

BAKER, N.P.

29th December, 1980

I am so sorry.

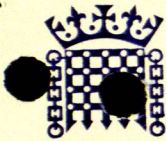
I have not acknowledged your letter dated 9th December, with which you enclosed the London Business School Forecast of the Economic Outlook dated November 1980.

This I have shown to the Prime Minister.

Despite all its imperfections as a measure of the rate at which the supply of money is growing, the relationship between the growth of Sterling M3 and the rate of inflation 18 months to two years later seems to me to be proven.

IAN GOW

Kenneth Baker, Esq. M.P.
House of Commons,
Westminster, London SW1



From: KENNETH BAKER, M.P.

HOUSE OF COMMONS
LONDON, S.W.1.

December 9, 1980

Ian Gow Esq MP
House of Commons
LONDON SW1A 0AA

Kenneth Baker
I would like to draw your attention to this Forecast Release from the London Business School.

It identifies why the sterling M3 figures have grown so rapidly, and why some of the other measures of the monetary aggregates may be more accurate reflections of what has been happening in the real economy. The abnormally high rates of return available on interest-bearing bank deposits have increased their share of sterling M3 from 38% to 63%. This is one of the unfortunate and unpredictable consequences of high interest rates.

It does provide post-facto justification for the reduction of MLR on November 24, and it also points the way to a further reduction of one point in January, and another point in February/March.

I have marked some of the relevant passages.

Kenneth Baker
KENNETH BAKER, MP
enc

The economic policy announcements of November 24 were made just after this Forecast Release had gone to press. They will be discussed in the December Forecast Release.

THE MONETARY CONUNDRUM

David Smith

The broad money supply, sterling M3, has grown by 14.1 per cent (ie an annual rate of over 30 per cent) over the past six months. Over the same period the narrow money supply definition (M1) has increased by only 4.4 per cent, while the difference between the two money supply measures — broadly speaking, the interest bearing component of sterling M3 — has grown by no less than 23.1 per cent. The real economy is showing all the signs of a severe monetary squeeze with stocks and imports falling rapidly, while the balance of payments and the exchange rate are exceptionally strong. Over the past six months, industrial production (excluding North Sea oil) has fallen by 7.9 per cent while wholesale prices have risen by only 4.2 per cent. Thus, there is a double conundrum: the sharply different growth trends in M1 and sterling M3, and the contrast between the explosive growth of sterling M3 and the subdued behaviour of the real economy.

One possible answer to this puzzle, spelt out in more detail in the following pages of this Forecast Release, is that the rate of interest being paid on the interest-bearing component of sterling M3 is now abnormally high. Consequently, the asset demand for the interest-bearing component of sterling M3 is exceptionally large, with the result that both the non-interest-bearing component of the money stock (ie M1) and the real economy are being squeezed. Under these circumstances, the short-run behaviour of sterling M3 may not be an entirely reliable guide to the behaviour of the real economy.

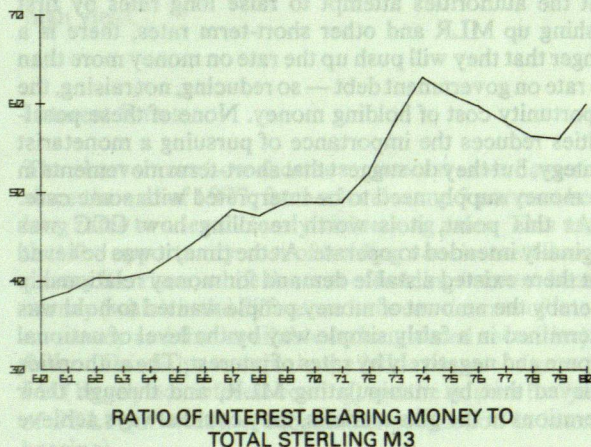
The Changing Composition of Sterling M3

The present importance of the interest-bearing component of sterling M3 reflects two factors; one short-term, one long-term. The short-term factor is the abnormally high level of current short-term interest rates, especially when compared to the rates obtainable on government debt. The longer-term development has been the changing composi-

tion of the money stock, particularly since the introduction of Competition and Credit Control (CCC) in 1971. For the first time, CCC allowed the clearing banks to compete for deposits on equal terms with the rest of the banking system. One consequence was that the clearing banks started offering their larger customers the attractive rates of interest that were previously only available to very large depositors in the wholesale money markets. After CCC, special rates generally become available on deposits of £10,000 or more. This limit has remained unchanged in money terms since the early 1970's, and therefore fallen quite sharply in real terms.

