctuations in notes and coin compared with total MO reflects the erratic nature of the bankers' balances and, to a lesser extent, till money. Separate work to explain movements in these confirms how difficult it is to model them.

* "Research into Narrow Money and its Implication for the Choice of Target Variable", October 1983.

iv. We have also looked further at the high short-term volatility of M0. About half the volatility in changes in M0 appears to be due to 'noise' in bankers' balances. The proportion of the 'noise' in total cash (ie non-bank holdings of notes and coin plus banks' till money) that is due to fluctuations in till money is small. So once bankers' balances have been excluded from M0 there does not appear to be a further significant reduction in volatility to be achieved by excluding till money.

While we can take some comfort from the progress of this research, it must be recognised that it cannot point to conclusive evidence. Such research, no matter how successful it may appear to be at the time, can only have a modest role in any justification of targetting a very narrow monetary aggregate. Data revisions or new econometric techniques can all too often upset previous results.

19. There will always be room for legitimate doubts about the extent to which such work "explains" the past, and still more about how far it can be used to forecast the future. It would be unwise to let any public target range for very narrow money rest on particular assumptions about future financial innovation and its effect on the demand for cash. It seems best here to stick firmly to the practice of not justifying target ranges by econometrics. But it is important to have reputable published research available so that we are not vulnerable to the charge of adopting targets for monetary aggregates without having studied their past behaviour.

M0 or Notes and Coin

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12-MONTH GROWTH OF NARROW AGGREGATES

NOTES AND COIN
M0
M1
M2

20
18
16
14
12
10
8
6
4
2
0

1976 1977 1978 1979 1980 1981 1982 1983

M2

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22. The Government's position on monetary base control is:

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BANKERS' OPERATIONAL DEPOSITS

Y-axis: -250, -200, -150, -100, -50, 0, 50, 100, 150, 200, 250, 300, 350

X-axis: 1977, 1978, 1979, 1980, 1981, 1982, 1983

Legend: — WEEKLY, MONTHLY

Year	Month	Weekly Deposits	Monthly Deposits
1977	Jan	40	140
1977	Jul	10	-50
1977	Aug	55	115
1977	Oct	-55	-115
1977	Nov	45	220
1977	Dec	-100	-200
1978	Jan	25	30
1978	Jul	-15	25
1978	Aug	45	115
1978	Oct	45	45
1978	Nov	-15	60
1978	Dec	-10	10
1979	Jan	-15	25
1979	Jul	45	25
1979	Aug	45	45
1979	Oct	-25	-75
1979	Nov	65	185
1979	Dec	-35	-125
1980	Jan	10	15
1980	Jul	25	165
1980	Aug	-80	-195
1980	Oct	-10	20
1980	Nov	90	90
1980	Dec	-25	-105
1981	Jan	55	85
1981	Jul	-40	-95
1981	Aug	10	85
1981	Oct	165	105
1981	Nov	-95	-165
1981	Dec	-25	20
1982	Jan	-20	-25
1982	Jul	50	50
1982	Aug	-70	-65
1982	Oct	55	155
1982	Nov	-35	-35
1982	Dec	45	40
1983	Jan	-15	-15
1983	Jul	35	95
1983	Aug	-65	-55
1983	Oct	25	135
1983	Nov	-35	-105
1983	Dec	60	40

WEEKLY
MONTHLY

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generate a high level of variability in the series. It would be possible, however, to smooth this by averaging the weekly or even daily figures for these balances over the banking month. Our experiments with weekly averaging suggest that it produces a much more stable series (see chart).

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v. MO consists entirely of the liabilities of the monetary authorities. This indeed is its great virtue if one is operating a system of monetary base control. But it is not easy to explain why we are choosing this aggregate to target if it is intended not to introduce MBC.

The problem of short-term volatility can probably be dealt with by calculating MO as a weekly or daily average for the month. There is indeed much to be said for that. This series would then differ from notes and coin mainly because it included till money. On statistical grounds, there is little to choose between total notes and coin and currency in circulation with the public. The two series move closely together and are virtually indistinguishable in terms of volatility and predictability; if little is gained from including till money, little is lost either. The fact that the series for total notes and coin is, in principle, better measured, suggests some presumption in favour of looking at the total. (While the monetary authorities know how much currency they have coined in total, the split between the public's holdings and till money has to be estimated from banking sector returns. Within month information about this split is only available from the smaller sample of banks that report weekly.)

24. So far as the markets are concerned, there might be a period of adjustment as they accustom themselves to narrow and broad aggregates with equal weight. But this should not prove difficult provided they do not believe policy is being relaxed.

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Policy will in fact be conducted in the same way as in the past; we have simply given a sharper expression to what we are doing.

25. There is a problem in targetting MO which arises because some will think that, whatever we say, we shall have moved to monetary base control. There might also be some pressure to move more quickly in the direction of monetary base control. These problems arise so long as MO is given a place in the constellation of monetary indicators which we monitor. So long as we continue to take a range of monetary indicators into account - and indeed have two targets - it is difficult to see that any serious misunderstanding of our intentions could arise.

THE OPTIONS FOR 1984

26. For the reasons given at the beginning of this paper, there are strong grounds for wanting to change the form of the monetary targets. In particular we need to find a better measure of narrow money than M1 and to sharpen the presentation of our policy. We would presumably not want more than two target ranges - one for broad money, the other, and lower, one for narrow money - and we would like them to have equal status. We would also want to stress that in assessing monetary conditions we took account of all the aggregates (whether explicitly targetted or not) and other indicators as well.

27. The three options set out below are essentially about how the target ranges are labelled. It is important that each range contains the same number of aggregates - to convey equal status.

OPTION 1: Two Aggregates

a. £M3 and MO

b. £M3 and notes and coin (NC)

Comments:- Clearcut; even-handed between broad and narrow. But hard to justify ditching target for PSL2; and both MO and NC have some unattractive

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features for targetting. Essential to emphasise that we would be monitoring other aggregates as well as those specifically targetted.

OPTION 2: Four Aggregates

a. £M3 + PSL2 and M0 + M2

b. £M3 + PSL2 and NC + M2

Comments:- This grouping has attractions because it includes a wide range of aggregates. But it is complicated and also has risks, given our limited knowledge of M2.

OPTION 3: A Compromise between Options 1 and 2

This would give primacy to one aggregate within each target range but would specifically mention another aggregate as well:-

broad money:	£M3 (PSL2) as now
narrow money:	M0 (M2).

HM Treasury
6 January 1984

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(Monte) →

log

PCC(84)2

6/1/84

HER MAJESTY'S TREASURY

f- POLICY CO-ORDINATING COMMITTEE

POLICY BACKGROUND TO THE MTFB

Note by the Secretaries

Done
huda
consults
page

Fin Strat

The attached paper by Sir Terence Burns is circulated for discussion at PCC on Tuesday, 10 January.

*SBH
Tavari*

How much to back

D R NORGROVE
J F WILLIAMS

Burns

1. MTFB 5 yrs (check for the case)
2. 7-11 for fulling year
3. Mon 988. present
4. Nansun - narrow range
5. Para 5b + 17

*2.
- SBH to back*

6 January 1984

6. Project 85 as well for price adjustment
7. Para 8 PSFD + 988
7. Submission only for 14 months for

M 3 Mo

Old 8 Jgt.

2. How express

3. 2 months for face

4. 1 month 4p 7-11

5. PS Deps

POLICY BACKGROUND TO THE MTFSTHE FIRST FOUR YEARS

1. The Medium Term Financial Strategy has now been in place for four years. It was introduced in 1980 at a time of high and increasing inflation, following large increases in world oil and other commodity prices and the breakdown of the previous administration's incomes policy. It set out targets for monetary growth and an illustrative path for the PSBR, with the aim of bringing inflation down progressively. Essentially the strategy has been successful, though the outturn has differed in a number of details from expectations at the time.

Economic Performance*

2. Recent behaviour of money GDP, output, and inflation is set out in the table below:

% growth	1973-79 average	1979-80	1980-81	1981-82	1982-83	1983-84 ^E
Money GDP	16.8	19.9	13.7	9.7	9.2	8
Output	1.7	2.6	-4.1	-0.1	2.3	3
Inflation						
- GDP deflator	14.8	16.8	18.6	10.0	6.7	5
- RPI	15.0	15.8	16.3	11.5	7.1	4½

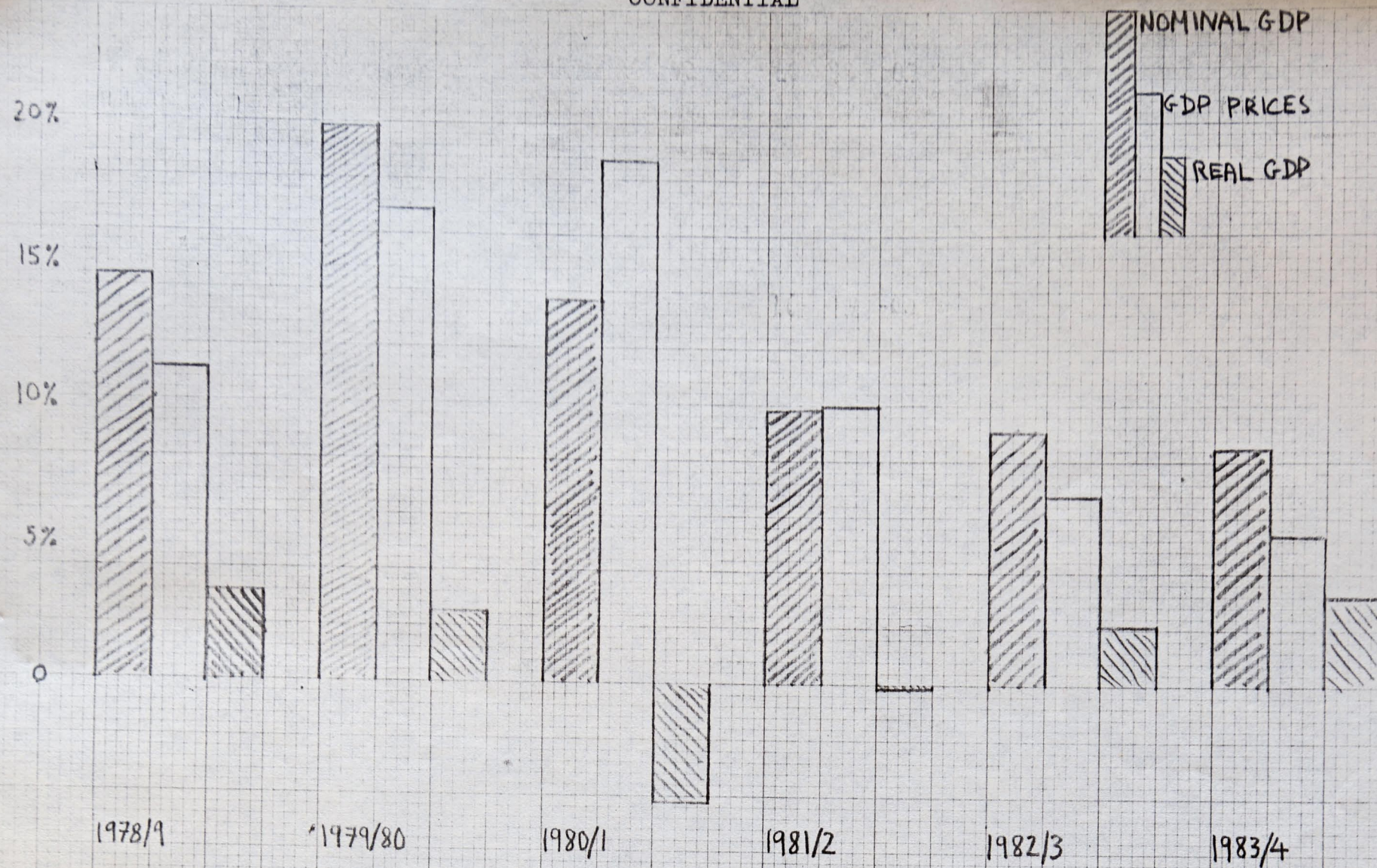
E = latest estimate

After growing by nearly 20% in 1979-80, money GDP decelerated to 9-10% by 1981-82 and has since remained broadly stable. The deceleration was rather sharper than assumed in the 1980 MTFS, which did not envisage nominal GDP growth under 10% until 1982-83, and then only for one year.

3. Inflation has also come down more sharply than anticipated in 1980, and has consistently been lower than forecast. The precise figures depend on the measure of prices used; but using the GDP deflator, inflation fell from nearly 19% in 1980-81 to 10% in the next year and an estimated 5% this year.

* Detailed comparison of present estimates of output and inflation with figures in successive versions of the MTFS is given in an Annex.

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GROWTH OF NOMINAL GDP AND ITS COMPOSITION

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4. The pattern of output has been broadly as anticipated in 1980, with falls in the first two years followed by increases in the next two. But the amplitude of the swings has been slightly greater than anticipated. The 4% fall in 1980-81 was greater than forecast, though from a higher level in 1979-80, and the recovery slightly faster, particularly in 1982-83. In the first year of the MTFS, both output and inflation turned out lower than expected; but in subsequent years lower money GDP growth has gone with a more favourable split between output and prices.

5. There have been marked fluctuations in income shares over the last four years. The share of non-oil company profits, which started 1980 just below 10% - well below the levels ruling in the 1960s and early 1970s - fell sharply to reach about 6½% in the first half of 1981. Since then, however, there has been a recovery, back to the level of early 1980. Meanwhile the share of wages and salaries has fallen by 3 points since 1980 to around 56%. This pattern was not anticipated in 1980: a fall in the wage share was foreseen; but the extent of the fall in profits, reflecting in part the unexpectedly high interest rates and real exchange rate, and the subsequent recovery was not.

