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Prime Minister

MCS 7/1

10 DOWNING STREET

Prime Minister

You, the Chancellor and the EST have often raised the point that Ted Heath used M_1 in 1970-73 and was misled and duly lulled into a false sense of inflation-free growth.

This note shows that the Heath view is not warranted by the evidence. M_1 was warning enough.

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Personal from Alan Walters

M1, M3 AND THE MONETARY MYTHS OF MR. HEATH

1. It is frequently said that one of the main arguments for not adopting a narrow aggregate such as M1 is that the Heath Government was concerned with monitoring M1 in 1970, 71 and 72, and that they missed the great expansion in M3 which occurred during that time. Mr. Heath said that on the basis of M1 there was no undue growth in the quantity of money over this period. The implication is that the inflation was generated by outside causes, trade union pressure, and the other rag-bag of extraneous events.

2. Although the Heath view is widely accepted, it is quite untenable. While it is true that M3 was a somewhat better indicator of the inflation that was to come, both M1 and the monetary base pointed in the same direction and almost the same order of magnitude. The annual increases in M1, £M3 and the monetary base are shown in the attached table.

3. If we judge by these annual figures then there is a clear indication of a rapid increase in the M1 figures beginning in 1970 and going through at an increasing rate to 1972. There was virtually no increase in M1 in 1969, but over a 9% increase in 1970, rising to a near 14% increase in 1972. Similarly, there was a rise in the monetary base figures, but these were slightly later than the M1 and only really got under way in 1971.

4. As I have often argued, we should really examine the trend of money supply over about a three-year period for the purposes of discussing its effect on inflation. Let us therefore do that for the periods 1967-1969 and 1970-1972. The average for M1 increased from 4% to 11%, that is to say a 7% rise. The monetary base average rose by 5 percentage points whereas the M3 average rose by 10 percentage points.

5. All these data are consistent with the increase in inflation of 7-10 percentage points which we experienced in 1973/4. I believe that the evidence points to M3 as being somewhat superior to M1 for this period. And there were good reasons why it should be the better measure. Competition and credit control suggested that there would be a switch from non-interest-bearing deposits into interest-bearing money deposits. This occurred. But the movements of M1

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THE MONEY STOCK AND THE MONETARY BASE

(Percentage change from end of previous year)

End of	M1	3 Year Average M1	£M3	3 Year Average £M3	M0	3 Year Average M0
1964	3.0		5.6		7.9	
1965	3.7		7.6		5.3	
1966	-0.2		3.4		3.6	
1967	8.7		9.5		4.1	
1968	4.2	4	6.9	6	4.6	4
1969	0.1		2.4		3.3	
1970	9.4		9.5		5.0	
1971	10.9	11	13.9	16	8.8	9
1972	13.6		24.5		12.4	
1973	5.1		26.3		8.9	
1974	10.7		10.2		15.6	
1975	13.1		6.6		11.6	
1976	11.3		9.5		11.1	
1977	21.5		10.0		17.1	
1978	16.4		15.0		13.2	
1979	9.1		12.7		9.7	

Source: Bank of England, Bank of England Quarterly Bulletin, and Bank of England Statistical Abstract.

Note: The money stock data are adjusted by the Bank of England for breaks in the series.

were a good and convincing indicator that the inflation was coming and that it would be in the order of about an 8% or so increase - that is to say, on top of the existing 7%, about 15% overall.

6. I conclude that in spite of CCC, the trend of M1 adequately predicted the inflation that ensued. In consequence the 1970-73 period does not discredit the proposition that suitable control of M1 (or MO) would have mitigated much if not all of the increase in inflation in 1974 et seq.

AW

7 January 1982

ALAN WALTERS