The result has been a shift in the proportion of the money stock which bears interest from only 38 per cent twenty years ago to 63 per cent in October 1980 (see chart A). Apart from the general upward trend, there are also quite distinct cycles, with the interest bearing component being largest when interest rates are themselves high. The non-interest-bearing component of the money stock broadly corresponds to the M1 definition of the money supply, (although, in fact, 15.5 per cent of official M1 consisted of interest-bearing overnight deposits in October). Thus, the current divergence between the growth of M1 and sterling M3 can be explained in terms of the abnormally high rates of return available on interest-bearing bank deposits. Within the interest-bearing component of sterling M3 there appears to have been a further shift, with the wholesale deposits element of total sterling M3 growing from just over 21 per cent in 1971 to 35-40 per cent more recently.

CHART A



Unfortunately one cannot be very precise about changes within the interest-bearing component of sterling M3 because the figures are not published. However, using the Committee of London Clearing Bankers evidence to the Wilson Committee, it is possible to make reasonable estimates. Using these figures, we have calculated the average rate of interest paid on money (the average 'own rate') by weighting the interest rates paid on different components of the money stock by the share of the corresponding deposit in total sterling M3. For this exercise, we assume that neither notes and coin nor current account pay an explicit return. It is then possible to define the average opportunity cost of holding money as the difference between the average rate of interest paid on sterling M3 and an appropriate long-term rate, in this case the 2½ per cent Consols' yield. The current perverse yield curve, with short-term rates above longer term yields, means that the average opportunity cost of holding money has recently fallen to its lowest level since CCC. Between 1971 and 1978, the opportunity cost of holding money averaged 7.2 per cent. It fell to 4.0 per cent last year, and is expected to average a mere 1.9 per cent in 1980. As Chart 4 on page 3 shows, all the important interest-bearing components of the money stock are now offering a better current yield than 20 year gilts, and the only reason that the own rate is not above that on gilts is that 37 per cent of sterling M3 still pays no explicit interest.

Consequences of the high interest rates now available on money

This growing role and attractiveness of the interest paid on money has had a number of important effects. First, it has made the money supply much more difficult to control, as the banks can now bid for private sector funds which might otherwise be invested in government debt. Second, the amount of money people wish to hold may now react positively to changes in the own rate, as well as negatively to changes in longer-term yields. Third, if the demand for money is strongly influenced by interest rates, the growth of sterling M3 may be only a poor guide to the likely consequences for the real economy. Fourth, to the extent that the authorities attempt to raise long rates by first pushing up MLR and other short-term rates, there is a danger that they will push up the rate on money more than the rate on government debt — so reducing, not raising, the opportunity cost of holding money. None of these possibilities reduces the importance of pursuing a monetarist strategy, but they do suggest that short-term movements in the money supply need to be interpreted with some care.

At this point, it is worth recalling how CCC was originally intended to operate. At the time, it was believed that there existed a stable demand for money relationship whereby the amount of money people wanted to hold was determined in a fairly simple way by the level of national income and negatively by rates of interest. The authorities believed that by manipulating MLR, and through their operations in the gilts markets, they could always achieve

the structure of interest rates required to ensure that the demand for money corresponded to the authorities' money supply target.

The Clearing Banks' willingness to bid for deposits following CCC meant that this policy faced major problems from the start. When the demand for bank credit is high, as at present, the banks will issue wholesale deposits at attractive rates. If the authorities are slow to raise yields on government debt, the banks may temporarily succeed in attracting funds that would otherwise have been invested in government debt. The authorities consequently may face short-term problems controlling the *supply* of money. In addition the use of MLR as a short term instrument for controlling the *demand* for money poses problems because a high interest rate makes money a more attractive asset. The behaviour of real output and prices is determined by the amount of money available to finance transactions. When, as at present, a high own rate means that a significant proportion of the money supply is being held as an asset, the amount available to finance transactions is reduced. One consequence that can be observed at present is the conjunction of a rapid growth in sterling M3 with all the symptoms of a major monetary squeeze. Paradoxically, once short-term interest rates start to fall, the recorded money stock could grow much more slowly, while simultaneously symptoms of excessive monetary ease began to appear in the real economy.