6. The incidence of policy, with particularly strong pressures on the company sector in the first two years, led to a sharp shake-out of labour. Productivity in manufacturing - though not elsewhere in the economy - has risen much more than expected; and this has evidently proved an easier way for manufacturing firms to relieve the pressure on them than cutting real wages. As a result employment has fallen, and unemployment risen, much more sharply than envisaged when the strategy was set out in 1980, even though the level of output is much as was envisaged.

The overall stance of policy

7. The four year programme in the 1980 MTFS showed declining growth in £M3 and an accompanying profile for the PSBR which was intended, given the other economic assumptions being made at the time, to give an acceptable path for real interest rates. In the event, both monetary growth and the PSBR have declined substantially since 1980 although the precise targets have been revised

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in subsequent versions of the MTFS and the scope of the monetary target has been widened to include PSL2 and M1 as well as £M3.

Monetary Growth

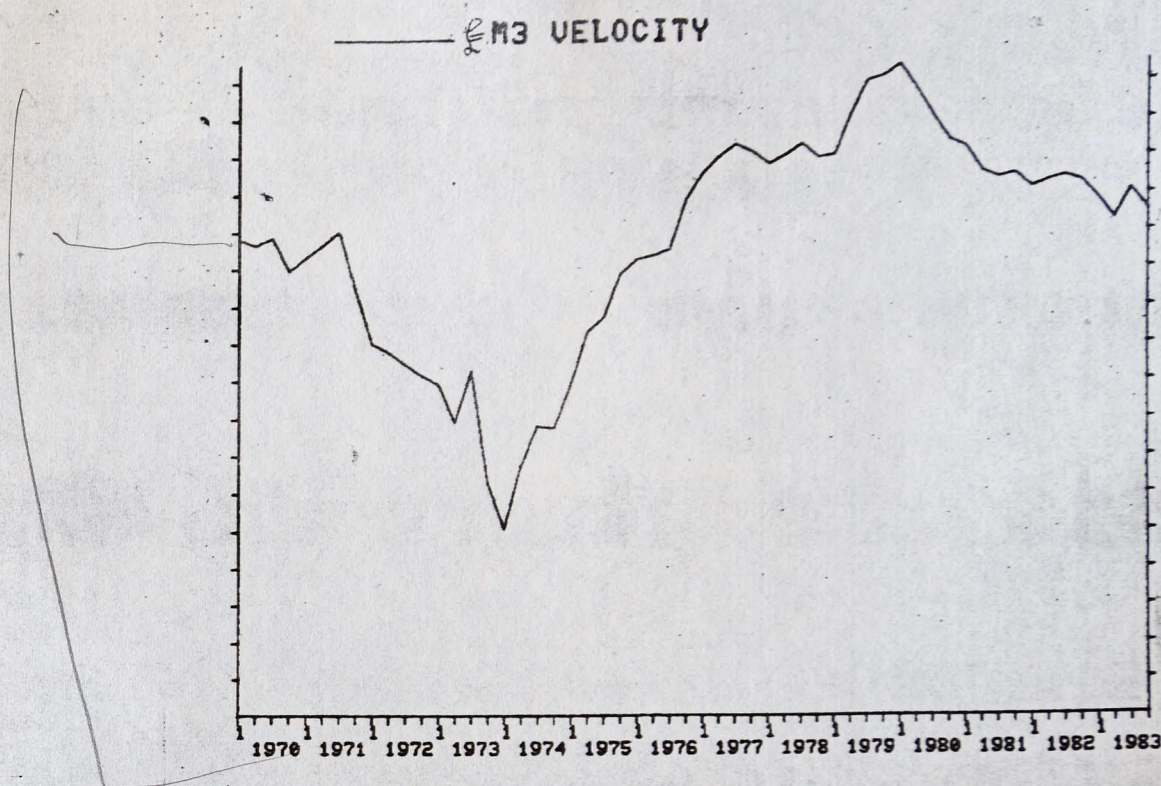
% changes* ,	1973-79 average	1979-80	1980-81	1981-82	1982-83	1983-84 ^E
Money GDP	16.8	19.9	13.7	9.7	9.2	8
M0	12.8	7.6	8.3	2.5	5.3	7
M1	13.3	3.3	12.4	3.9	14.9	12
£M3	12.1	11.5	21.2	12.0	11.5	10
PSL2	12.3	11.5	15.3	10.8	11.4	11

E = latest estimate

* Apart from money GDP, the growth rates quoted are % changes through the financial year (ie mid-April to mid-April).

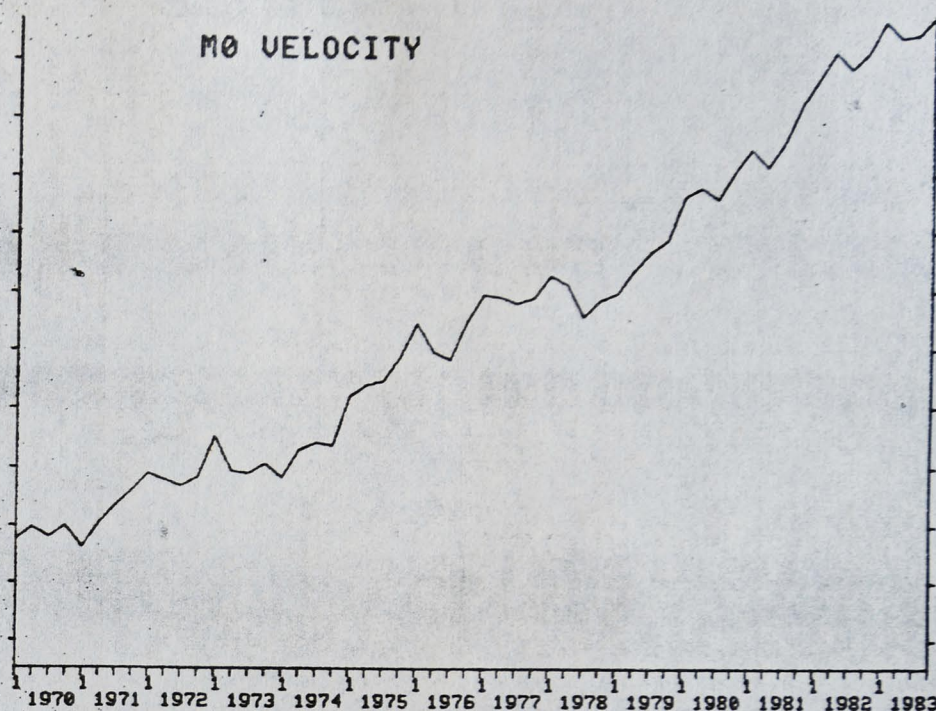
8. In spite of unexpectedly rapid deceleration of prices and money GDP, the growth of broad money has exceeded our forecasts throughout the period. £M3 growth was well above the target ranges in 1980-81 and 1981-82, though subsequently it has been just within the higher ranges set in the 1982 MTFS. Throughout the period, broad money growth has exceeded the growth of money GDP, in contrast to the experience of the 1970's on which monetary ranges in the 1980 MTFS were largely based.

9. There have been a number of reasons for this. Financial deregulation, and particularly the ending of the corset in 1980, has led to greater intermediation by the banking system and an increase in the provision of credit to the private sector. The private sector increased its net saving substantially in 1980-81 to compensate for the effects of increased inflation on the real value of its wealth, and kept much of the increase in liquid form. High real interest rates since then may have encouraged a higher wealth/income ratio. Rapid broad money growth relative to money GDP has coexisted with tight financial conditions and better than expected progress on inflation.



10. Narrow money has behaved rather differently. The growth of M0 has been consistently some way below the growth of money GDP, as suggested by previous trends, and fell progressively from 1979-80 to 1981-82 under the influence of financial innovation and high nominal interest rates. Since then, nominal interest rates have come down and the growth of M0 has picked up somewhat, though remaining below money GDP growth. The path of M2 has been similar. The behaviour of M1 has been significantly more bumpy, reflecting its greater interest sensitivity. But taken together, the narrow aggregates have given a better indication of the tightness of policy than the broad aggregates.

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11. The real money supply fell sharply in 1979-80 on all definitions as the inflation rate increased. For narrow money the fall continued almost unabated for another two years before turning up in the last two years. Real broad money has risen continuously since 1980-81.

Real Monetary Growth

% changes	1973-79 average	1979-80	1980-81	1981-82	1982-83	1983-84 ^E
M0	0.4	- 11.6	- 3.3	- 6.3	1.3	1.5
M1	0.8	- 5.2	0.3	- 5.0	10.5	6.1
£M3	- 0.3	- 8.4	10.8	2.4	7.2	3.8
PSL1	- 0.1	- 8.4	2.9	1.3	7.1	5.3

E = Estimate

12. In terms of the PSBR, attempts to tighten fiscal policy in the first two years of the last parliament were not successful. The PSBR in 1980-81 turned out significantly higher than the figure in the 1980 MTFS, due to a considerable extent to the effects of recession. But 1981-82 marked a step change by comparison with the previous two years. The PSBR as a share of GDP was reduced from 5½% in 1979-81 to under 3½% in the next three years. This contrasts with a progressive tightening of fiscal policy which the government was aiming for, and reflects an unexpectedly low PSBR in 1981-82 and an unexpectedly high figure in prospect for this year.

13. Some commentators have argued that fiscal policy has become less tight in the last two years, and there is probably some truth in this. The proponents of this view point to an increasing contribution of asset sales, among other things, arguing that these are rather different from other constituents of the PSBR. The table below gives figures for the PSBR adjusted for asset sales, and for the public sector financial deficit (PSFD)

The Stance of Fiscal Policy

£ billion (share of GDP)	Average 1979-81	1981-82	1982-83	1983-84 ^E
PSBR	11.6 (5.2)	8.7 (3.4)	9.1 (3.3)	10.0 (3.4)
PSBR <u>plus</u> asset sales	12.4 (5.6)	9.3 (3.6)	10.6 (3.8)	12.3 (4.1)
PSFD	9.9 (4.5)	6.1 (2.4)	9.0 (3.2)	9.9 (3.3)

14. The broad picture from these various indicators is that fiscal policy was probably tighter in 1981-82 than in the last two years; and there has been little change in the last year. But they confirm that fiscal policy is now tighter than in 1979-81, though probably less so than the reported PSBR figures suggest.

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15. Fiscal conditions have undoubtedly become easier in the last two years. This partly reflects a higher nominal fiscal deficit, but mainly the effect of lower inflation. Various indicators of the real fiscal balance are shown below. They all show a significant turnaround since 1981-82, which has contributed to the recovery in output.

<u>% of GDP</u>	<u>Fiscal conditions</u>			
	<u>Average 1979-81</u>	<u>1981-82</u>	<u>1982-83</u>	<u>1983-84^E</u>
Real PSBR	- 0.4	- 0.5	+ 1.1	+ 1.6
Real PSBR plus asset sales	-	- 0.3	+ 1.6	+ 2.3
Real PSFD	- 1.1	- 1.5	+ 1.0	+ 1.5
Contribution of inflation	- 5.6	- 3.9	- 2.2	- 1.8

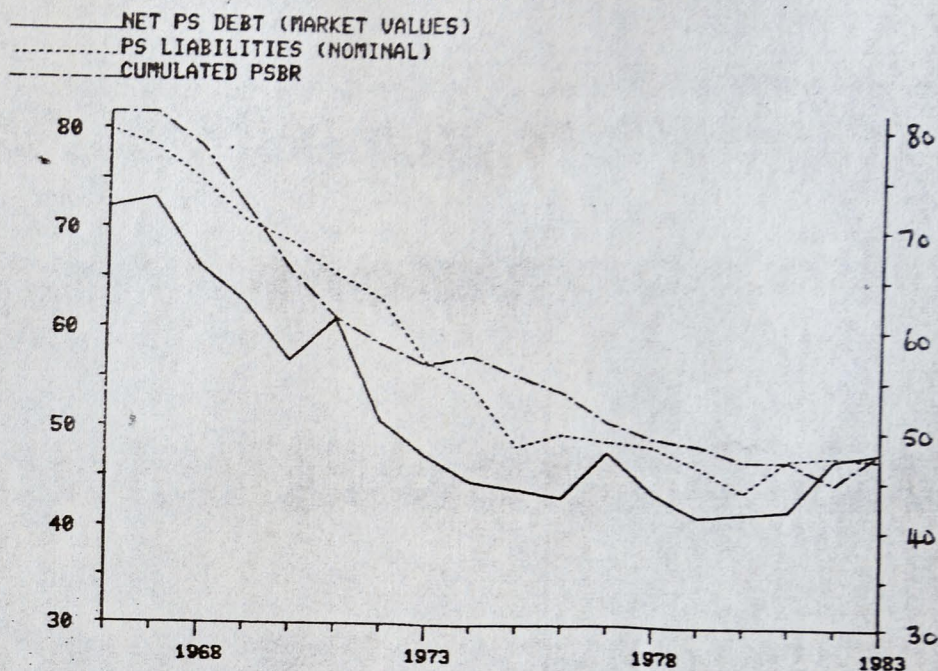
E = latest estimate

16. An alternative way to view fiscal policy is to examine movements in the stock of public sector debt relative to income. This is done on various definitions in the chart below. The precise picture one observes depends on the precise definition of debt adopted. However, whichever definition is adopted, there has been a clear flattening off since the early 1970's in the downward trend in the debt/income ratio and a reasonable degree of stability since then. For total gross debt, which conforms most closely to the PSBR, there is still some downward trend, but it is much less than in the 1960s. Because it is related to nominal income, and so takes account of changes in output, the turnaround in fiscal conditions in the last two years which is evident in the real PSBR figures, is less evident in the debt/income ratios. Only the measure which uses debt at market values shows a significant increase, due to the effect of falling interest rates on gilt prices.

