CONFIDENTIAL

cc Principal Private Secretary
PS/Chief Secretary
Mr Burns
Mr Middleton
Mr Bridgeman
Mr Unwin
Mr Riley
Mr Odling-Smee
Mr Grice
Mr Cumming
Mr Wren-Lewis

Mr Ridley
Mr Cropper
Mr Cardona

PS/FINANCIAL SECRETARY

GROWTH OF M1

Mr Middleton passed to me your note of 4 July.

2. I too have been surprised, and increasingly rather worried, by the continuing fall in M1 that has taken place in most months since last October. The main explanation must be the sharp rise in MLR that took place at that time, but it is open to question now whether that is sufficient to explain such an abrupt fall in M1 in real terms. An equation recently estimated by Norman Cumming of HF3, which does take account of the effect of interest rates, would suggest an increase of about 14 per cent in M1 during this year. This is a very erratic series, but it looks doubtful whether an increase on anything like that scale will in fact occur.

3. We have been looking into the possibility that M1 may be useful as a leading indicator of £M3. I attach a chart taken from a recent paper by Joe Grice of FEU. Up to 1970 the two series moved quite closely together with little suggestion of a useful lead or lag. From 1971 to 1974 their movements were very different, with £M3 growing very much faster than M1. Since 1974 there has been a loose relationship between the two series with perhaps just some suggestion that M1 does lead at turning points. The difficulty with a purely graphical analysis, however, is that it does not take account of variations in interest rates - which have of course been substantial in recent years.

4. Simon Wren-Lewis of MP2 has been looking at the relationship between money supply and prices. His best results use £M3 and come up with the familiar result that money leads prices by about 2 years or so, this conclusion being derived mainly from the experience of 1972-1974. As Lord Kaldor says in his evidence to the Select Committee, this could be interpreted as suggesting that competition and credit control caused the oil price increase. Attempts to use M1 in place of £M3 as the variable to explain prices have been relatively

unsuccessful (as might be predicted from the history of 1972). The next step will be to look at the possibility of using M1 in combination with oil prices as an alternative to £M3. Taking just the experience of the last few years it is rather striking that the very rapid growth of M1 in 1977-78 might provide a more adequate explanation than one can derive from £M3 of the 1979-80 inflation.

5. Finally I might refer to some work I did myself during my sabbatical leave and in the months immediately after my return. Using annual data I found the real value of M1 (lagged one year) contributed usefully to an explanation of cyclical variation in output - although it is an open question whether this relationship implies causation. On this basis we now face the prospect of an exceptionally deep recession.

6. It has never been an aim of monetary policy in the UK, unlike the US, to keep M1 on a preset target. Our attitude is that M1 is one of the various monetary aggregates that we monitor and, in some unspecified way, take into account when "assessing monetary conditions". At the present time there is some conflict of evidence: the wider aggregates suggest that we are still having some difficulty in getting monetary conditions as tight as we might wish; M1 suggests that monetary conditions are very tight indeed.

AJCB

A J C BRITTON

10 July 1980

CHART III

Growth Rates of £M3 and M1, Quarterly