Implications for Monetary Targets

If variables such as the own rate on money have a large influence on the demand for money, the recorded growth of the money supply may no longer be a good indicator of the tightness of monetary policy. This may be the case at present, with the exceptionally high interest rates now available on bank deposits making the interest-bearing component of sterling M3 a particularly attractive asset to hold, and M1, most of which pays no interest, particularly unattractive. As a consequence, neither measure accurately reflects financial conditions. M3 underestimates the severity of the squeeze, and M1 overstates it. Since both measures are distorted by the 'own' rate phenomenon, there is no reason to use M1 rather than M3 as the basis for official targetry.

None of this suggests that the money supply is not important or that the rate of monetary expansion can safely be ignored. The practical implication is that the authorities should temper their adherence to monetary targets by reference to the behaviour of the real economy. The current conjunction of interest rates is a temporary phenomenon. As short-term interest rates fall, so too will the asset demand for sterling M3. As that happens the authorities should aim to achieve a sharp reduction in the rate of growth of sterling M3 and claw back the overshooting now taking place. However, the financial markets will remain under pressure as long as the PSBR continues to run well above target. It will always be difficult to control the money supply in the face of excessive public borrowing.

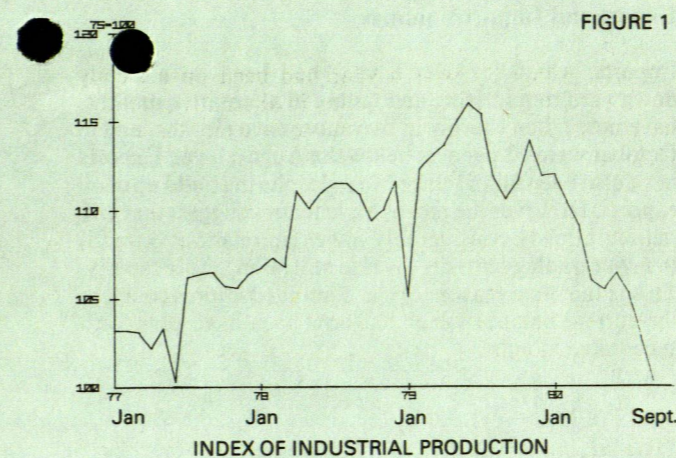


FIGURE 1

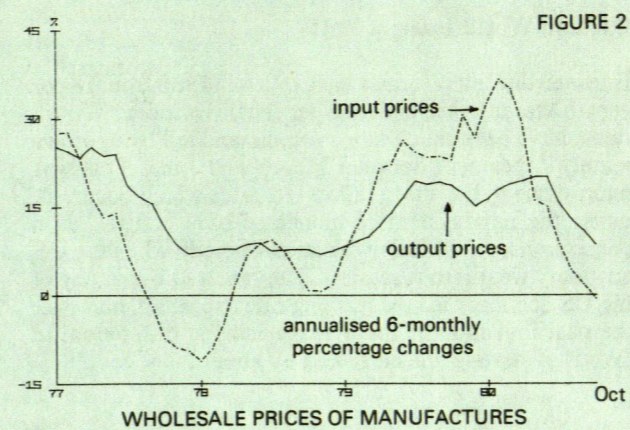


FIGURE 2

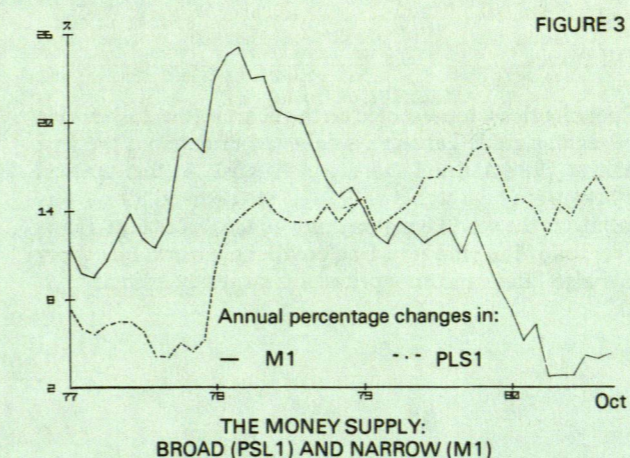


FIGURE 3

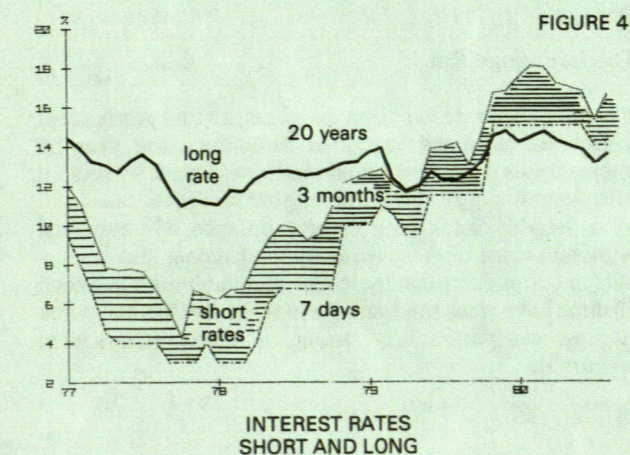


FIGURE 4

Industrial Production

Industrial production has now been on a downward trend since June 1979, and it has fallen by 13½ per cent over this period. The fall over the past two months has been especially sharp, and it is now likely that the year-on-year fall in GDP and industrial production in 1980 and 1981 will be greater than we forecast in the October *Economic Outlook*. The fall in production volumes together with the rapid deceleration of inflation discussed below means that the *value* of UK industrial output has not risen over the past 6 months.