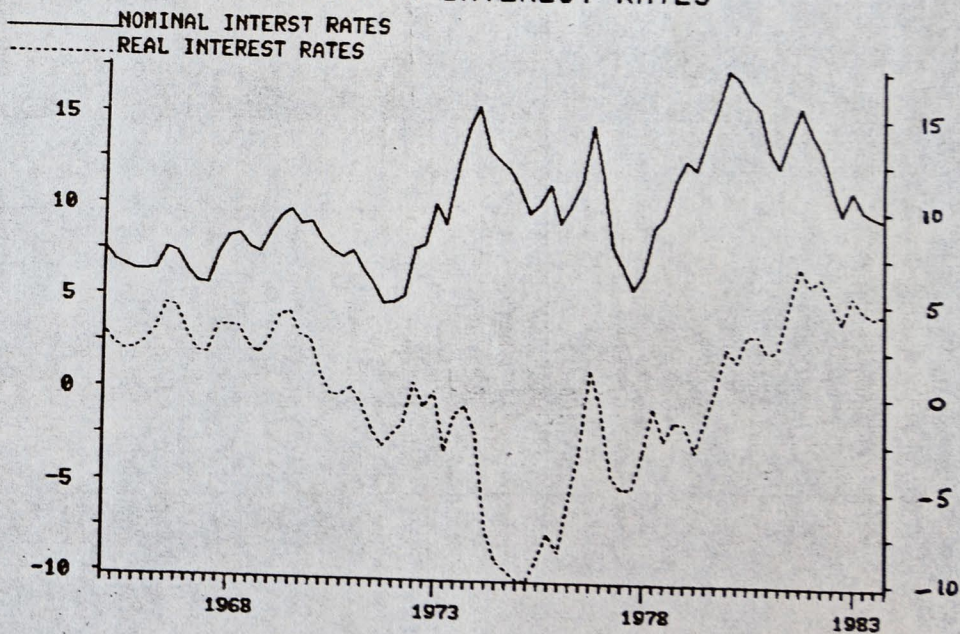
17. After being raised to 17% in late 1979, and remaining high in 1980, nominal interest rates have been brought down significantly as inflation has fallen, with a temporary interruption in late 1981 reflecting weakness in the exchange market. However real interest rates remain high in both the UK and in other countries. They are

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MEASURES OF PUBLIC SECTOR DEBT (% OF GDP)



REAL AND NOMINAL 3 MONTH INTEREST RATES



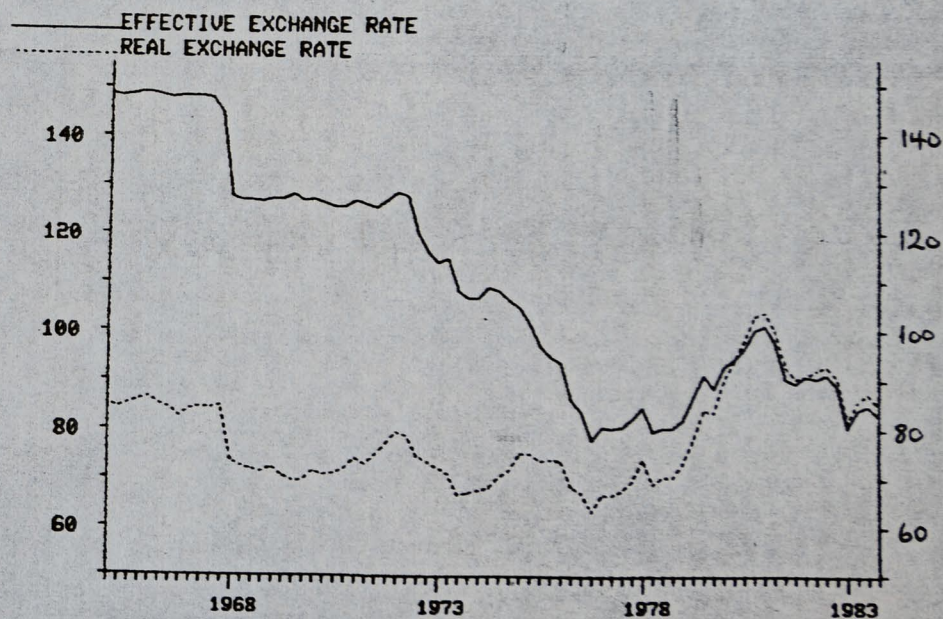
REAL = NOMINAL MINUS AVERAGE OF FORWARD AND BACKWARD LOOKING INFLATION

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as high, or higher, now in the UK as they were in 1980, and on this basis monetary conditions clearly remain tight.

18. The real exchange rate is now some way below its peak in the early months of 1981. Mainly this is due to a lower nominal exchange rate. The factors which drove it up from 1979 - including high nominal interest rates and high oil prices - have been at least partially reversed, but it remains well above the average level of the late 1970s. Pressure on the traded goods sector of the economy remains, though less so than in the first year or so of the MTFS.

REAL AND NOMINAL EFFECTIVE
EXCHANGE RATE



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THE PERIOD TO BE COVERED BY THE MTFS

19. The first MTFS in 1980 covered four financial years (1980-81 to 1983-84). The next three covered only three financial years. If the practice of rolling forward by one year only were continued, the 1984 MTFS would cover 1984-85 to 1986-87. However it is worth considering whether to extend this period to four or even five years.

20. The main argument for extending it is that it is appropriate at the beginning of a new Parliament for the Government to indicate its intentions over the whole life of the Parliament. The final year of a five-year period would be 1988-89, the Budget for which could in principle take place under the present Government if it ran its full five years.

21. The MTFS sets out the Government's broad objectives and plans for policy over the medium term. This acts as a constraint on policy in future and thereby contributes to the consistency and stability of policy over time. It also signals to the private sector what the policy framework will be, and hence encourages more efficient decisions. The longer the period of the MTFS the greater are the benefits of this kind that result.

22. There are some potential problems with a 5 year MTFS. Previous MTFSs have set out the assumptions about inflation and money GDP growth rates over the medium term which formed the basis for the financial framework. It would be difficult not to continue to do this. If a five-year period were adopted the assumptions about the end of the period would be interpreted as evidence of the Government's views about longer-term growth and inflation possibilities. It would be necessary to follow a careful line between appearing to be too optimistic and appearing over-pessimistic, while all the time emphasising the uncertainties. Similar difficulties arise with the output growth and inflation assumptions underlying any long-term public expenditure exercise, with which the MTFS would, of course, have to be consistent. The problems of this sort would be less if the MTFS covered a shorter period.

23. Another argument against extending the MTFS is that the figures for the later years carry little credibility because of the likelihood of unexpected developments. The MTFS may not therefore have a significant impact on expectations or behaviour. One aspect of the unreliability of figures for later years is that the Public Expenditure Survey only goes up to 1986-87.

24. The unreliability aspect should not, however, be given too much weight. In the case of public expenditure, the broad intention of holding the total constant in cost terms has already been mentioned in public. Any Green Paper or other document on long-term public expenditure would provide the basis on which to prepare projections up to 1988-89. More generally, the later years of the MTFS will not be regarded as unconditional projections of what fiscal and monetary policies will be - come what may. The discussion of the MTFS in the PSBR has always made clear that policies may have to change if domestic and world developments differ from those foreseen. The purpose of the numbers in the MTFS is to fill out the description in the text of the Government's broad strategy, on one particular set of assumptions about future developments. We have seen in recent years that revisions to monetary targets and PSBR paths have not affected credibility adversely when we have explained the reasons for them.

25. On balance, I favour extending the MTFS to cover five years (1984-85 to 1988-89). I do not judge the disadvantages of presenting figures for later years that are admittedly subject to considerable revision to be serious beside the advantage of being able to chart a consistent strategy over the whole lifetime of this Parliament.

MEDIUM-TERM OUTLOOK

26. Policy for the medium term has to be set against a background of likely developments in the absence of significant policy changes. This section discusses the outlook in general terms, the next section discusses objectives, and then the remaining sections discuss the financial framework consistent with the achievement of these objectives.

27. Taking inflation first, the central question is whether it will continue to fall over the medium term. Those who argue that it will do so place considerable weight on the depressive effects of the relatively low level of economic activity and low inflationary expectations. Unemployment is expected to remain above the natural rate for some years, and capacity utilisation to be considerably short of full capacity. A further, perhaps substantial, reduction in earnings growth may occur. The low capacity utilisation may limit the extent to which companies are able to raise profit margins, and it may stimulate them to make further improvements in productivity.

28. On the other hand, others place more emphasis on the effects of changes in the level of economic activity. They draw attention to the pressure that rising activity tends to place on costs and prices: commodity prices and wages would tend to rise more rapidly, the exchange rate might come under pressure, and companies would take the opportunity of the growing demand to restore some of the reduction in their profit margins that they have suffered in recent years.

29. Another way of posing the question about whether inflation will come down further is to ask whether the labour market will continue to adjust. Labour market adjustment can be thought of as a situation in which real wages grow significantly less rapidly than productivity. In this situation, profit margins will increase, as they have been doing over the last couple of years, without necessarily preventing a continued downward movement in inflation.

30. The argument that the low level of activity will contribute to a further downward movement in inflation relies to a considerable extent on the expectation that there will be continued adjustment in the labour market. This could be reflected either in lower growth in real wages without much change in productivity growth, or in a continuation of the relatively rapid productivity growth of the last 2-3 years without much slowdown in real wage growth (or a combination of the two). Those who emphasise the inflationary impact of the rise in level of activity tend not to expect much adjustment in the labour market.

31. The extent of labour market adjustment is also critically important to an assessment of likely developments in output and unemployment. So also is the type of adjustment, namely whether it takes the form of slower growth in real wages or faster growth in productivity. Both types improve profitability and hence contribute to faster output growth. Real wage adjustment is likely to lead to a faster fall in unemployment than productivity adjustment. Indeed the latter may well involve some temporary rise in unemployment if the productivity gains were especially sharp. However, productivity adjustment would produce more rapid output growth than real wage adjustment, because it represents a larger rise in the rate of growth of productive potential. The real incomes of those in work would also grow faster.

32. Thus an assessment of the extent and nature of future labour market adjustment is central to the view that one takes of medium and longer-term developments. The evidence from the past provides some pointers:

- there has been considerable adjustment during the last two or three years, especially in manufacturing: profitability has risen sharply, albeit from a low level;
- this has occurred almost entirely on the productivity side: on average we have not seen markedly slower growth in real wages than had been achieved in the past;
- in general, companies have reacted to the financial pressure on them by improving productivity rather than by striking tougher bargains over real wages, by contrast with what has been occurring in the US; and on the union side there has apparently been a willingness to see jobs lost as long as the real wages of those in work were maintained.

33. Looking to the future, this sort of pattern may well continue. The low levels of productivity in the UK, especially in manufacturing, compared with those in other European countries, show that there is still plenty of scope for productivity adjustment, even without any new investment. Furthermore, the historical relationship between

productivity growth and investment suggests that only a small rise in the share of investment in GDP over the next few years would be necessary to sustain faster productivity growth of, say, an extra 1 percentage point a year, assuming that the new investment is at least as productive as it was in peace-time periods up to the late 1960s.

34. Thus some labour market adjustment on the productivity side can probably be expected. There may also be some on the wage side. It is difficult to see the present higher unemployment and changes in labour market institutions not leading to some increase in flexibility, including a greater responsiveness of real wages. But the effect may not be dramatic and it may be most significant in non-manufacturing. The emphasis in manufacturing is more likely to be on high than on low wages and productivity.

35. There may therefore be some tendency for productivity growth to fall over the course of the next five years, with diminishing scope for further catching up ^{on our competitors} and with the growth of some relatively low productivity employment. In considering the growth of productive potential it is also necessary to take North Sea oil and labour supply into account. Production in the North Sea may begin to decline later in the MTFS period, tending to pull down the growth of output per head in the economy as a whole. There may also be some decline in the growth of labour supply. Since all three components of potential growth may tend to decelerate, it is likely that potential growth at the end of the period will be considerably less than it is now, at perhaps about $1\frac{1}{2}\%$ a year.

36. Some tentative conclusions can be drawn about the medium-term outlook, assuming a broadly unchanged stance of policy. Some relatively slight decline in inflation from the present 5% may occur. There should also be some fall in unemployment, again possibly not very large. Output growth should remain better than in the 1970s but not necessarily as high as in the most recent period.

MEDIUM-TERM OBJECTIVES

37. The medium-term outlook on unchanged policies provides a context within which objectives can be considered. Three broad options for the medium term may help to clarify the choices: a move to price stability over the course of the MTF5 period; an acceptance of steady inflation at around the present level; and something inbetween.

38. If price stability were to be achieved in five years, there would have to be a major deceleration of money GDP growth fairly early in the period. The pattern of the 1980-83 disinflation suggests that initially output growth would be affected more than inflation, but after a time the split of money GDP growth would become more favourable: output growth would rise again and inflation would fall. Unemployment would be adversely affected in the early years.

39. There would have to be a sharp reduction in the PSBR as a percentage of GDP and in monetary growth. Even with a tighter fiscal stance there would probably be a rise in real interest rates, and they would stay higher for a time; nominal interest rates would also be temporarily higher. It is difficult to see any room for tax cuts, unless significant reductions in expenditure could be achieved, or the disinflationary pressures in the economy turned out to be greater than seems likely.

