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- 2. Conditional ← m.i. XP

Clawback

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 MTFE
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 Polay

Mr Burns

cc Mr Ryrie
 Mr Britton
 Mr Monck

Comparison Not Inds

MONETARY AGGREGATES AND ALL THAT

1. Thank you for your minute of 22 December. It covers the ground which we identified for further urgent analysis.
2. Time is short and we need to get started immediately on the issues identified in paras 9-14 of your minute. There will be a limit on the amount of new research which can be done and any complicated econometric work will have to be deferred for the time being. The main immediate need is to assemble and assess the data drawing on past work and work in progress wherever possible.
3. I suggest that this part of the work should be crystallised into 3 crisp papers:
 - a. the behaviour and significance of the narrower aggregates, distinguishing their special characteristics,
 - b. the behaviour and significance of the wider aggregates and their use as a guide to fiscal policy and interest rates. This can incorporate the work we have done on PSL1.
 - c. the significance of other indicators - especially indicators of exchange rate pressure but also PSPI.
4. The danger is that we shall arrive at the conclusion that everything provides some relevant information without providing a guide to policy. So the work needs to take place recognising that the immediate objective is to revive the monetary strategy and express it in a way which increases its credibility rather than make it so diffuse that it becomes meaningless. We shall also need a further paper which:
 - d. outlines the practical problems for monetary management, for internal policy formation and public exposition of a regime in which we take seriously the claim that we look at a range of monetary indicators. In particular it should consider how this could be formalised, on the assumption that £M3 or one of the PSL's remains the main objective for the

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medium term strategy. This paper, which could not be completed till the other work was done, but which could certainly be started, would need to consider the issue from two angles:

- i. using different aggregates for different purposes or with different weights - giving say £M1 a greater role in the determination of short rates and £M3 a greater role in long rates.
- ii. using a number of aggregates and other indicators to determine interest rates.

5. I am afraid that there is also another paper which we shall have to do. The Chancellor said that he would find it helpful to have an account of developments in the money supply since the Government took office - including the implications of the abolition of exchange controls and the corset. This would complement the work being done on 3b; what is needed is a note of the sort done by Mr Shields for the Prime Minister's summer seminar relating developments in the aggregates to developments in the economy more generally.

Organisation

6. I do not want to overburden HF/FEU with too much work, especially as there is still a lot to do on monetary control and funding, where the Prime Minister has reapplied the heat; I also want more work done on the effect of the various ways of rectifying the sectoral imbalance, particularly by changing nationalised industry prices on the money supply which will take some of Mr Shields' time in the near future. So we shall have to split forces somewhat.

7. We shall need to discuss this with Mr Monck and Mr Britton. Perhaps Mr Rylie could limit the meeting he suggested in his minute to me of 19 December to the five of us and we could then decide who does what. I should like however to organise things as follows:

- a. Mrs Lomax and FEU should be given the task of preparing the papers in paragraph 3.
- b. Mr Turnbull and HF3 should take on those in paragraphs 4 and 5.

- c. The work on monetary control should continue to be a joint HF/FEU activity processed by Mr Monck's group.
- d. Work on new funding methods and new sources of income for the Bank should have respectively HF3 and HF2 in the lead. It will be essential to keep up the momentum in Sir Douglas Wass's group.

The Substance

8. Perhaps I could make a comment on the substance of your minute. In the run up to the Budget we shall have to do our best to separate questions relating to:

a. the degree of monetary restraint as expressed by the medium term EM3 targets, however we build in flexibility by looking at other monetary indicators. Here the crucial question is whether we think there has been a shift in the demand for money and if so whether it is likely to be long lasting or permanent. This is closely related to our view of the exchange rate.

b. Monetary control and the determination of interest rates. We shall not be able to do more than make a guess at the first question. But the risks of continuing to inject large amounts of liquidity into the economy are clearly the greater if there is no way of using monetary instruments to claw back excess growth if the exchange rate does fall or if prices start to rise in response to some other shock. So the question of funding is very important indeed. There are obvious limits to what can be done at the long end without a feed back to short rates and the general level of interest rates. But if we cannot move towards a system where short rates reflect the response of the market to selling debt to keep EM3 broadly on track rather than being seen as a means of bringing about these sales indirectly via expectations, relying on any of the wider aggregates is going to involve great risks.

