CONFIDENTIAL

MR BURNS

TREASURY
12 JAN 1981
FEU CS

cc Mr Middleton
Mr Cassell
Mr Evans
Mr Monck
Mrs Lomax (o/r)
Mr Riley
Mr S Davies
Mr Grice
Mr Meyrick
Mr Pickford
Mr Shields
Mr Spencer
Mr Bennett
Mr Crook
Mr Cumming
Mr Fisher
Mr Surr

MONETARY ECONOMISTS' MEETING

1. I held a meeting of the economists in FEU and HF3 last week to discuss in very general terms the behaviour of the economy and the money supply over the past year, and to consider the implications for policy. This continues a tradition of occasional seminar-style meetings initiated by Mr Middleton. I agreed to write a brief note of some of the issues raised.

Is the Recession Policy-Induced?

2. I started by saying something to the effect that the recession was going more or less according to plan. This provoked four different lines of comment:-

(i) The recession was really attributable to the exchange rate, and through that to the North Sea. It was not the consequence of the policy - or not entirely.

(ii) The recession resulted from the unbalanced way in which an open economy responds to monetary restraint, with extreme overshooting on the exchange rate.

(iii) The recession resulted from the presentation of policy, not from any actual fiscal or monetary actions. Firms have cut stocks and have shed labour because they have come to believe that policy measures will no longer be taken to maintain demand.

(iv) The question is purely semantic. Policy allowed the recession even if it did not create it.

Is the Recession now too Severe?

3. We asked whether it was against the spirit of the strategy to take account of the level of output when setting money supply targets or deciding on budgetary measures. On the face of it, the answer seemed clear enough - the Government has explicitly rejected demand management. It was suggested, however, that the policy was one of gradualism - it had not been proposed to stop inflation dead in its tracks. The reason for gradualism was concern about the adjustment costs of the policy. If these costs were higher than anticipated, perhaps a more "gradual" approach was needed.

4. There was an inclination to consider some kind of feedback rule for policy in which output as well as prices, the exchange rate etc could be explicit contingencies for policy changes. But it was recognised that this would involve a substantial change from the unconditional money supply rules laid down in the MTFS.

The Odd Behaviour of £M3

5. The strategy was conceived on the assumption that there was a robust relationship between £M3 on the one hand and prices, output or nominal incomes on the other. The odd behaviour of £M3 this year suggested that these relationships were not very robust after all. Two possible interpretations were offered, with very different policy implications.

(a) The trend in the velocity of the wider aggregates, especially £M3, may have shifted - perhaps because of the ending of direct controls over bank lending. There is precious little evidence for this, but the possibility is enough to raise questions about the appropriateness of medium-term financial targets.

(b) Inflation is "suppressed" by the high level of the exchange rate - in much the same way as it has on occasion in the past been suppressed by subsidies or indirect tax cuts.* It

*Some calculations I made after the meeting may be of interest. Between the fourth quarters of 1979 and 1980:-

(a) The exchange rate rose by 30 per cent relative to the RPI. Its direct effect on the RPI is about 20 per cent. The exchange rate on this basis "suppresses" 6 per cent inflation.

(b) The extra increases in the prices charged by nationalised industries, in rent and in rates, add back about 2 per cent to the RPI.

therefore the inflation figures which are misleading, not the money supply figures. It may now be necessary to tolerate an overshoot this year, but there should be an undershoot later on, especially if the exchange rate falls.

AJCB

A J C BRITTON
23 December 1980