40. If the objective were to settle for the continuation of inflation at about the present level, the growth of money GDP should be 7%-8% a year. Unemployment would possibly fall and there would be scope for some tax cuts and reductions in interest rates. The objections to this option are that postponement of the movement to price stability will:

- damage credibility
- create a floor to inflationary expectations
- make it more difficult to make further progress on inflation at a later stage.

Do you
need both

44

41. The unsatisfactory nature of the first two options suggests that something in between should be examined. Inflation would be kept on a downward path, but without aiming for price stability within five years. This would be done by bringing the growth of money GDP down significantly to, say, 5-6% a year. The split of money GDP growth between inflation and output growth will depend on the overall performance of the economy, and especially on labour market adjustment. If the sort of developments discussed earlier occur, and there is continued adjustment on both the productivity and real wages sides, inflation might be of the order of 3-4% after five years, and output growth in much the same range. There would be a reasonable expectation of some fall in unemployment.

42. If the economy performed less well than this, inflation might not come down so far and output growth would tend to be lower for given growths of money GDP. On the other hand a better performance might see further progress being made towards the ultimate inflation target, and output growth being somewhat better. In the former case there would be little prospect of a fall in unemployment but it would be more likely to occur in the latter case.

Assumptions for the MTFS

43. The MTFS has to be based on certain assumptions about inflation and output growth. These assumptions have been made public in the past (see attached extract from last year's MTFS). It might help to decide about medium-term objectives if their implications for the MTFS assumptions are considered.

44. The table shows possible assumptions that correspond to medium-term objectives that lie somewhere between the two extremes discussed above. The three cases differ according to the amount of adjustment in the economy, especially the labour market. They are designed to have about the same growth of money GDP. Case A is one of moderate adjustments such as one may reasonably expect to occur. Although output is assumed to be growing by 2% in the final year, the average growth rate during the whole MTFS period is somewhat higher because of the faster growth of productive potential in the early years.

The PSBR in 1982-83

- 2.14 The latest estimate for 1982-83 is £7½ billion equivalent to about 2½ per cent of GDP. This is some £1½ billion lower than the Autumn Statement forecast, and about £2 billion lower than expected at the time of the 1982 Budget, though still some way above the 2½ per cent of GDP envisaged for the year now ending in the 1980 FSB. Identifiable factors contributing to the lower outturn this year include unexpectedly high receipts from North Sea oil taxes, reflecting a higher sterling oil price, and underspending in some areas of public expenditure, notably local authority capital.

PSBR projections

- 2.15 The PSBR for 1983-84 is forecast to be £8 billion, equivalent to about 2½ per cent of GDP, as suggested a year ago and in the Autumn Statement. The fiscal projections summarised in table 2.5 show a further reduction in the PSBR as a proportion of GDP, to around 2½ per cent in 1984-85, and 2 per cent in 1985-86. This path should leave room within the monetary guidelines for a fall in interest rates over the next few years. The figures for 1984-85 and 1985-86 are illustrative. Decisions about the appropriate size of the PSBR in any particular year will be taken nearer the time.

Assumptions

- 2.16 The fiscal projections in tables 2.3-2.5 are based on the public expenditure plans shown in the Public Expenditure White Paper (Cmnd 8789), updated where necessary to take account of Budget changes and estimating changes. Further details for 1982-83 and 1983-84 are given in Part 5. Real output is assumed to grow by 2½ per cent a year on average over the three years. The general rate of inflation, as measured by the GDP deflator, was 7 per cent in 1982-83. It is forecast to fall to 5½ per cent in 1983-84. (The forecasts for the GDP deflator and the more widely known Retail Prices Index are discussed in para 3.29. There are many reasons why the two indices may move differently over relatively short periods of time including, for example, the differing impact of changes in mortgage interest rates, seasonal food prices, oil prices and import costs.) In the later years, the GDP deflator is assumed to rise by 5½ per cent in 1984-85, and by 5 per cent in 1985-86. These assumptions imply an average growth in money GDP of about 8 per cent over the period as a whole.

See note

Public expenditure

Public Expenditure

- 2.17 Table 2.3 shows the relationship between the planning total for public expenditure shown in Cmnd. 8789 and general government expenditure in national accounts terms (the definition of public expenditure lying behind the general government borrowing requirement).

Table 2.3 General Government Expenditure

	£ billion, cash				
	1981-82	1982-83	1983-84	1984-85	1985-86
Public expenditure planning total ⁽¹⁾	104.7	113	119½	126½	132½
Planning total adjustments ⁽²⁾	-1.0	1½	1	—	—
General government expenditure ⁽³⁾	103.7	114½	120½	126½	132½
Differences due to policy measures and economic assumptions ⁽⁴⁾	—	-1½	-1	-1	-½
National accounts adjustment ⁽⁵⁾	2.7	3	4	5½	5
Interest payments ⁽⁶⁾	13.8	14	14	14	14
Total expenditure in national accounts terms⁽⁷⁾	120.2	130	137½	145	151

(1) Public expenditure planning total, see Cmnd. 8789, table 1.1, line 9.

(2) Adjustment to line 1 to exclude certain public corporations' capital expenditure, public corporations' net overseas and market borrowing and general allowance for shortfall as in Cmnd. 8789.

(3) Expenditure on programmes by central government and local authorities plus the contingency and provisional reserves and special asset sales. Broad assumptions have been made about the share of general government in the total of expenditure on programmes shown in Cmnd. 8789, table 1.1 for 1984-85 and 1985-86.

(4) Incorporates later information for 1982-83 than in Cmnd. 8789. For 1983-84 onwards includes Budget measures and estimating changes, shortfall and the net effects of different economic assumptions from those in Cmnd. 8789. Revised planning totals for 1982-83 and 1983-84 are shown in table 5.5.

(5) Adjustments to line 3 to the definitions used in National Accounts Statistics.

(6) For 1981-82 see table 2.1, Financial Statistics, February 1983. For 1982-83 and 1983-84 see table 5.8.

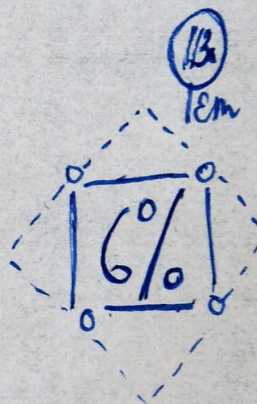
(7) For 1981-82 see table 2.4, Financial Statistics, February 1983. For 1982-83 and 1983-84 see table 5.8.

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Assumptions for the MTFS
(per cent a year)

	<u>Output growth</u>	<u>Inflation</u>	<u>Money GDP growth</u>
<u>A. Moderate Adjustment</u>			
Period Average	2½	4	6½
Final year	2	3½	5½ ✓
<u>B. Little Adjustment</u>			
Period Average	2	4½	6½
Final year	1½	4	5½ ✓
<u>C. Rapid Adjustment</u>			
Period Average	3	3½	6½
Final year	2½	3	5½ ✓

These means
we know
how to
defence
the price/output
spine



[Handwritten signature]

MONETARY POLICY

45. Monetary policy will continue to be directed to the achievement of targets for monetary growth. For present purposes we assume the targets are set consistent with an objective for money GDP growth falling to 5-6% by 1988-89. Unlike previous years, however, it is the intention to have separate ranges for broad and narrow money. For broad money, the focus of attention might continue to be £M3 (and PSL2). For narrow money the aim is to focus maybe on M0 (and M2).

46. Setting targets for broad money involves a number of difficult judgments. Growth of broad money has exceeded growth of money GDP since 1979-80, and the question is to what extent this downward trend in velocity will continue. Some of the factors reducing velocity in recent years may well be less important in the next five years, and some may even be reversed:

- the effects of financial deregulation should eventually slow down or stop, though how long the process of adjustment will take is not easy to predict.
- Some reduction in real interest rates may partially reverse the increase in financial wealth relative to income which has been observed since 1979.

47. Whether it is reasonable to expect a reversion to the upward trend in velocity observed in the 1970s is debateable. It would mark a significant change from recent behaviour. A more cautious approach would be to work on the assumption that the velocity trend flattens off over the period. On this basis it would probably be reasonable to aim for a 1 point annual reduction in target range for broad money over the period of the MTFS from the present range of 7-11%. However this may mean £M3 in the upper half of the ranges and PSL2 near the top end. This suggests staying with 7-11% in 1984-85, particularly if the range is also to apply to PSL2, and reducing it steadily in subsequent years. One possible set of assumptions which, of course, will have to be considered in the light of the forecast and the views of the Bank, is illustrated below.

*Chart
further
back*

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Broad Money Targets

	<u>1983-84</u>	<u>1984-85</u>	<u>1985-86</u>	<u>1986-87</u>	<u>1987-88</u>	<u>1988-89</u>
Money GDP	8	7½	7	6½	6	5½
£M3	10	9	8	7	6	5
PSL2	11	10	9	8	7	6
Target range	7-11	7-11	6-10	5-9	4-8	3-7

48. For narrow money the ranges will have to be lower than for broad money. They will have to be based primarily on the behaviour of M0 since we have insufficient data for M2. It is reassuring, therefore, that M0 and M2 growth rates have been broadly similar since M2 data has been collected. The velocity trend for M0 has been upwards at an average about 4% pa in the last 20 years. The acceleration of velocity after 1979 probably owed something to high nominal interest rates - the disinflationary policy bringing down M0 growth ahead of money GDP. There are signs of a deceleration in velocity in the last year as interest rates have come down. The likely effects of interest rate changes and the pace of financial innovation on velocity are the two main factors to be taken into account when setting the targets.

49. The pace of financial innovation in the next five years is very difficult to predict. But our research suggests that the effect on M0 velocity has in the past been relatively smooth. We have no reason to expect that the pace of change will differ significantly from the experience of recent years. Some reduction in nominal interest rates is likely to add to M0 growth over the next five years by comparison with previous trends if inflation is brought down further and real interest rates fall to some extent. If interest rates fall by 4% over the period of the MTFs this might add around 6% to the level of M0 relative to income. Since the timing is difficult to predict it makes sense to assume it is spread fairly evenly over the period.

50. This points to a less rapid decline in the rate of growth of narrow money in the next 5 years than for broad money. Given the objective for money income it suggests reducing the range by only ½ point each year, perhaps as below:

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Narrow Money Targets

	<u>1983-84</u>	<u>1984-85</u>	<u>1985-86</u>	<u>1986-87</u>	<u>1987-88</u>	<u>1988-89</u>
Money GDP	8	7½	7	6½	6	5½
MO	67	5	4½	4	3½	3
Target range	-	3-7	3-7	2-6	2-6	1-5

FISCAL POLICY

51. Fiscal policy, as noted earlier, appears to have been less restrictive in 1983-84 than intended at budget time. This is part of the reason why broad money growth is near the top of the range in spite of heavy funding. High real interest rates may be another contributory factor, which may also explain the strength of the real exchange rate. It is very difficult to judge what is the appropriate real exchange rate in the medium term, but the present level is significantly above the range experienced in the latter part of the 1970s.

52. This pattern - high real interest rates, real exchange rate, PSBR and broad money growth - points to fiscal policy being relatively lax in relation to monetary policy in 1983-84. Some correction is probably desirable in the budget. The approach adopted here is to examine the appropriate longer term size of the PSBR as a percentage of money GDP, and then to discuss the appropriate speed of adjustment to the chosen level.

(i) The Medium Term

53. The 1983 MTFS assumed a PSBR ratio coming down to 2% per annum in the medium term. This was thought to be broadly consistent with nominal income growth of 8% per annum over the period as a whole. Possible reasons for reducing this figure include:

- lower inflation and nominal income objectives
- higher asset sales/lower net capital expenditure

We therefore need to reconsider the appropriate medium term ratio.

54. One way of proceeding is to focus on trends in the ratio of public sector debt to money GDP, which are illustrated in Chart on page 8. As noted earlier, the downward trend observed since the war has flattened off in the last 10 years whichever definition of debt is adopted. This has occurred in spite of a high rate of investment in overseas assets in recent years - the counterpart of large surpluses in current account - following the abolition of exchange controls, and may owe something to the high levels of real interest rates.

55. The likely trend over the next two years is difficult to assess. If real interest rates fall, the downward trend could increase again. But with the current account expected to be broadly in balance, and hence little net UK investment in overseas assets, demand for public sector assets may account for a higher proportion of the private sector's net saving.

56. The table below gives figures for the PSBR as a % of GDP, for different inflation and growth assumptions, assuming the ratio of public sector debt to money GDP remains at about 0.4.

PSBR ratios (% of GDP)

Real Growth (%)	0	3	5
1	$\frac{1}{2}$	$1\frac{3}{4}$	$2\frac{3}{4}$
2	1	$2\frac{1}{4}$	$3\frac{1}{4}$
3	$1\frac{1}{4}$	$2\frac{3}{4}$	$3\frac{1}{2}$

Marg 7

If the downward trend in the debt/income ratio were to continue at, say, 2% per annum - close to the average of the last 10 years - it would be appropriate on this methodology to reduce each of the figures in the table by about 1% of GDP. This would imply a more cautious approach, consistent with the previous versions of the MTFS and falling real interest rates.

57. A further factor to be taken into account in judging the appropriate PSBR is the amount of net capital expenditure the public sector is undertaking. This is discussed at greater length in a parallel paper. At first sight this gives somewhat different answers from the simple debt/income calculations. Capital expenditure net of depreciation is projected to average less than 1% of GDP in the next few years, and it is arguable that the Government should borrow only to the extent that it is accumulating capital and hence generating future income. To the extent that it is running down the stock of public sector capital in relation to GDP - partly via low gross investment and partly via asset sales - it would be appropriate to run a relatively low PSBR.

