MR SCHOLAR

10 DOWNING STREET

MR. BURNS
MR. MIDDLETON

NOTES ON THE MTFS

I have put down in a shorthand form some of the ideas I had about the new MTFS. I think I differ significantly at times from the draft which we discussed earlier this week. However, I am not at all certain that I am correct in my interpretation of some of the numbers involved. I would like you to put me right if you think I have gone substantially wrong.

I am not proposing to circulate this draft any wider for the time being. In particular, I will not circulate it to the Prime Minister at this stage.

AW

18 December 1981

ALAN WALTERS

CONFIDENTIAL

ALAN WALTERS

NOTES ON THE MTFS

THE INCREDIBILITY OF M3 TARGETING

1. I believe that any target for M3, even if we believed it was feasible, effective and desirable, would be straining the credulity of all the commentators. For what I believe are very good reasons we have departed with various degrees of deliberation from the target path of £M3. Everyone knows this. Why should there be any degree of belief at all in our announcement now of £M3 targets.

2. This is not to say that our monetary policy has been substantially different from the real intentions underlying the policy announcements. On the contrary, I think our actual monetary policy has been broadly in line with the intentions, except perhaps for the undue stringency in part of 1980. Thus in an odd sort of way, the £M3 targets, by our missing them, have served us quite well. But I suspect that our line of credibility is now exhausted.

FORECASTS OF FUTURE M3 FIGURES

3. I believe that we cannot forecast the £M3 figures with any suitable degree of accuracy. We have not been successful in the past in forecasting the shift from non-bank to bank intermediation, and the great expansion of credit generated by the marked differences in degrees of prosperity of the various sectors of the economy. The 60% of interest-bearing deposit liabilities which comprise £M3 seem to be extraordinarily volatile and to be a consequence of factors which we find very difficult to predict. I am convinced that eventually the £M3 figure will come back into the general fold of the other aggregates. But I am equally sure that I cannot predict with any certainty when this will occur, for all the reasons set out above.

USING M1, MO AND RETAIL M1

4. Clearly on the issue of controlability, M1 or the other narrow aggregates are to be preferred. Current account deposits are very sensitive to interest rates. And while we are constrained to using interest rates to control the quantity of M1, at least in the short run, some narrow aggregate of this kind ought to be our preferred target.

/5. Paradoxically,

5. Paradoxically, however, the fact that M1 is interest rate sensitive is thought to present difficulties in targeting. In Terry Burns's draft of 2 December, the expectation that nominal interest rates will fall means that the forecast M1 growth which is consistent with something like an 8% growth in money GDP is 14-18% in 1983/84. This may be correct but it does depend crucially upon first the predictions of changes in nominal interest rates and secondly, the stability of the behaviour of M1 with respect to changes in interest rates. There is also a third problem; much of this high increase must be due to a once-and-for-all stock adjustment process. It must be a once-and-for-all shift not a continuous trend process. Thus the 14-18% in 1983/4 foresees a <u>fall</u> in nominal rates over that year.

6. There are also other constraints on the growth of M1 which seem to me to be likely to begin being effective as the rate of inflation and nominal interest rates fall. We have been told by the clearing banks that the cost of operating current accounts is some 8% or 9%. If we, naively perhaps, accept this figure, then as interest rates fall below this value one would expect that the increased competition would bring with it charges for the operations on current accounts. Or, alternatively, there may be some minimum balance condition. This would have the net effect of decreasing M1 velocity if the minimum balance condition were imposed on current accounts. If, however, it were imposed on savings accounts there would be likely to be some increase in M1 velocity.

7. Apart from all these side effects, I would argue that the interest rate effects on the demand for M1 balances are likely to be self-regulating and counter-cyclical. If interest rates rise then the demand for M1 is reduced and consequently with the same rate of growth, the monetary stringency is automatically reduced. (This of course occurs only during the adjustment period.) If, on the other hand, nominal interest rates fall then, during the adjustment period, the effect of a constant rate of growth of M1 is to introduce more monetary stringency than had hitherto existed. I would expect these effects to occur not in response to short term transitory changes in interest rates but only when the rates persist for some months. As a consequence, I would be tempted to ignore forecasts of interest rates in planning the appropriate M1 target. This is especially the case if, and I shall argue we should, we take the view that the

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target rate of growth should be considered over a fairly long period, such as 2-3 years.

M1 AND THE RATE OF GROWTH OF MONEY GDP

8. I take it that apart from CCC distorted conditions from September 1971 onwards, there is some evidence that M1 is not inferior to £M3 as the appropriate magnitude to control in influencing nominal incomes. I believe that David Howard's study has shown that M1 is superio to £M3. The question is what sort of numbers should we therefore adopt for targeting purposes?

9. My inclination is to argue that over the three year period to 1984/85 we should ensure that the average growth of M1 does not exceed 6%. Ideally one would like to deliver a figure somewhere in the region of 3 or 4% at the end of the period. But I do not think that any such number should be spelled out. It may be wise to deviate from it for that particular year. However, 3-4% would be roughly the value we had in the fifties and early sixties. And it would be consistent with an inflation rate of about 5%.

10. I believe it would be a good idea to think about a similar target for the monetary base. It would be important, of course, to explain the basis for any such figure. The monetary base at present has many statistical difficulties of interpretation and volatility. But we expect that these will be reduced over time. In this sense I should have thought a monetary base, again over a three-year period of not exceeding 5% per annum, would be both appropriate and achievable.

11. In view of the discussion in paras 5, 6 and 7, I think any targets should be heavily qualified with statements about institutional and regulatory changes which would much affect the figure concerned. In other words the commitment to a target is not open-ended and unconditional. These should be heavily qualified.

£M3 AND ITS ROLE

12. While we are agreed that £M3 should not be used for the purposes of interest rate adjustments, most of us would accept the view that there is information in £M3 and PSL2 which is useful for determining the impact of monetary policy. I think it is best to say that we will continue to monitor £M3 closely. But we shall not use £M3 as an indicator in determining policy with respect to interest rates. We

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might go on to say that we should expect £M3 to grow over the three-year period at something like a 6-8% rate of growth. But we should heavily qualify this by statements like saying that this depends very much on the role that the banking system plays in total credit markets etc.

THE ROLE OF THE EXCHANGE RATE

13. For reasons which we shall probably have to discuss elsewhere, I think it would be most unwise to have a target band for exchange rates in conducting either intervention or strictly monetary policy. Nevertheless, again it is useful to keep a close eye on the exchange rate since it gives us some indication of the stringency of monetary policy. However, it is very difficult to interpret. Exchange rates are affected by many factors, particularly by monetary policies of our competitors and of course by political events. Although it is difficult to exclude these factors, I still believe that the exchange rate again conveys some useful information.

18 December 1981

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