World Man wire n' r see me. Second possibly consual Howard's note that that is not his content to allow point. matters to take their course? or would

15 December 1981
ALAN WALTERS

Prime Minister

Alan argues that we cannot and should not keep Howard's study under wraps -

PRIME MINISTER

FEDERAL RESERVE BOARD'S STUDY OF MONETARY AGGREGATES IN THE UK

you like us to

keep the UK =

distribution to

1. I am concerned at the annotations which you put on my memorandum of 10 December.

the minimum (we can't affect the US distribution)?

2. Let me try to set out the facts as I understand them.

    a. Howard's study is merely one among a very large number that have concluded that £M3 has been a mis-leading indicator during recent years. Examples are numerous and ubiquitous; they include Niehans, Budd and Christopher Johnson. (Terry Burns and Peter Middleton are now quite convinced that £M3 was and is a misleading indicator.) *But they are not recommending that we leave it until they are clear about what to fit to.*

    MCS 16/12

    b. By our actions in November 1980 and subsequent-ly we have pursued policies which were inconsistent with our announced targets for £M3. Commentators have observed this deviation - and in general they have, rightly in my view, applauded it. It has been observed, again rightly, that our monetary policy in 1980 was restrictive in spite of the overshoot of the £M3 target.

    c. I believe that it was to the Government's great credit that the severity of the monetary squeeze of 1980 was relaxed in November of that year. This adjustment of policy, together with the further relaxation in March 1981, was seen by the vast majority of commentators, as entirely justified. (The only exceptions were Brian Griffiths and his group at City University.) Of course it was possible for our enemies to say that we were wildly overshooting our £M3 monetary targets. But those critics wanted us to overshoot them even more! Such critics have little intellectual integrity and should be discredited or ignored.

/3. Opinions differ

3. Opinions differ on what will be the best guide for monetary policy.
    However, considering M1 and £M3, I believe that the vast majority
    of commentators would prefer M1 (or M0 or retail M1).

4. You raise also once again the experience in 1971-74. Indeed, I
    used M3 in 1971-2 to predict the inflation which ensued in 1974.
    Although I had worked mostly with M1, for example in my "Money in
    Boom and Slump" (1968), I believed that "competition and credit
    control" would render M1 quite unreliable in this period. The
    changes brought about by the CCC regime were bound to channel monetary
    growth into interest-bearing deposits during the period in which the
    banks were adjusting their portfolios. I believe that I was correct
    in interpreting £M3, or as it was in those days M3, as the most
    reliable aggregate during the years after the CCC regime was brought
    into effect. My judgement at the time has been confirmed by another
    study by David Howard called "Inflation, Indexation and the Oil-Price
    Shock: The British Experience", July 1981. After an extensive
    discussion of monetary aggregates over the period 1970-79, he
    concludes:

    > "Thus it is probably the case that during this period
    > the behaviour of the £M3 aggregate was the more
    > appropriate measure of underlying monetary growth."

    What I believed were the good reasons for using M3 during the CCC
    period have not been discredited by subsequent research and
    reflection. *But this is a complicated argument to explain*

5. Using similar arguments since 1980, I am convinced that the M3 figures
    have been severely distorted, primarily by the corset and the after-
    math. During these recent years the narrower aggregates have been
    the appropriate indicators of monetary stringency. (I have also
    argued that all the other measures, real interest rates, the
    exchange rate and other "real" effects are consistent with this
    interpretation.)

6. Finally, I think it is quite impossible to suppress or even effectively
    to discourage views of this kind being expressed. And even if it
    were possible, I believe it would be undesirable. We have nothing
    to fear from the truth. Apart from being a shade too severe in 1980,
    our policies have been entirely right and can be easily defended.

    ALAN WALTERS