58. In part this difference may be explained by the definition of capital expenditure used in the national accounts which omits considerable quantities of expenditure which should be treated on a par with capital expenditure in this context. Much education expenditure comes into this category. Health and defence are further examples. While proper evaluation of the true "net capital" element of public expenditure and tax would be a major undertaking, there is probably a presumption that the national accounts figure understates it.

59. The arguments deployed so far do not give a clear indication of what PSBR should be by the end of the MTFS period. Assuming money GDP growth comes down to 5-6% one could easily justify PSBRs within the range 1-2½% of GDP. As the aim is to reduce inflation by means of balanced fiscal and monetary policies, there is a case for being in the lower part of the range. This is supported by the analysis earlier in the paper. A sensible conclusion might therefore be to aim for 1½% of GDP by the end of the period.

(ii) The Short Term

60. We start from a position in 1983-84 in which the PSBR looks like being 3½% of GDP. The key issue is how quickly it is reasonable to get down to the medium term objective of 1½% of GDP.

61. It is quite acceptable to allow the PSBR to deviate from its medium term 'norm' in response to cyclical factors. That was

an important reason why we felt able to allow a rise in the PSBR ratio in the 1981 Budget. How much it should be allowed to vary over the cycle depends partly on the relative efficacy of fiscal policy and interest rates in stabilising the economy. There is no presumption that the stabilisers inherent in the fiscal system should be automatically allowed to operate fully. The combination of PSBR and interest rates appropriate at any stage in the cycle is a matter of choice for the Government.

62. Arguably it makes sense for the Government to bring the PSBR back to its appropriate medium term norm as the economy approaches a cyclically neutral position. In practice, a move towards lower inflation probably involves the economy operating below a cyclically neutral position for a period, but it also means fiscal policy adjusting ahead of output and inflation. This suggests it would be appropriate to bring the PSBR down to its appropriate medium term level even while unemployment remains some way above its longer term level.

63. A further consideration is that before the end of the MTFs, the contribution of oil revenues to the PSBR will start to decline as production falls. By comparison with the peak over the next two years, oil revenues may well fall by about $\frac{1}{2}\%$ of GDP, and for any given PSBR this means higher receipts from other sources. The process of adjustment to a lower PSBR is thus likely to be harder in the later years than the PSBR numbers themselves indicate. This suggests making as much progress as possible in the early years, before the oil revenues start to fall away significantly in 1987-88.

64. Against this, however, the room for manoeuvre on fiscal policy looks to be most limited in the next year or two. On current forecasts it may be necessary to raise taxes slightly next year in order to get back onto the path set in the 1983 MTFs, which envisaged a PSBR of $2\frac{1}{2}\%$ of GDP in 1984-85. This picture - a relatively difficult fiscal position in the next year or so giving way to an easier position later on - has been a feature of most recent forecasts, and in view of recent experience in controlling public expenditure we should retain a healthy scepticism. But it argues against attempting to reduce the PSBR too quickly from its present level.

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65. A further factor to be taken into account is the profile of asset sales. Relatively high figures in the early years, for example, would point to a relatively quick reduction in the PSBR.

66. As regards 1984-85, there is a clear need to get back onto a downward path after the prospective overshoot this year. With asset sales rising by £1 bn next year, we need to cut the PSBR by close to this amount even to stand still. In order to redress the imbalance between monetary and fiscal policy in 1983-84, and enable real interest rates to come down, there is a clear case for a larger reduction. The precise number must await the outcome of the Winter Forecast, but I would want to consider seriously the possibility of going for £8½ bn rather than £8 bn - particularly if the underlying fiscal prospect proves to have worsened since the Autumn Statement, and significant tax increases would be necessary to achieve the lower figure.

67. After 1984-85, the room for manoeuvre is likely to be somewhat greater; and there is then a strong case for making fairly rapid progress towards achieving our medium term objective. The medium term path I envisage might look as follows:

	<u>PSBR path</u>					
	<u>1983-84</u>	<u>1984-85</u>	<u>1985-86</u>	<u>1986-87</u>	<u>1987-88</u>	<u>1988-89</u>
£ billion	10	8-8½	7	6½	5¾	6
% of GDP	3½	2½	1¾	1½	1½	1½

68. If we succeed in holding public expenditure constant in real terms this should still leave room for tax cuts, even in the last two years when oil revenues are falling away. Estimates of the fiscal adjustment must be very speculative at this stage, and extremely uncertain in any event. But the qualitative conclusion seems right. On the basis of the Autumn Forecast and the profile for the PSBR, there would probably be little scope for any net tax cuts in the 1984 Budget. To achieve a PSBR of 2½% of GDP some increase may be necessary.

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BANK OF ENGLAND
LONDON EC2R 8AH

11 January 1984

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London
SW1P 3AG

Mr Cassell

cc Economic Secretary
Sir P. Middleton
Sir T. Brown
Mr Hankester
Mr March
Mrs Lomas
Mr Ridley.

JDL.
12/1.

Dear Nigel,

I enclose a Bank paper on Monetary Targets
ahead of our meeting on Friday.

Yours ever,
Robin

72/1/1

T604/19

MONETARY TARGETS

This note sets out the Bank's views on the role and form of monetary targets, particularly targets for narrow money, complementing the Treasury paper "Monetary Targets" of 6 January. It first considers the role of narrow money targets; then discusses the available measures of narrow money in that role; and finally, in the light of the discussion to this point, the appropriate form of targets for the next MTFS. It thus covers the ground identified as issues for decision in paragraph 5 of the Treasury paper, though in a somewhat different order.

1 The role of narrow money targets

We are generally agreed that, conceptually, narrow money is a relevant indicator - alongside broad money - of monetary conditions, and more particularly of the development of "retail transactions". We are also agreed that the present debate relates to the comparatively limited point of which is the best available statistical measure of narrow money, ie we are not considering a change in our methods of monetary control.

As an indicator of monetary conditions we agree that narrow money is relevant to decisions about interest rates; and, conversely, that interest rates must be the primary means of seeking to influence narrow money. We also agree that broad money is of particular relevance to decisions about fiscal and funding policy; and conversely. But we do not agree that narrow money has now, or will prove to have in future, any kind of primacy as a guide to short-term interest rate policy, which we think must continue to take account also of broad money, as well as the other relevant indicators, including the exchange rate. In particular, we think that lending to the private sector must continue as an important influence on interest rate policy, and we do not believe that there is any serious or systematic evidence to show that such lending is in general perverse with respect to interest rates, even though it is by no means highly or predictably interest-sensitive. Equally, we do not think that short-term interest rate and funding (ie longer-term interest-rate) policy can in practice be very far divorced, as special emphasis on narrow money as a guide to short-term interest rates would imply.

We are reassured in thinking that there may be no substantial difference between us on the role of narrow money targets by various references in the Treasury paper, eg paragraph 4 "There is no suggestion that the present process of arriving at interest rate decisions - or of market operations to support them - should be altered" and, again, in paragraph 26 "We would also want to stress that in assessing monetary conditions we took account of all the aggregates ... and other indicators as well". But we think it important that the point be absolutely clear at the outset if recurrent difficulties in arriving at interest rate decisions are to be avoided:

2 The available measures of narrow money

We are less confident than the Treasury in rejecting M1 as the best available indicator of narrow money for the purposes of 1 above at this stage; but we recognise its deficiencies which are likely to increase over time and the fact that its credibility has already been diminished. The available options considered are therefore: notes and coin with the public; M0; and M2.

(a) Notes and coin with the public is conceptually unsatisfactory as a measure of transactions money because it clearly excludes transactions deposits altogether. It is perhaps in this sense that it is described in the Treasury paper as "sounding primitive". Essentially for this reason it will not, in our view, carry conviction with outside commentators or with markets as a sufficient measure of transactions money.

This fundamental scepticism - which we ourselves share - is likely to be all the greater because outside commentators are as aware as we are of a range of developments (increasing use of bank transfers for wage payments; increasing use of plastic cards; increasing use of cash dispensers; changes in the structure of bank charges; and so on) that necessarily have an uncertain but important effect on the distribution of transactions money between cash and deposits. As a result neither we nor the markets can have any real confidence in movements in this component of narrow money as an indicator of monetary conditions - the recent econometrics notwithstanding. (What, for example, would we have made of the sudden acceleration of the velocity of notes and coin

with the public in 1978/79? Or what should we make of the slowdown of this velocity in the past year which could not be adequately explained by the forecasting relationships to end-1982 which it was thought had been established at the time of the Mansion House speech?)

Nor, given the nature of cash holdings as only a part of transactions money, and the developments likely to affect such holdings, are we persuaded that this particular component of narrow money will in practice respond predictably to interest rates.

We are also concerned that the availability of published weekly figures for the note circulation would give rise to weekly speculation about the authorities' reactions, as currently happens in the US.

(b) M0

M0 suffers from all these same disadvantages as notes and coin with the public. But as an indicator, it has an important additional conceptual disadvantage in that it includes, anomalously, bankers' till money and bankers' operational balances which do not belong as elements of transactions money on any normal reckoning. Even if it were accepted as appropriate to go as narrow as this in the first place, we can see no convincing explanation for choosing M0 as the indicator rather than its predominant component, notes and coin with the public. The fact is that advocates of M0 have always seen it as a control variable through which influence might be exerted on the banks' balance sheets as a whole, but that is expressly not the role now being considered for it.

The inclusion of bankers' balances in M0 also introduces an unnecessary additional degree of volatility; and, while this can no doubt be smoothed away by some averaging process, the fact that we needed to do so would simply point up the anomaly of including these balances in the indicator in the first place, weakening credibility further.

(c) M2

Leaving NIBM1 aside, essentially because it too is likely to be distorted - in the opposite direction - by the current and prospective developments affecting M1, we are effectively left with M2. In our view - and probably that of most market commentators - this is conceptually the best available measure of transactions money, and probably less susceptible to distortion from monetary innovation. But it has of course no track record; and we certainly have no better idea

① Check M_1 against M_2

② M_1 goes as far as spotlight

③ Sep regis for narrow + broad
V new M_2

- M_2
- is new
- its true
- sezyon
- motos

M_2

T604/19

about how it might respond to interest rates than for the other aggregates.

3 The form of targets for the MTFS

Important considerations in choosing target aggregates are that we ourselves (Treasury and Bank) should be convinced that they are the most relevant indicators, and that they should carry conviction with outside commentators.

There is no difficulty on either front with the general idea of narrow and broad money, with separate ranges. Given the period over which the MTFS extends (which we understand may now be lengthened to five years), there would be advantage, whichever aggregates are chosen initially, in retaining flexibility to change the target aggregates within these umbrella concepts - as has been done in the past.

As far as broad money targets are concerned, we see no immediate reason to wish to move away from the present EM3 and PSL2, the latter acting as a crosscheck and providing markets with reassurance, in particular, that we do not intend to neglect the liquidity provided by the intermediation of the building societies which is of especial importance at this particular time. It would not, in our view, be sufficient to argue that we did not need to target PSL2 because we take account of all the aggregates anyway: the removal of target status would be seen as reflecting lesser concern with building society liabilities and might very well in practice have that effect.

Returning to the narrow aggregates, if we had to choose a single indicator for the immediate future, ie to choose between - as we see it, and as we believe the market would see it - the lack of conceptual credibility of notes and coin with the public and MO on the one hand and the lack of experience with M2 on the other, we would opt for M2, recognising the risks that this would entail. But we would ourselves feel more comfortable, and believe it would carry more conviction with financial commentators generally, if the lack of a satisfactory single measure were openly acknowledged and explained, so that we were obliged to look at both notes and coin/MO and M2, using the latter as a crosscheck on the former, which we know to be partial, and liable to distortion by monetary innovation.

In that case, because it was being given less exclusive importance, choice between notes and coin with the public and MO as one the narrow targets would be less sensitive.

10 January 1984

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FROM: F CASSELL

11 January 1984

CHANCELLOR

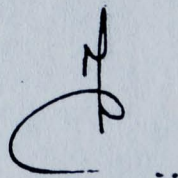
cc - Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
- Sir P Middleton
Sir T Burns
Mr Littler
Mr Bailey
Mr Battishill
Mr Kerr
Mr Ridley
Mr Lord
Mr Portillo

Sir Lawrence Airey, IR
Mr A M Fraser, C&E

on MTFs file.

CHEVENING: PERSONAL BORROWING

I attach a paper on the recent growth of personal borrowing and its implications.



F CASSELL

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21. The greater the extent of equity withdrawal for a given amount of mortgage lending the less likely is that lending to generate house price booms such as occurred at the beginning and end of the 1970s. Lending for house purchase may contribute to the build up of personal sector financial assets or to higher consumption, particularly of durables, or to some combination of the two. There are no specific indicators of the extent to which equity withdrawal is increasing consumers' expenditure, and maybe inflation. The effect of equity withdrawal on consumers' expenditure is one of numerous factors that will influence judgement on monetary and fiscal policy, even though it is not directly observable.

(ii) Lower Saving

22. The recent rise in borrowing has been associated with a steep fall in the personal saving ratio. After being flat for two years, consumers' expenditure in total rose by $5\frac{1}{2}$ per cent in the five quarters to the third quarter of 1983. Spending on durable goods, which is more directly dependent on borrowing than other forms of consumption, rose by $25\frac{1}{2}$ per cent over the same period. The saving ratio peaked at $15\frac{1}{2}$ per cent in the third quarter of 1980 and has since fallen to $8\frac{1}{2}$ per cent in the third quarter of 1983. (See Chart VI).