Wholesale Prices

Wholesale output prices have risen by less than ½ per cent in each of the last 3 months, and the 6-monthly rate of inflation is now only 8½ per cent, having been 20 per cent as recently as June. This partly reflects a sharp squeeze on profit margins, but the rapid deceleration of wholesale input prices is also a major factor. The strong exchange rate and the weakness of world commodity prices mean that wholesale input prices, which rose at an annual rate of 36 per cent in the 6 months to February, have not risen at all over the past 6 months.

The Money Supply

The rate of growth of the narrowly-defined money supply (M1) is determined mainly by transactions demand, and has fallen sharply reflecting the fall in inflation and output. By contrast the broader definition (PSL1) which is partly supply-determined and includes a substantial proportion of interest-bearing deposits, has continued to grow steadily. This is due in part to the government's difficulties in controlling public sector borrowing. It also reflects the high demand for certain kinds of money, included in the wider definition (e.g. deposit accounts), that are held not for transactions purposes but as an asset. This kind of asset is particularly attractive at the present time because of its high yield.

Interest Rates

The chart shows how short term interest rates have risen, since the end of 1977, from a level some 5 per cent below long rates to a level clearly above long rates. This means that the opportunity cost of holding *non-interest-bearing* money has risen, while the cost of holding *interest-bearing* money (which is the difference between the rate of interest on money and that available on long-dated securities) has *fallen*. This helps to explain the fall in the rate of growth of M1 (largely non interest bearing) and the relative buoyancy of PSL1 (of which a substantial proportion is interest-bearing).

