

no final as at 29.10.79

Alan Budd, Esq.
London Graduate School of Business Studies
Sussex Place
Regent's Park
London NW1 4SA.

59 61

My dear Alan,

Peter Middleton very kindly gave me a sight of your forthcoming LBS Policy Viewpoint on 'Monetary Target and a Financial Plan'. As Chief Adviser on domestic monetary affairs in the Bank, I obviously have a close and direct interest in the subject, and, following publication, I would be bound to be asked for my views on your work. The advance sight does, however, give me the opportunity to comment on this to you in advance in a personal vein, and I feel impelled to take the opportunity, for reasons that will become obvious as you read on.

You set out specific numerical targets for future monetary growth, and clearly imply that the authorities should commit themselves to these. Your targets are based on three factors, an intended downward path for inflation, a presumed underlying trend rate of growth in the economy and a velocity - or demand for money - function. I am not clear exactly where you get that inflation path from, how firmly based you think it is, but that consideration matters relatively less to me since I could certainly agree that the aim by the end of the horizon should be to try to get inflation down to around, say, 4% p.a., and once the end point is agreed the details of the path become of less importance in this kind of exercise.

My concern relates more to your other two assumptions. What was the basis for your insight into the future trend rate of growth of real output in the UK? As you note, this has varied over time and between countries. Just how do you predict the future here? Your

crystal ball seems slightly clouded since your text varies inconsistently between assuming a trend of $1\frac{1}{2}\%$ and 2% per annum.

My main concern, however, was generated by your statement that, "Our calculations suggest that the underlying rate of inflation is approximately equal to the rate of growth of the money supply. (The trend growth of output of about 2% a year is offset by the tendency for money demand to grow 2 per cent less rapidly than output)." Unless your drafting is unclear, that must imply a demand-for-money (velocity) function of the following form:-

$$\log M = a_0 + b_1 \text{ time} + b_2 \log \text{ Price} + b_3 \log \text{ Real Output}$$

where $a_0 = 0$, $b_2 = b_3 = 1$ and b_1 is a coefficient such that M falls by 2% each year, *ceteris paribus*.

Now I should be most interested to see the calculations that generate these coefficients and your econometric testing, *inter alia* for the stability of the function over time.

Having been more closely associated with demand-for-money studies than, I would be willing to claim, virtually anyone else in this country, I would certainly not rule out the possibility that you could find some time period over which the above coefficients might be generated; I would, however, want to check the working very carefully. What really gets to me is the implicit self-confidence that you, Alan Budd, have now identified a stable demand-for-money function, on which future policy can firmly be based. After all our experience in recent years, can you seriously claim that 'your calculations' - undemonstrated - are a sound basis for official policy. Frankly I feel that the process of picking numbers in this way for serious policy recommendations is breath-taking in its irresponsibility.

If you actually wish to be responsible, then you need to start from quite a different posture, a much more humble one in which one recognizes that within quite large bands neither you in the LBS - nor

I in the Bank - can predict at all closely either the trend rate of output, the velocity of money, the natural rate of unemployment, etc., etc. In this condition of inherent uncertainty, how then should one guide policy? For example, the trend rate of output could, I suppose, be anything between $-1\frac{1}{2}\%$ and $+5\%$ in the next decade, the income elasticity of the demand for money anywhere between 0.5% and 1.75% , etc. The point estimates in your calculations and your *ex post* standard errors really do not slim future possibilities down much below that; failure to recognize that uncertainty is deplorable.

Even were your central point estimates the best available, and I must take leave to doubt that until I had thoroughly crawled over the undisclosed econometric evidence, it would be right at least to ask yourself the question of what would happen if your estimates turn out to be wrong, on one side or the other, as they will in the event turn out to be. Are the probabilities of error symmetric, are the policy risks symmetric? If you under-estimate the likely trend growth of output and demand-for-money, are the risks of setting too low a target symmetric in all respects to the possibility of over-estimating those factors. The be-setting sin of all economists, monetarist or Keynesian, is over-confidence in our own latest empirical work. I am no doubt equally guilty myself, but I can see the mote in the eyes of others.