23. It is not easy to determine whether the rapid increase in borrowing was in part at least a cause of the increase in consumption or whether it merely represented a means of financing it. There have been few satisfactory empirical estimates of the influence of the availability of credit on consumers' expenditure. The main explanatory variables in empirical work have been real personal disposable income, and financial influences such as liquidity, financial wealth, real and nominal interest rates, inflationary expectations and perhaps some proxy for uncertainty such as movements in unemployment.

24. The relationships embodied in the Treasury model suggest that increased real personal disposable income and the reduction in inflation explain much of the recent increase in consumption. However, there remains a significant element both of the earlier rise and the more recent fall in the saving ratio for which there is no adequate explanation. Chart VII shows that at the beginning of the recession, when the saving ratio rose sharply, the path of consumers' expenditure was lower than predicted. Over the past eighteen months, however, this increase has been much more than predicted (though, given the previous over-prediction, the current level of consumer spending is much as predicted). It is difficult to believe that the more ready availability of credit has not been an important factor in this.

CHART VI

PERSONAL SAVING RATIO (per cent)

Annual data 1970-79
Quarterly data 1980(1)-86(4)

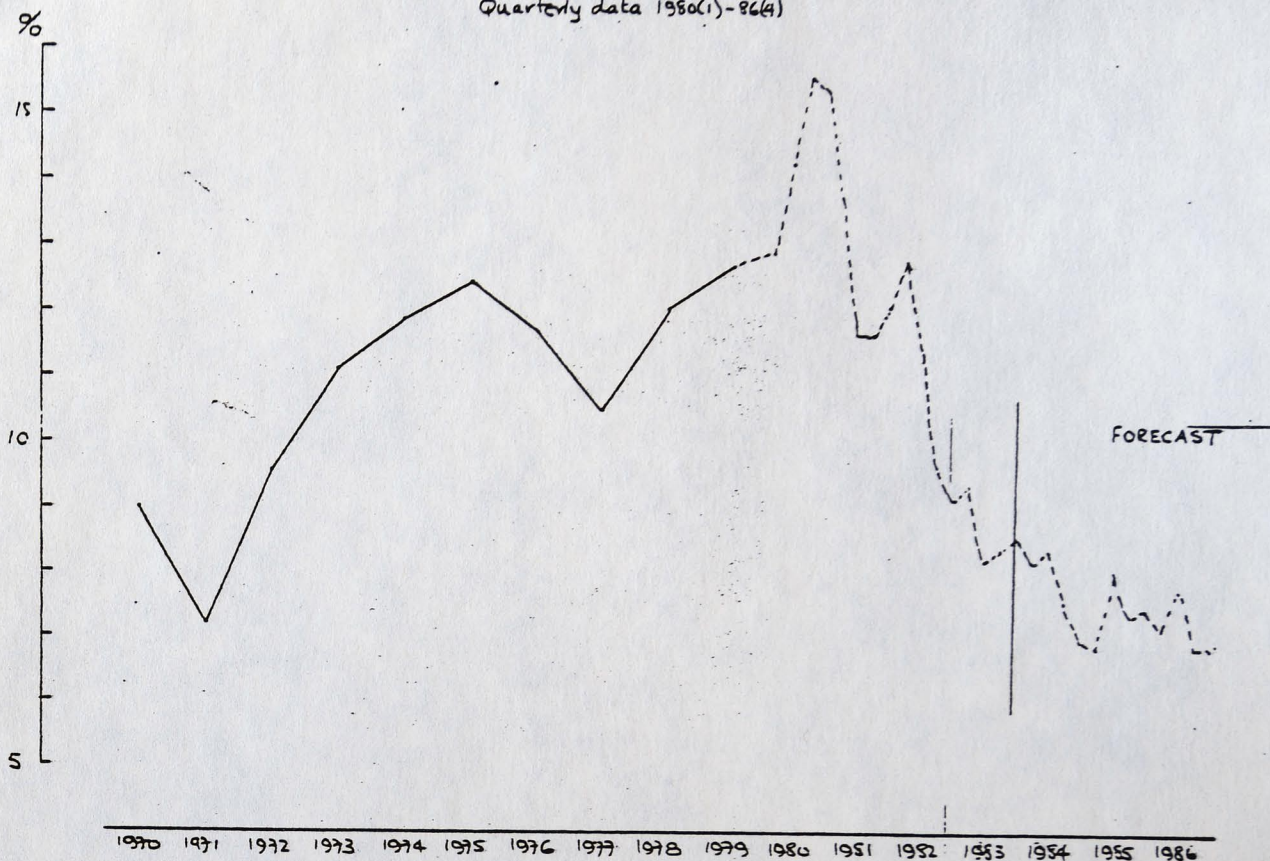
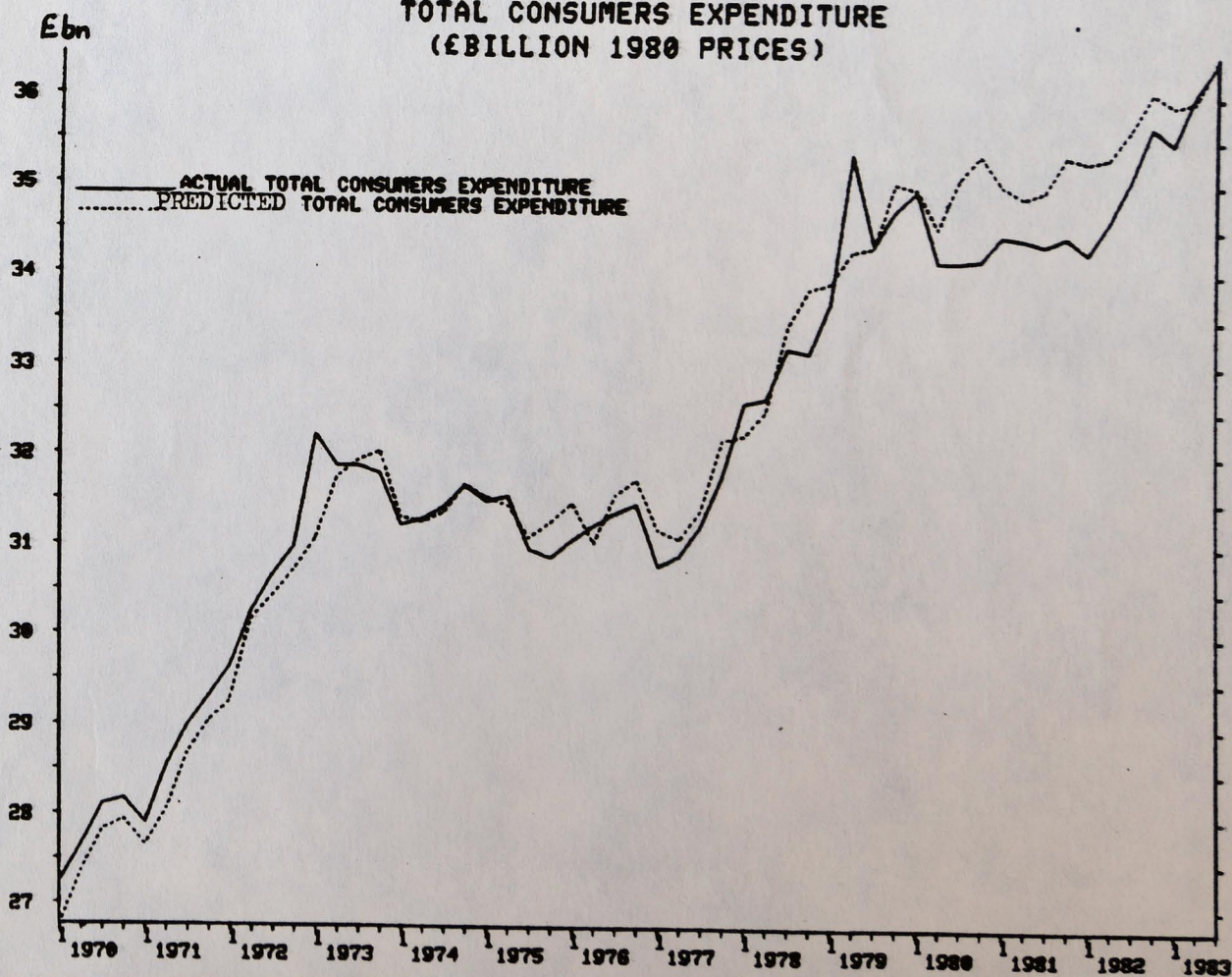


CHART VII

TOTAL CONSUMERS EXPENDITURE
(£BILLION 1980 PRICES)



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25. Consumers are now taking up credit that was previously unavailable, or very expensive. This means that expenditure that might in the past have been postponed until sufficient savings had been accumulated is now going ahead. It may be some time yet before persons reach their desired debt/income ratios and levels of income gearing and the adjustment is complete. So there could be for some time to come higher levels of borrowing accompanying higher levels of consumption than would have been the case before liberalisation.

IV. CONCLUSIONS

26. Explanations of the recent behaviour of personal borrowing are too tentative to permit firm conclusions for future policy. However, some implications can be drawn from this assessment:-

- (i) The ready availability of credit over the past two years has almost certainly played some part in the strong growth of consumer spending. The fact that expenditure on durables has increased so much faster than would have been expected from past relationships with movements in income, certainly points in that direction. However, it is easy to exaggerate the independent part that credit has played. Most of the decline in the personal saving ratio can be plausibly explained by changes in real income, real wealth and interest rates.
- (ii) The recent trends in borrowing could go on for some time. The evidence reviewed in this paper does not support the view of some outside forecasters that the debt/income ratio is now so high that persons will be unwilling to let it rise further, and in consequence consumption will decelerate sharply. But while it is not difficult to find plausible reasons why the debt/income ratio has risen, and could continue to rise, it is much harder to assess how stable the present ratio might be. This is a major uncertainty in the forecast, and for policy. So it is not easy to judge whether the present level of borrowing gives cause for concern. The pace of consumer spending foreseen in the autumn economic forecast (on the assumption that borrowing continues on its upward trend) looks compatible with the Government's objectives for the economy. But there is a wide margin of error, both ways, around that forecast.
- (iii) The strength of personal demand for credit could give rise to serious monetary problems if there were a marked resurgence in company demand for credit. The growth of bank credit would then create problems for monetary control, which would compel us to over-fund the PSBR or to accept a faster growth of broad money.

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- (iv) These risks will need to be carefully assessed in setting the monetary targets for 1984-85. The fact that persons have been borrowing heavily from banks and at the same time building up their financial assets raises the question whether it would be acceptable to accommodate the demand for credit by setting a somewhat higher range for the growth of broad money than the 6-10 per cent previously envisaged - on the argument that the additional money balances would be willingly held (ie idle balances). How far this would be acceptable would depend partly upon what was happening to narrow money. However, there are considerable risks in allowing the economy to become highly liquid. This may have no immediate effect on inflation, but it creates conditions in which spending and inflation could accelerate rapidly if some factor (eg a fall in real interest rates) led the private sector to want to spend more or, more generally, if expectations turned.
- (v) If, to guard against these risks, it was desired to restrain the growth of personal borrowing, the instruments to hand are not extensive. The most effective one would be to remove or reduce tax relief on mortgage interest. If that is ruled out, it might be possible to move a little in that direction by defining more tightly the rules for eligibility (which in practice would mean confining the relief to loans for house purchase, not improvements) or, more radically, by some form of quantitative restriction on the relief on second purchases (perhaps related to a proportion of the purchase price of the house). Such restrictions would create unfairnesses and anomalies. However, if we are genuinely worried about the growth of personal borrowing they need to be considered. A consumer credit tax - covering mortgages as well as other credit - could have some marginally helpful effect in restraining credit. Beyond that, if we are seriously concerned about the risk of excessive consumer spending developing in the coming year, we need to look again at the possibility of devising a regulator for personal taxes that is available for use within the fiscal year.
- (iv) Another aspect to be considered is the implication of the strong growth in personal borrowing for the proposals afoot for liberalising the lending activities of building societies. The societies would like to be free to make personal loans for purposes other than house purchase (they envisage only a limited amount, though in aggregate the sum could be large). A widening of their powers would be consistent with the Government's general stance on market forces and competition. However, the analysis in this note suggests that we should be very cautious in moving in this direction (at least while we

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have so little influence over the total volume of their lending) even though this may be seen as an arbitrary form of quantitative restriction.

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ANNEX

PERSONAL SECTOR FINANCIAL LIABILITIES

The following table shows the published personal sector financial liabilities.

	<u>£bn</u>		<u>% of total liabilities</u>	
	1978Q4	1983Q2	1978Q4	1983Q2
<u>HP and other instalment debt</u>	3.0	2.9	4.9	2.2
(Adjusted* to allow comparison with 1983Q1)	(2.2)		(3.6)	
<u>Bank lending other than for house purchase</u>	8.8	27.9	14.5	21.1
(Adjusted* to allow comparison with 1983Q1)	(9.6)		(15.9)	
<u>Bank lending for house purchase</u>	1.8	12.5	3.0	9.4
This includes trustee savings bank mortgages				
<u>Building Society lending for house purchase</u>	31.7	62.8	52.4	47.4
<u>Insurance company and pension fund lending for house purchase</u>	1.7	2.2	2.8	1.7
<u>Local Authority and other public sector lending for house purchase</u>	3.4	5.9	5.6	4.5
<u>Trade Credit</u>	7.7	14.3	12.8	10.8
This is primarily trade credit of unincorporated businesses but also includes unpaid household gas and electricity bills, and trade credit of non-profit making bodies. No precise breakdown is available.				
<u>Other financial liabilities</u>	2.3	4.0	3.8	3.0
The largest component is other domestic long term loans (£3bn in 1983Q2 of which about half should be consolidated). This is a catch-all category which includes among other items long term debt of stockbrokers and jobbers long term debt of charities, mortgages not included elsewhere, and several items of long term debt within the personal sector, which are not netted out of the published figures. Other financial liabilities also includes accruals of taxes, rates and interest (£0.7bn in 1983Q2) and domestic liabilities not covered elsewhere (£0.3bn in 1983Q2).				
<u>Total financial liabilities of the personal sector</u>	60.4	132.5	100	100

*From 1981Q4 onwards the introduction of the monetary sector in the statistics reallocates a substantial part of HP and other instalment debt to banking lending. This adjustment rescales the earlier figures to allow comparison across the break in series.