Perhaps therefore I could end on a note of caution. I was very interested to see your graphs, which again lead back to the question of why bank lending has remained so high. But it may be that we are over the worst on that score; and

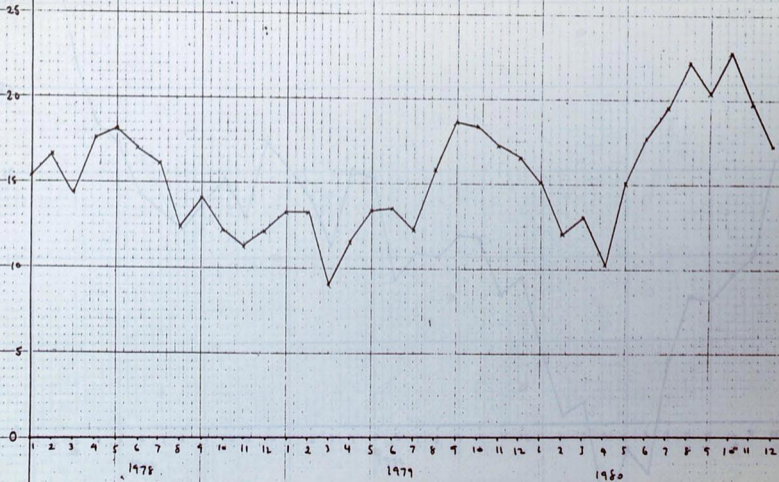
in considering the role of the narrow aggregates in the determination of short rates we might reflect that the growth in the narrow aggregates over the most recent months would point to higher short rates and the growth in the wider ones to lower rates. I would not want to build too much on this, though the forecast points in the same direction; we must wait for the work that has been set in hand.



P E MIDDLETON
30 December 1980

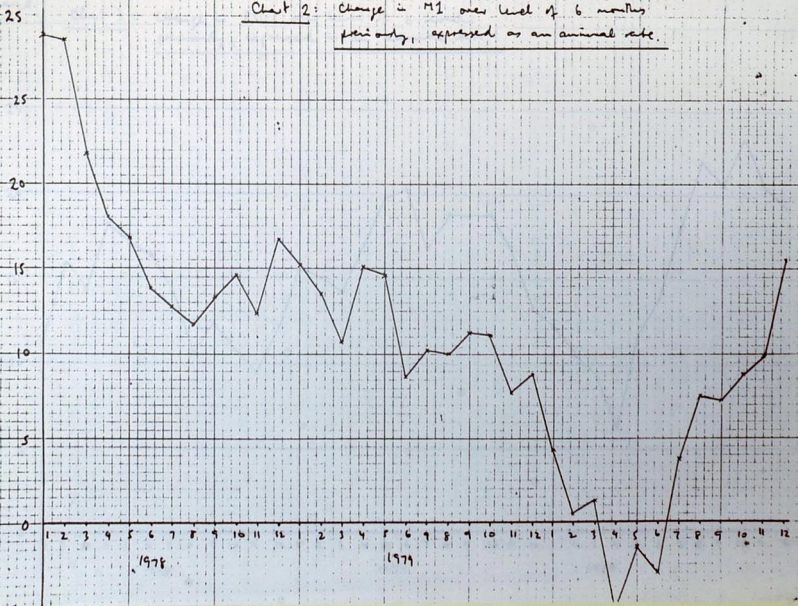
%
change

Chart 1: Change in 'Adjusted' FMS over level of 6 months
previously, expressed as an annual rate.



σ
change

Chart 2: Change in M1 over last of 6 months
periods, expressed as an annual rate.



% change

Chart 3: Change in PSLI one level of 6 months
previously, expressed as an annual rate

25

20

15

10

5

0

1 2 3 4 5 6 7 8 9 10 11 12 1 2 3 4 5 6 7 8 9 10 11 12

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