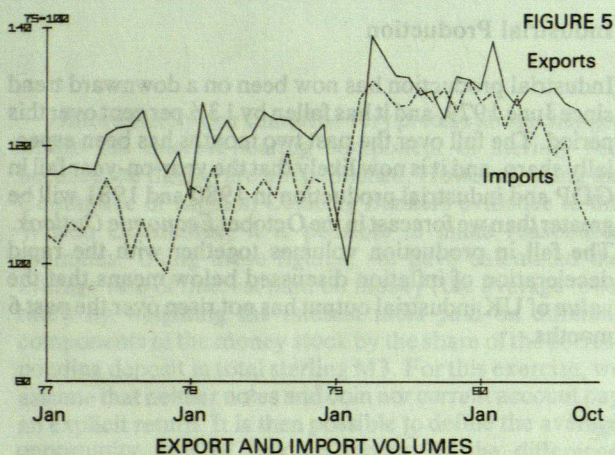


FIGURE 5

EXPORT AND IMPORT VOLUMES

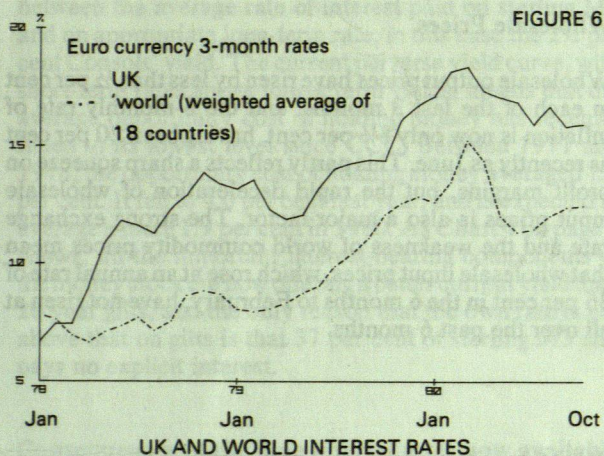


FIGURE 6

UK AND WORLD INTEREST RATES

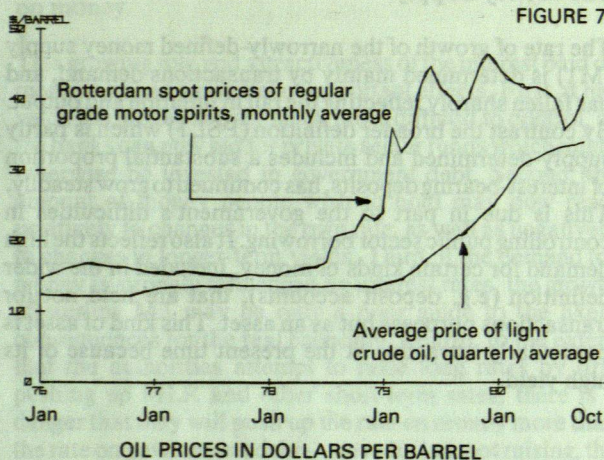


FIGURE 7

OIL PRICES IN DOLLARS PER BARREL

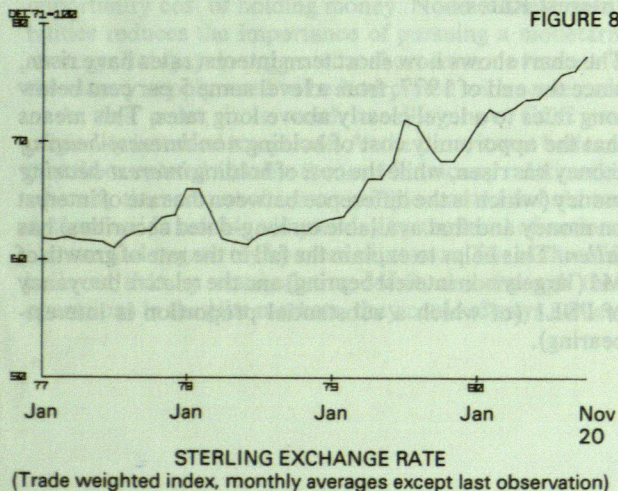


FIGURE 8

STERLING EXCHANGE RATE

(Trade weighted index, monthly averages except last observation)

Export and Import Volumes

Imports, which for over a year had been on a steady downward trend, rising and falling in alternative months, have now fallen sharply in two successive months, and in October were 12 per cent below the August level. Exports have also been falling since May, despite the build up of oil exports. However the recent trade figures suggest that UK output, already considerably lower (in relation to trend) than our trading partners', is also still falling more rapidly. This is the main reason for the continued improvement in the current balance which has now been in surplus for 6 successive months.

UK and World Interest Rates

Euro sterling interest rates have fallen in 1980 from 18 per cent in March to just under 16 per cent in October. 'World' rates, have been much more volatile and fell by approximately 4 per cent between March and June. This was mainly due to the sharp fall in US rates which occurred, under the new system of monetary base control, as a consequence of the fall in demand for credit when the US economy went into recession. The renewed buoyancy of the US economy is now pushing rates up again, and over the past four months the average interest differential in favour of sterling has narrowed by about 2 per cent.

Oil Prices

Spot oil prices, represented on the chart by the dollar price of regular grade gasoline, weakened throughout the first half of 1980 and fell sharply in August. At this time oil stocks were high world wide, and the demand for oil was falling as the world economy moved into recession. However following the Iran-Iraq conflict the world oil supply has also fallen and spot prices are currently rising.

The Exchange Rate

The exchange rate has risen every month this year except March. It has been sustained throughout the year by interest rates which are higher than world rates, by spot oil prices significantly above the long run contract prices, and by a steadily improving current balance of payments. Although some of these factors have become less favourable in certain months, there has been no month in which all three have weakened simultaneously. In October, when sterling was particularly strong, all three factors were favourable.