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FROM: F CASSELL

12 January 1984

CHANCELLOR

cc - Economic Secretary
- Sir P Middleton
Sir T Burns
Mr Lankester
Mr Battishill
Mrs Lomax
Mr Ridley
Mr Sedgwick

MONETARY TARGETS

You are meeting the Governor to discuss this tomorrow. The two papers for the meeting are:

The Treasury paper of 6 January (which was sent to the Bank at the end of last week; and to No 10 on Monday).

The Bank's paper (attached to the Governor's letter of 11 January) commenting on it.

2. The main issues to be discussed are set out in those papers. Paragraph 5 of the Treasury paper suggests four issues for decisions:

- a. Should we move to two target ranges, one for broad and one for narrow money. If so,
- b. Which aggregates are suitable for target purposes;
- c. Should each target range refer to one monetary aggregate or to more than one;
- d. What should be said about non-targetted indicators and monetary conditions.

3. Before discussing these, or turning to the three options at the end of the Treasury paper, you might like to establish with the Bank that they are broadly in agreement with the propositions set out in paragraphs 3 and 4 of the Treasury paper. This would

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give you the opportunity to reassure them on the point that particularly seems to concern them - that there is no intention of changing the present process of arriving at interest rate decisions by looking at the whole range of financial indicators. Part of the Bank's worries about giving greater emphasis to very narrow aggregates is their fear that movements in these aggregates will be given (as their paper puts it) "primacy as a guide to short-term interest rate policy". This fear underlies most of the concern expressed in the section of their paper headed "The Role of Narrow Money Aggregates". You should be able to comfort them. But they lay it on rather thick: as the attached charts show, movements in interest-bearing money (£M3-NIBM1) have in the past been a poor, and often perverse, guide to setting short-term rates.

4. On question a. above there should be no dispute. The Governor's letter says: "There is no difficulty ... with the general idea of narrow and broad money, with separate ranges."

5. On b. we might get fairly quick agreement that two of the main aggregates are too subject to distortions to be suitable for targetting - NIB M1 (which is also highly sensitive to interest rate changes) and M1 (which now does not fit neatly into either the broad or narrow category). The Bank may be a bit hesitant in ditching M1, but as their paper acknowledges they recognise its "deficiencies which are likely to increase over time and the fact that its credibility has already been diminished".

6. This would effectively leave us with five aggregates to consider for targetting: notes and coin, M0, M2, £M3, and PSL2. The choice among these will depend partly upon which of the three options listed at the end of the Treasury paper is chosen. You may therefore at that stage prefer to go straight to paragraphs 26-27 and look at the choice of aggregates in the context of those options.

7. Since we want to give equal status to the two target ranges, the choice is between two aggregates and four aggregates. The

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Bank presumably will opt for option 2.b., while your starting point would be option 1.a. The main advantages and disadvantages of each of these options are listed briefly in the paper. There is one further point to be borne in mind. The Treasury paper (as it makes clear at the beginning) is concerned with the form of monetary targets, not with the particular numbers for 1984-85 or later. However, it is important to be satisfied that the two aggregates embraced in each category under option 2 would fit within a range of the customary 4 percentage points - and, for broad money, of about the levels envisaged in last year's MTFS. So far as we can tell MO (or NC) and M2 should be compatible (the forecast growth of MO now looks like falling comfortably within a range of 4-8). But over the past year PSL2 has grown 1-2 points faster than £M3 and the likelihood is that it will continue to do so. This could pose a problem for option 2, in that it might compel us to raise the range for broad money from that envisaged in last year's MTFS. The compromise suggested in option 3, where PSL2 is in brackets as a cross-check on the primary indicator, would not pose such a problem in this respect.

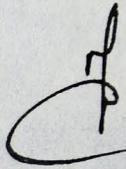
8. It seems unlikely that the Bank would agree to option 1.a. They might very reluctantly agree to option 1.b. But you will have to judge whether this is preferable to the compromise suggested in option 3. The tone of the Bank paper suggests they would settle for that. Indeed, it seems to accord best with the point they make on page 4 that:-

"Given the period over which the MTFS extends ... there would be advantage, whichever aggregates are chosen initially, in retaining flexibility to change the target aggregates within these umbrella concepts - as has been done in the past."

9. In options 2 and 3 the choice between MO and NC becomes less tense. You may, however, like to ask the Bank how seriously they take the point made in the second full paragraph of page 3 of their paper, about weekly traumas.

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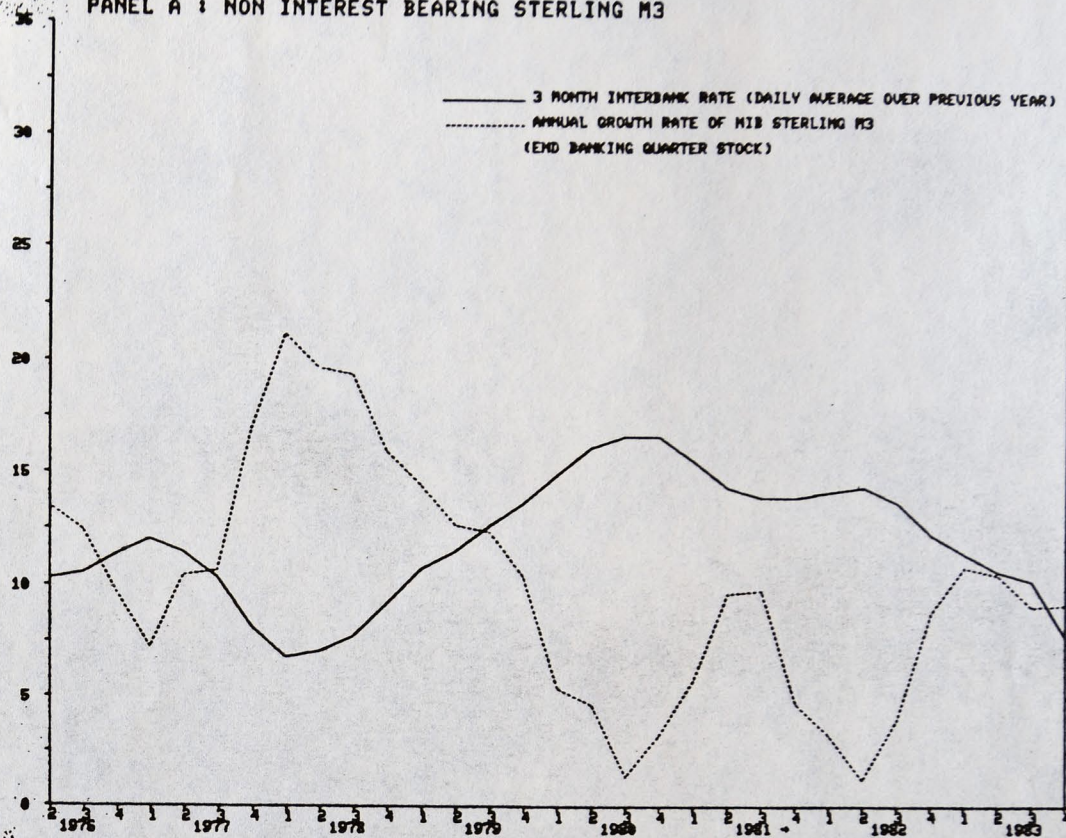
10. There are a number of other issues concerning the targets for next year to be decided - whether they should run for 14 months or some shorter period, how monetary growth should be presented (eg by using averages rather than the growth in the stock between two dates), and of course the actual numbers to be chosen for the ranges. We will prepare a submission on all these aspects, but it seems preferable to do so after we have had the broad general discussion at the Friday afternoon meeting and the benefit of the strategy discussion at Chevening.

A handwritten signature in black ink, appearing to be 'F. Cassell', with a stylized, looped initial 'C'.

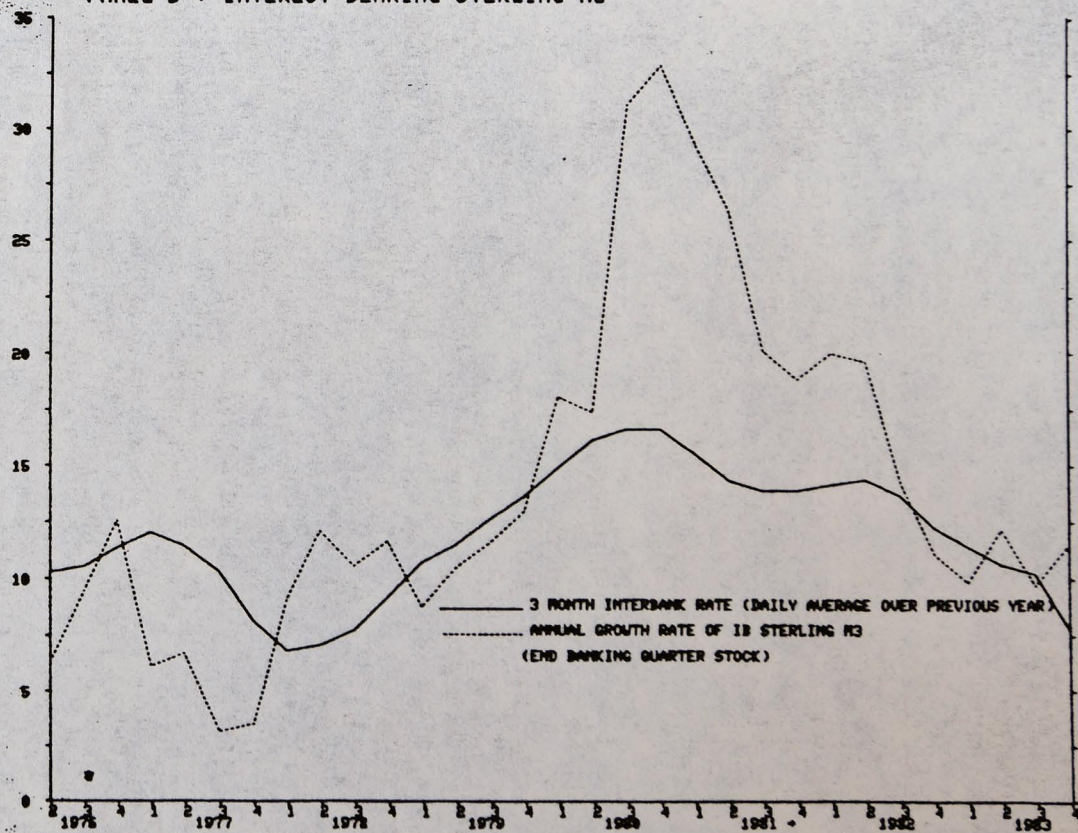
F CASSELL

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3 MONTH INTERBANK RATE AND MONETARY GROWTH PANEL A : NON INTEREST BEARING STERLING M3



PANEL B : INTEREST BEARING STERLING M3





MONETARY TARGETS: NOTE OF A DISCUSSION
IN THE CHANCELLOR'S OFFICE AT
2.45 P.M. ON 13 JANUARY 1984

Present:	Chancellor of the Exchequer	Governor	Mr Cassell
	Economic Secretary	Deputy Governor	Mr Battishill
	Sir P Middleton	Mr George	Mr Lankester
	Sir T Burns	Mr Goodhart	Mr Ridley
			Mrs Lomax

Papers: Treasury paper of 6 January;
Bank paper of 10 January

Ree

It was agreed at the outset that it would be necessary, in the 1984 MTFs, to move to two target ranges, one for broad and one for narrow money. The discussion then centred on the choice of narrow money target aggregate(s).

2. The Governor and Mr George argued that M2 was conceptually the best measure of transactions balances. But, because its track record was as yet very short, it would be rash to go for M2 as the single narrow money target aggregate. It would however be no less rash to choose M0 alone, for, just as it had proved useful to refer specifically to PSL2 as a cross check on £M3, so it would be useful to have two narrow money target aggregates. Sir T Burns thought that introducing M2 would invite questions which, given the short track record, would be very hard to handle; but it was noted that the Mansion House speech references to M0 had similarly raised a number of questions. Sir P Middleton pointed to the danger of differential movements in M0 and M2, and the Chancellor pointed out that the reasons for their recent similar movements were not fully understood. Targeting either carried risks, but they would not be reduced by targetting both.

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3. The Deputy Governor however argued that the aim now should be to make a modification to the targets which should prove durable. To bring in M2 would be helpful in avoiding a risk of discontinuity if, as its track record lengthened, its primacy became obvious. Moreover M0 figures could virtually be derived on a weekly basis by outside observers: if M0 were the only narrow money target aggregate, we might face something similar to the weekly problems now faced by the Fed. And two target aggregates would be mutually reinforcing: if only one were adopted, the difficulty of defending inaction in the face of a couple of aberrant months would be considerable. The Chancellor thought that the converse was that the market might think that having two target aggregates represented a recipe for inaction. The authorities might be perceived to have moved still further away from the initial firm stress on £M3, with a plethora of target aggregates to ensure that at least one would be hit. This risk was however thought to be containable: Mr George thought that the market was in no doubt that the Government took the exercise seriously, and that it made sense to look at both broad and narrow aggregates. He saw a considerably greater risk of an adverse market reaction if M0 were singled out as the narrow money target aggregate, and the Governor thought it important to go for two broad and two narrow target aggregates.