Turning to the latter half of your paper, on the PSBR, I would agree that fiscal policy must be consistent with monetary policy for targets for the latter to be met. You imply, however, not only necessity but sufficiency, and here, again on the basis of past experience, I would disagree. Recent history suggests, at least to me, that monetary disturbances have owed more to volatile movements in lending to the private sector than in lending to the public sector.

More seriously, your calculations proceed on a very broad brush basis. You assert, an 'approximate rule of thumb', that a cyclical variation in PSBR around its trend will be offset by an equal offsetting

fall in net lending. Was this rule of thumb an accurate guide in 1972/73, for example? Where are the calculations to support this? In your calculations for the PSBR in 1983/84, you proceed by assuming constant ratios of bank lending and 'stock of nominal debt' to GNP. This implies that your best functions for bank lending and nominal debt holding take the following form:-

$$\log BL = a_0 + b_1 \log \text{Prices} + b_2 \log \text{GDP} + b_3 \frac{\text{actual PSBR}}{\text{trend PSBR}}$$

where $a_0 = 0$, $b_1 = b_2 = 1$ and $b_3 < 0$,

with a similar equation for bond sales.

Do you actually want to stick by that? Is that the best that econometric testing can produce? What about the certainty that these relationships, even if now the best possible - which again I take leave to doubt - will change in future? Are the probabilities and risks symmetric? Do you really want to advocate on the basis of this work that the Government should commit itself now to a PSBR of 2.7% of GDP in 1983/84 and monetary growth of 4%, or are we to treat these as merely illustrative figures which you would want to spend a lot more care upon, if you thought that anyone might actually take you seriously? By the way, is your figure of £5.7 bn. for the PSBR at presumed 1983/84 prices, or 1979/80 prices, or what? I should be interested to see your work sheets here, in addition to your econometric calculations for the demand for money, demand for bank lending and for bonds.

I have written earlier to Terry to congratulate him on his new position. Some of his well-deserved lustre will fall on to the LBS as well, and quite properly. That means that outsiders will see a larger degree of influence in your pronouncements, and accordingly such pronouncements should, perhaps, bear an added responsibility. I have to say that I see little evidence of such responsibility in this paper, but instead a combination of partly-considered numbers introduced with an entirely spurious self-confidence.

Yours sincerely,

subset in
File 6.

Copies behind of a COMMENTS

24.10.79

61

THE GOVERNORS' PRIVATE SECRETARY

Copies to Mr. Fforde

- Mr. McMahon
- Mr. Dow
- The Chief Cashier
- Mr. Walker
- Lord Croham
- Mr. Dicks-Mireaux
- Mr. George
- Mr. Quinn
- Mr. Taylor
- Mr. Threadgold
- Mr. Clark
- Mr. Foot
- Mr. Green

The Governor

60

62

The piece I mentioned

to you on the 'phone:

was read $\frac{18}{25}$

How CAEY $\frac{10}{10}$

is not going to write. JF commends the
draft to your attention.

MONETARY TARGETS AND THE FINANCIAL PLAN:
LBS VIEWS

$\frac{26}{10}$

see 23.10.79

Alan Budd sent to Peter Middleton (HMT) a copy of the forthcoming Policy Viewpoint, which will be published by the LBS in mid-November. This is, indeed, a joint piece of work by Terry Burns together with Alan Budd, although it will be signed only by Alan Budd. Even so, commentators may well assume that Terry Burns has been closely associated with it, and the publication is, therefore, quite likely to generate considerable Press interest.

For all these reasons, Middleton thought it necessary and right to circulate the paper to the Chancellor and Financial Secretary, as well as to officials in HMT. His views on the paper are not, I think, any more favourable than my own but, for obvious reasons, Middleton felt that he had to be somewhat constrained in the tone of his comments.

Having read the paper, I think it such a poor piece of work that my initial reaction was to draft a letter to Alan Budd, telling him why I thought, in effect, that this piece of work was not up to proper academic standards, even less providing a guidance for responsible policy-making. I enclose a draft of this letter, which was perhaps written rather in the heat of the moment. I shall certainly sit on it for a few days, and would in any case welcome any views that recipients might have whether the despatch of such a letter would be politic. Perhaps not. Anyhow recipients of this note will all have the following three attachments:-

- (i) Middleton's cover note to the Chancellor;
- (ii) the paper itself; and
- (iii) my draft letter commenting on that paper.

