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MONETARY OBJECTIVES AND PROSPECTS

Note by HM Treasury

This note sets out the Government's present monetary objectives, and some of the implications of seeking to achieve them.

Monetary Objectives

2. The Government is committed to reducing progressively the target rate of monetary growth as the main means of controlling inflation.

3. No one monetary aggregate can satisfactorily measure all aspects of monetary condistions. Moreover, there is an almost inevitable tendency for any aggregate selected as the target to be distorted by the very fact of becoming the target. Nevertheless, there are advantages in selecting one aggregate for which there is a publicly announced target: at present £M3 remains the most suitable for the purpose. But account must be taken of the other measures, M1, M3, DCE, wider liquidity etc, especially given the risks of distortion just referred to, which can affect the £M3 statistic without affecting underlying conditions.

4. As a first step, the Chancellor set a target range of 7-11% pa for the growth of £M3 in the 10 months ending on the April 1980 banking make-up day. We now know that the growth in the first two months of 1979-80 was 2.3%: achieving the mid-point of the range for the following 10 months would give a growth of 9.9% in the year as a whole - virtually the same as the post-Budget forecast of 10.1%.

5. This target is undoubtedly a tight one and was deliberately so chosen. A tight monetary policy is self-evidently one in which the intention is to make money scarce, and necessarily involves holding its price - the rate of interest - high relative to what it would otherwise be. One effect of so doing is to make people more economical in the use of money ie finance their

transactions with less liquidity and thus increase the "velocity of circulation". The change in velocity of circulation implied by the relationship anticipated between the rate of monetary expansion and the rate of growth of GDP in current prices is a good, though imperfect, guide to the increse in the tightening of monetary policy: the post-Budget forecast envisaged growth of the former by about 18.2% and of the latter by about 10%, implying a rise in the velocity of circulation of 8%. While such a change in velocity is not unprecedented, the velocity has already grown substantially over the last 5 years, from the low level to under 2.4 in the first quarter of 1974 to 3.3 at the end of 1978: by the first quarter of 1980 it is forecast to reach 3.5, which is a record.

6. An alternative is to compare the growth of private sector gross financial wealth with the growth of the money supply within that. The greater the deviation from the normal split between monetary and non-monetary wealth the greater the inducement (higher interest rates) will need to be. Total wealth is forecast to grow by about 12%, while the growth of the monetary element in the total is to be kept to 10%, Here again the task is made more difficult by the fact that the change is required after five successive years in which £M3 has grown by less than gross private sector financial wealth: in early 1974 it represented 58% of such wealth while it now represents only 51%.

The Components

7. The "post-Budget" financial forecast envisaged that the components of £M3 in the year might be broadly as follows:-

	£ billion	
	Year 1978-79	Year 1979-80
Public sector borrowing requirement	9.2	8.3
Sales (-) of gilts to the non-bank private sector	-6.2	-6.4
Sales (-) of other public sector debt to the non-bank private sector	-2.3	-2.0
Bank lending in £ to private and overseas sector	6.7	7.0
Domestic Credit Expansion	7.5	6.9

	£ billion	
	Year 1978-79	Year 1979-80
Domestic credit expansion	7.5	6.9
External adjustments	-1.1	-0.5
Increase in banks' net non-deposit liabilities etc	-1.1	-1.1
Increase in £M3	5.4	5.3
% increase	11.6%	10.1%

As the Treasury note on the monetary base explains the above table reflects the accounting identity linking the PSBR, gilt sales, bank lending and external factors to the money supply, and the causal relationship between them is complex. However the critical fact remains that to the extent that there is an overshoot on one element, there will have to be offsetting changes on others if the target is to be achieved. For example there may be some scope for offsetting an overshoot on bank lending by higher gilt sales: the cost would be, of course, yet higher interest rates - and the increase may have to be quite sharp as we are already looking to a high proportion of the inflows into the capital markets to be applied to financing the PSBR, or acquiring the public sector assets to be disposed of. As comes out at a number of points in the papers on the gilt-edged market, the larger the amount to be financed through that market, the less, other things being equal, the freedom of tactical manoeuvre which the Bank has to achieve the funding in the most cost-effective way.

8. A similar point arises in relation to intervention in the foreign exchange market. Although the relationship is not exact, the greater the degree of intervention to reduce upward pressure on sterling, the greater the inflows which add to £M3. (Broadly speaking, it is the inflow into the non-bank private sector which adds to £M3). So if there were significant intervention over the year, it would have to be offset in one or more of the other components.

Interest Rates

9. It is implicit in the decision to have a monetary target that the Government then has to accept the interest rates to go with it: this is no more than the basic economic proposition that one cannot control both the quantity and the price of a good. The interest rates required to achieve the target will be affected by the fiscal stance. Other things being equal, the cuts in public expenditure should, as they take effect, reduce the interest rates which will be required to achieve the target.

10. It is not possible to forecast at all accurately what interest rates will be necessary to achieve a particular target since so much depends on market expectations - about inflation, about future interest rates and about the Government's resolve to carry through its policies. The forecasters best guess at the time of the Budget was that by the end of the year short rates might be somewhat lower than now, and long rates slightly higher. Whether short term rates will fall and if so when, will depend critically on whether bank lending declines as anticipated, and on whether the expected reduction in the PSBR occurs in the second half of the year, with cash limits holding.

11. Direct monetary controls - existing or proposed - are not an alternative to interest rate changes. For example, the extent to which banks can control borrowing from them by rationing, particularly under existing facilities, is limited - they have to rely primarily on the rates they charge. Both the existing Supplementary Special Deposit Scheme, and the proposed monetary base scheme, have to be seen, as the Bank's paper points out, as a means of ensuring that the structure and levels of interest rates vary sufficiently quickly and widely to achieve the control of the monetary targets. Similarly direct controls on bank lending, such as attempted by the Labour Government in the later 1960's, would drive up interest rates at time of pressure.

12. Indeed, the critical limitation of the present gilt-edged market techniques that emerges from the discussion in the other papers is that we at present lack a means of bringing about a shift in long term interest rates when that may appear to be desirable.

Conclusion

13. To sum up:-

i. while £M3 is the target variable, account will need to be taken of the development of the other monetary aggregates;

ii. the target set for £M3 this year is a tight one, which will require a "monetary squeeze";

iii. once the Government has decided on its fiscal stance for the year, and on the monetary target, it has to be ready to move interest rates to the levels which may prove necessary to achieve the target - such interest rates will not always be generated automatically byt the markets;

iv. there may be some scope to accommodate limited changes in one of the components - say higher bank lending or greater intervention in the foreign exchange markets - by offsetting changes in others - say higher gilt sales - but at a cost in terms of higher interest rates;

v. the prospects for lower short term interest rates later this year depend on the expected declines in bank lending and the size of the PSBR;

vi. other monetary controls, such as the "corset" and the monetary base control, if there were one, have to be regarded as ways for bringing about the necessary changes in the level and structure of interest rates, not as an alternative to them.