

Chancellor of the Exchequer

cc Chief Secretary
 Financial Secretary
 Minister of State (L)
 Minister of State (C)
 Sir Douglas Wass
 Sir Kenneth Couzens
 Mr Ryrie
 Mr Burns
 Mr Monck
 Mr Britton
 Mrs Lomax
 Mr Turnbull
 Mr Ridley
 Mr Fforde - B/Eng

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THE MONEY SUPPLY TARGET

1. The papers on monetary issues are now well on the way to completion. Rather than present you with an indigestible mass of paper at the last minute, we will let you have them at an early stage. As a first instalment I enclose two which are already in a finished (or nearly finished) state:

a. A paper by Mr Britton on "The Money Supply Target in Retrospect" which seeks to draw lessons from our experience last year; and

b. A paper by Mrs Lomax on "The Choice of Target Aggregate" which assesses £M3 against the rival attractions of M1, Mo, PSL1 etc.

2. We are now discussing the analysis in these papers amongst ourselves and with the Bank. You may find it convenient to have them in advance of the further material, which will include:

c. A paper on the target for 1981-82 which will set out the main issues for decision, which we will let you have on Monday, after a meeting which Mr Ryrie is taking with the Deputy Governor, Professor Walters and others.

d. A note - which I hope to let you have for the weekend - on monetary control, and the implementation of the changes foreshadowed in the November statement;

e. A paper on funding, reporting the discussions in the Wass/McMahon group which you will receive next week.

Perhaps it would help if I indicated very briefly where it seems

to me that our deliberations have taken us so far.

The Money Supply in Retrospect

3. Mr Britton's paper is an essential piece of background. It has been discussed with the Bank who go along with the general analysis. They would perhaps put more weight on the effect of the exchange rate and the squeeze on company costs as indicating the possibility of continuing problems with M3, but this is a matter of emphasis rather than a fundamental difference of view.

The Choice of Aggregate

4. Mrs Lomax's paper has also been discussed with the Bank who are broadly content. There are supporting detailed annexes which I have not included at this stage, but which can be provided if necessary.

5. The events of the last year or two have called in question the status of £M3 as "the" money supply. It is difficult to control, either by existing methods or by MBC; its economic significance is not as clear-cut as it once seemed, and it does not provide a clear guide to short term interest rates. But simply switching to another aggregate now is clearly unattractive from all sorts of points of view. We should need to be very sure that the change would offer the prospect of a real improvement.

6. The leading contender must be M1 (perhaps non-interest bearing M1) which is well-known and well-documented. The wide base (or M₀) is also there in the running as a fancied outsider. Neither of these would however provide greater certainty in forecasting the required level of interest rates, and though more responsive to short rates than £M3, they still require many months to bring under control following a major deviation. Retail deposits (or M2) is a theoretically attractive measure, but it does not actually exist yet.

The Nature of the Target

7. The retrospective paper suggests way we might explain why £M3 overshot the 1980-81 target. The more successfully we justify that overshoot, the more our unconditional commitment to

future targets and the precise MTFPS path is weakened. We will be providing you with further material on the experience of other countries who have adopted money supply targets which were explicitly conditional. 95

8. Perhaps the crucial link is with the exchange rate. The more the overshoot is justified in terms of the exchange rate, the more the targets are made conditional on future movements in the exchange rate, the nearer one is to having an exchange rate target. Such conditionality could apply either to £M3 or a narrow aggregate - or perhaps both if £M3 is restricted to a long term role with a time horizon of several years. It would be relevant mainly to setting short-term interest rates - although it could reopen the question of intervention as well.

Monetary Control

9. The November statement set out a number of changes as useful in their own right and consistent with a gradual evolution to MBC. The main question which the note on monetary control will pose concerns the speed of change to a MBC system, and what the Government wish to say about this. No decision has been taken, even in principle, to move to MBC, whether mandatory or non-mandatory. There are however pressures to move quickly. This would mean, in effect, to move to a non-mandatory system, and to make our intentions clear in the Budget Speech.

10. The Bank has to engage in a further rapid round of consultations with the banks about:

- a. the Reserve Assets Ratio;
 - b. Prudential Control;
 - c. the Cash Ratio; and
 - d. Money Market Operations.
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If Ministers wished for a rapid move to MBC the issues would all need reconsideration.

Funding

11. On funding, there are 3 broad issues:

- a. Indexed debt - where the only outstanding issues concern timing;

- b. Short-term instruments - on which market soundings are being made by the Bank; and
- c. Changes in marketing techniques for conventional debt.

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These decisions will influence your consideration of different target aggregates, and are relevant to whether multiple targets are practicable.

The Target for 1981-82

12. Finally, of course, there is the immediate question of tightness, however defined, and however applied, that is thought appropriate for the coming year. To this the forecasts you have seen remain very relevant. As the fiscal options narrow, the choice of monetary target becomes increasingly, in effect, a choice of interest rates. How much of a risk are we prepared to take that interest rates will have to rise to validate our chosen target? In this respect you will remember that the rate of growth of narrower aggregates is forecast to increase more rapidly than the wider ones in the next 2 years.

13. Looking further ahead, there is the whole question of the validity of the MTPS numbers. The aim is to "maintain the thrust" of the strategy. We have to decide whether this means clawing back some or all of the overshoot of the current year. The medium term outlook suggests it could be difficult. Clearly these quantitative considerations feed back on to the questions raised earlier about the way in which the policy is defined and implemented.

Pm.

P E MIDDLETON
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