CAEG
24th October 1979.

C.A.E. Goodhart

24.10.79

THE GOVERNORS' PRIVATE SECRETARY

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- Mr. Fforda
- Mr. McMahon
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- Mr. George
- Mr. Quinn
- Mr. Taylor
- Mr. Threadgold
- Mr. Clark
- Mr. Foot
- Mr. Green

26/10.

CAEG

I certainly support your protest
 at the quality of this LBS
 work (and understand you
 are going to protest even a lunch
 rather than by letter). I suppose
 the trouble is that over the years
 there has developed a lucrative sellers'
 market for self-confident but low

MONETARY TARGETS AND THE FINANCIAL PLAN:
 LBS VIEWS

quality work which gets favourable
 publicity in the Press (which is itself too biased in
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(favour of what the low-quality work is saying.)

JSP 24/10¹² CAEG 26/10¹³

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24th October 1979.

C.A.E. Goodhart

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 Mr.Threadgold
 Mr.Clark
 Mr.Foot
 Mr.Green

Mr Goodhart
Politic or not
I think you should
write. Such trash
should not
be remarked

Jan 25/10

MONETARY TARGETS AND THE FINANCIAL PLAN:
LBS VIEWS

Alan Budd sent to Peter Middleton (HMT) a copy of the forthcoming Policy Viewpoint, which will be published by the LBS in mid-November. This is, indeed, a joint piece of work by Terry Burns together with Alan Budd, although it will be signed only by Alan Budd. Even so, commentators may well assume that Terry Burns has been closely associated with it, and the publication is, therefore, quite likely to generate considerable Press interest.

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CAEG

24th October 1979.

C.A.E. Goodhart

11/15/79

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BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

61 63

24th October 1979.

P.E.Middleton, Esq.
H.M.Treasury
Parliament Street
London SW1.

Dear Peter,

see 23.10.79 in
main file

24/10/79

As I told you over the telephone, I have drafted a letter to Alan Budd, criticizing the Policy Viewpoint which you kindly sent to me. I should certainly say that this letter was written in the heat of the moment, and it could well be that the best thing to do would be to tear it up. Nevertheless, both you and I will probably be asked for our considered comments on their proposals, and I would have to say that I regard the paper as a shoddy piece of work. Perhaps that message could be dressed up in somewhat more diplomatic terms than I have set out in my draft letter to Alan, but I could not sugar the pill all that much.

24.10.79.

Anyhow, what do you think?

Yours sincerely,

Charles

C.A.E.Goodhart.

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30.10.79

THE GOVERNORS' PRIVATE SECRETARY

Copies to Mr.Fforde
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Mr.Clark
Mr.Foot
Mr.Green

62 3/11

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MONETARY TARGETS: LBS VIEWS,
FURTHER DEVELOPMENTS

Following the circulation of my note of 24.10.79 on this subject, I had further discussion with Middleton (HMT) on how to handle the matter. In some ways he was even more concerned about the proposed LBS Viewpoint than I was, both because of policy considerations, in that it might steal any thunder should the Government decide to come out with longer-term monetary targets itself, particularly if the proposed rate of monetary growth in the LBS Viewpoint was to be lower than that adopted by the Government, and also because of the sensitivity surrounding Terry Burns' involvement in this exercise. Middleton, therefore, thought it best to try to handle this difficult problem by a personal approach to Messrs.Burns and Budd, and he invited me to join him to discuss the problem on Monday, 29th October.

We had an amicable meeting with them and I think that Terry Burns is fully seized of the difficulties that we saw. I believe that we have persuaded them to remove all the specific quantification from their paper, including that based on their (undisclosed) calculations of a velocity function, which both Burns and Budd admitted could be an unsafe basis for extrapolating a monetary target forward. As a result, the forthcoming Policy Viewpoint should be a more general discussion paper, animadverting on the general advantages of having a medium-term monetary target, together with expenditure and tax plans consistent with such a target, but without putting in any specific numerical proposals. If their paper is changed in this way, as they seem to agree, it should defuse the problems that had most worried us, and would be as good an outcome as could be expected from this situation.

In the event, of course, there was no need for me to send off my, somewhat intemperate, critical letter to Alan Budd.

CAEG

30th October 1979.

C.A.E. Goodhart