4. It was agreed that option 3 in the Treasury paper of 6 January would be the appropriate solution for the 1984 MTFS. For broad money one would look at £M3 (and PSL2) and for narrow money M0 (and M2). Sir P Middleton presented a possible MTFS formula (attached) which was agreed to be satisfactory, subject to further discussion on the length of the target period (and possible consideration of a change of name for PSL2). The Governor expressed satisfaction with the decision taken: the new arrangement was in his view logical and workable, and would have the whole-hearted support of the Bank.

Joe.

Distribution

Those present
Chief Secretary
Financial Secretary
Minister of State
Mr Monck

J O KERR

16 January 1984

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From: J WILLIAMS
Date: 20 January 1984

NOTE FOR THE RECORD

cc Sir T Burns
Mr Bailey
Mr Littler
Mr Cassell
Mr Battishill

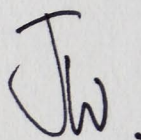
F TIMETABLE FOR FORECAST/MTFS

At the meeting of Second Permanent Secretaries this morning, and in subsequent discussions, the following arrangements for processing the forecast and MTFS were agreed:

- (i) The pre-Budget forecast would be circulated on Monday 30 January.
- (ii) It would be taken by PCC as scheduled on Tuesday 31 January.
- (iii) It would then be considered immediately afterwards at the 31 January overview meeting.
- (iv) Sir Terence Burns would prepare a note for both PCC and the overview meeting on the monetary and PSBR ranges to be included in the MTFS.
- (v) This note would tie in with HF's more technical note on monetary targets. Mr Cassell will try to submit this to Sir Peter Middleton also on 30 January.

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2. This timetable would prepare the Chancellor for his discussion with the Prime Minister on 1 February about the Budget and the 9 February Economic Cabinet. It was also agreed that the Chancellor should be shown by 27 January first drafts of the economic paper for the 9 February Cabinet and drafts of the two public expenditure papers. The objective is for these papers to be in the final form by 1 February

A handwritten signature in dark ink, consisting of a stylized 'J' and 'W' followed by a period.

J WILLIAMS

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FROM: RACHEL LOMAX
DATE: 26 JANUARY 1984

MR HALL

cc: Chancellor
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Lankester
Mr Sedgwick
Mr Page
Mr Willetts ✓
Mr Wynn Owen

SAM BRITTAN: TREASURY AND BANK MAKE PEACE

Sam Brittan's article in today's FT is, to my eyes, clearly based on Bank of England briefing. It gives a version of recent discussions about the choice of target aggregates for the new MTFS, conveying the impression that the Bank managed to inject a degree of sensible pragmatism into the ideas floated in the Mansion House Speech. ("In recent discussion it has, however, become clear that the movement of broad as well as narrow money will after all be taken into account in setting interest rates; and that other evidence apart from the monetary numbers, will be considered in setting policy. The 1983 Red Book makes it clear that the pursuit of monetary targets was conditional on the following words... The Bank is now satisfied that similar considerations will continue to apply, even if the language changes slightly.") He goes on to outline "present thinking" on what measures of money to target, suggesting that "we seem to be moving towards two pairs of targets, making four in all", (ie £M3, PSL2, M0 and M2).

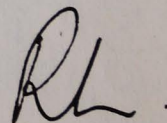
2. For your information, the thoughts about the final shape of the MTFS are broadly correct, though it all sounds a bit fuzzier than my recollection of what was agreed, and there is no indication that two of the four targets are likely to have clearly subsidiary status (further use of the brackets that are now round PSL2). But the implication that the Bank have scored a famous victory is ridiculous -

They have had to swallow very hard to accept target status for MO, and that always seemed to me to be the main bone of contention. It is rather naughty of them to put all this out; we have been scrupulous in not pushing our line too hard in recent weeks.

3. None of this is for use. We cannot, of course, confirm or deny gossip about Treasury/Bank relations (who said there was a war in the first place?) Commentators will have to wait for the MTFS itself. But you could point out that the supposed concordat is not inconsistent with the Mansion House Speech, which was not in fact as hardline as this article implies. (Paragraph 36 is particularly relevant, since it sets the proposition about the relevance of narrow aggregates to short term interest rates in context:-

"It will not always be possible to ensure that all the target aggregates are held always within their ranges, and we will continue to interpret their behaviour in the light of other available evidence. Within this process there is some presumption that the narrow aggregates might have particular relevance for short term interest rates while the broader aggregates might be more relevant for decisions about fiscal and funding policy. It is important, however, that this kind of distinction is not carried too far; in the real world, the different aspects of policy are necessarily inter-related.")

4. I don't think we need to make a fuss about this; but the above may be useful if you get direct questions.



RACHEL LOMAX

CONFIDENTIAL



FROM: J O KERR
DATE: 26 January 1984

Mr Cassell

BF 31,

cc Economic Secretary
Sir P Middleton
Sir T Burns
Mr Lankester
Mrs Lomas
Mr Hall
Mr Sedgwick
Mr Willetts

SAM BRITTAN: MTFS TARGET AGGREGATES

No. | The Chancellor has read with interest Mrs Lomax's minute about the Brittan piece today. He agrees that it bears all the marks of Bank of England briefing; and that we are entitled to feel aggrieved. He proposes to have a private word with Mr George when they next meet; and he is inclined to think it the more important, following the Brittan piece, that what we say in the MTFS and the Budget speech about the choice of target aggregates should stick very closely to the wording of the Mansion House speech.

I must speak
about this at
the balance
Jm

Go back
today -

JOK.

J O KERR

CONFIDENTIAL

35-26-1

21 FEB 1984

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FROM: J O KERR
DATE: 21 February 1984

Mr Riley

cc Sir P Middleton
Sir T Burns
Mr Bailey
Mr Cassell
Mr Battishill
Mr Evans
Mr Odling-Smee
Mr Lankester
Mr Sedgwick
Mr Scholar
Mrs Lomax
Mr Stibbard
Mr Melliss
Mr Ridley

MEDIUM TERM FINANCIAL STRATEGY

The Chancellor has seen the new version of the MTFS which you submitted on 17 February.

2. On the first twelve paragraphs, he has only the following new suggestions:-

a. para 4, sentence 2. The reference should surely be to most/many "other major industrial countries".

b. para 5. Before Table 2.1. A chart of interest rates should be included.

c. para 8, sentence 1. It would be best to drop the reference to the last three months, and stick to only the last twelve and six.

3. In the new paras 13-23, he has made a number of suggestions, side-lined in the attached clean text. But you should also know that

a. he is not entirely happy about the argument in the last two sentences of para 13.

b. he does not think that paras 15 and 16 work very well, in their present form.

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c. he sees a problem with the second sentence of para 17, which could be construed as undesirably postponing price stability.

d. he will focus in detail on paras 2.4, 2.5, and 2.6 when the numbers are available. But he will not wish the fiscal adjustment line in 2.6 to be shown cumulatively. The line in the table ought, in his view, to be a year-to-year line: the cumulative figures should be in the footnote.

e. he has dropped the last part of para 22, since it duplicates material in para 18.

f. he is not entirely happy with para 23, as now drafted.

A handwritten signature in dark ink, appearing to be "J O Kerr".

J O KERR

FISCAL POLICY

^{three} 13. In the last years, fiscal policy has been significantly tighter than in 1979-80 and 1980-81. The PSBR has averaged [less than 3½ per cent] of money GDP, compared with over 5 per cent in the earlier years, and this tightening is confirmed by the reduction in the public sector financial deficit. [Because of the reduction in inflation, erosion of the real value of existing public sector debt has become much less rapid. This has meant lower saving by the private sector, and so a lower nominal PSBR, relative to GDP, has been consistent with recovery in the real economy.]

Table 2.3: Public Sector Finances

<u>% of GDP</u>	<u>Average 1979-81</u>	<u>1981-82</u>	<u>1982-83</u>	<u>1983-84</u>
PSBR	5.2	3.4	3.3	3.5 (estimated)

14. The PSBR in 1983-84 is now forecast at about £10 billion, equivalent to [3½ per cent] of GDP. This is broadly as forecast in the Autumn Statement, but, despite the measures announced in July, about £2 billion higher than was expected at the time of the 1983 Budget. Local Authority borrowing seems to have been running much higher than expected, and Central Government expenditure, particularly on non-cash-limited programmes, has exceeded last year's forecasts.

The PSBR path

15. Government policies have been directed to achieving a progressive reduction in public sector borrowing over the medium term. Fiscal restraint is essential to the achievement of lower inflation and interest rates. [The PSBR is still above the level that would be consistent with price stability and acceptable interest rates, taking into account the composition of public sector receipts and expenditure.] [rewrite required]

[16. The appropriate path of the PSBR from year to year reflects many considerations, including the cyclical position of the economy and the growth of private sector credit. The profile of public sector asset sales is an important aspect of the composition of the PSBR which has also been taken into account, since they are unlikely to make a large contribution

to reducing interest rates. The establishment of a high level of asset sales over the next five years points to a significant downward shift in the PSBR path. The pattern of North Sea oil revenues is also relevant: the likelihood that they may be close to their peak in 1984-85 is a further reason for seeking to make rapid progress this year in reducing the PSBR.] [rewrite required]

PSBR projections

17. The PSBR for 1984-85 is forecast to be [£7½ billion], equivalent to [2½ per cent] of GDP, slightly below the figure assumed a year ago and in the Autumn Statement. The fiscal projections summarised in table 2.6 show further small reductions in the PSBR as a proportion of GDP in subsequent years, to [1½ per cent] in 1987-88 and 1988-89, [with the prospect of further reductions consistent with a move to price stability.] [omit] The figures after 1984-85 are illustrative, and decisions about the appropriate PSBR in particular years will be taken nearer the time. But the illustrative profile should be compatible with falling inflation and monetary growth, and ~~at the same time~~ declining interest rates in both nominal and real terms.

Assumptions

18. For the period to 1986-87, the fiscal projections in tables 2.4-2.6 are based on the public expenditure plans shown in the Public Expenditure White Paper (Cmnd 9143), updated where necessary to take account of Budget measures and estimating changes. Further details for 1983-84 and 1984-85 are given in Part 5. For 1987-88 and 1988-89, no public expenditure decisions have yet been taken and the projections assume that the public expenditure planning total remains unchanged in real terms. Asset sales in 1987-88 and 1988-89 are assumed to remain at the levels in the White Paper for the previous three years. Real output is assumed to grow by 2½ per cent a year on average over the five years. The general rate of inflation, as measured by the GDP deflator, which was [5] per cent in 1983-84, is assumed to fall to [4½ per cent] in 1984-85, and to 3 per cent by 1988-89. These assumptions imply growth of money GDP falling from [] per cent in 1983-84 to 5 per cent by the end of the period.

PUBLIC EXPENDITURE

19. Table 2.4 shows the relationship between the planning total for public expenditure and general government expenditure in national accounts terms (the definition of public expenditure lying behind the general government borrowing requirement).

[Table 2.4: General Government Expenditure]

REVENUE

20. The growth of Government revenues in cash terms over the medium term will depend on the growth of incomes, spending and prices, as well as policy decisions. Revenue is projected on the conventional assumption of constant tax rates and indexed allowances and thresholds at the proposed 1984-85 levels. No change is assumed in National Insurance contribution rates. Projections of North Sea tax revenues assume that oil prices do not change much from current levels for the next two years and then rise broadly in line with world inflation.

21. On these assumptions, general government receipts are projected to rise by [about 35] per cent between 1983-84 and 1988-89, [broadly in line with the growth in total money GDP]. Government revenue from the North Sea is expected to fall in real terms after 1984-85 as North Sea output falls, but this is more than offset by rising revenues from the growing non-North Sea economy.

[Table 2.5: General Government Receipts]

PUBLIC SECTOR BORROWING

22. The projections of Government receipts and expenditure are brought together in table 2.6 to provide projections of the general government borrowing requirement (GGBR) and the PSBR. The size of the fiscal adjustment, conventionally assumed to take the form of lower personal taxes, depends critically on the estimates of revenue and expenditure. These are subject to major uncertainties about; for example, the tax yield for an assumed set of tax rates or the behaviour of oil prices.

[Table 2.6: Public Sector Borrowing ⁽¹⁾]

CONCLUSIONS

23. The projections shown in tables 2.4-2.6 are no more than illustrative of one particular evolution of the economy. If the domestic and world economies develop in a different way, the projections for public finances could be substantially affected. The actual path for the PSBR cannot be predicted with precision from year to year. However the underlying trend matters much more than the inevitable short-term fluctuations. The policy response to such fluctuations would depend on their nature, but the intention would be to hold firmly to the

strategy, by maintaining financial conditions consistent with a continued trend to lower inflation. The key to sustained recovery lies in reducing the growth of costs and increasing the returns to investment and enterprise. Within the financial framework set out here, there will be room for a satisfactory growth in output without damaging the outlook for inflation.

24. Progress in reducing inflation over the medium term will be influenced to some extent by events outside our own control. But the pre-eminent determinant will continue to be the financial discipline imposed by the Government's monetary and fiscal policies. There will inevitably be short-term fluctuations around the underlying trend. But, subject to that, the Government's policies will continue to be firmly directed towards achieving a progressive reduction in the rate of inflation, with the ultimate objective of stable prices.