39) **MONEY SUPPLY AND WIDER ISSUES - PART A**

3RD NOVEMBER 1978 - 4TH DECEMBER 1978

[redacted]

Mr. Bridgeman

I am content — indeed pleased as I believe this will be in time to prevent trouble with £.

There is a figure mistyped in Table on page 4 — see X.

D.H. 3/11

CHIEF CASHIER

cc Mr Fforde
Mr Littler
Mr Middleton
Mr Hancock
Mr Wiggins
Mr Riley
Mr Hewitt

MONETARY TARGETS ETC

I attach the draft note for the No 10 seminar on this: as you will recognise it is essentially the minute which I prepared after Mr Littler's meeting on Wednesday, fleshed out a bit to make it more self-contained.

2. I should welcome comments on it, preferably by lunchtime Friday, from you and the other recipients of copies. One point we need to discuss - bringing in Mr Fforde and Mr Littler - is how far movements in the last 24 hours require us to change the size of the suggested adjustment in MLR.

3. I should be grateful if Mr Riley would check the figures particularly since there appears to be some discrepancy between the banking quarters version of the forecast and the expected outturn for the 6 months to mid-October.

4. On timing, the Chancellor is presently inclined to action on Thursday 9th: the Bank would announce the MLR change at 12.30pm and the Chancellor would announce rolling forward the target in his speech in the economic debate that afternoon. This will presumably be one of the points which the Chancellor will wish to discuss at his meeting with the Governor on Monday afternoon.

J.M.B.

J M BRIDGEMAN
3 November 1978

[redacted]

MONETARY POLICY

The Roll-forward of the Target

Note by / Bank and Treasury 7 Officials

This note discusses the options for the roll-forward of the monetary target and the possible need for monetary measures which, if they were to be taken, might appropriately be announced at the same time as the announcement of the roll-forward.

The Reasons for the Roll-forward

2. The Chancellor announced the switch to rolling targets in his Budget Speech in the following terms:-

> "I also intend to adopt a system of rolling targets, in which the target is rolled forward once every six months. This will enable me regularly to reassess progress on the monetary front in relation to developments in the rest of the economy and either to continue with the existing target range or to modify it. For example, if events have moved as I would hope on counter-inflation policy, it would be appropriate to consider in the autumn whether to lower the target range.
>
> The target range for sterling M3 for 1978-79 will be 8 per cent to 12 per cent. The corresponding level of DCE will be below the £6 billion which was set out in the Letter of Intent I wrote to the International Monetary Fund in 1976."

3. The reasons for switching to rolling targets were:-

   i. as stated, to enable the target to be varied after 6 months if there had been a change in the economic circumstances during that time;

   ii. to provide an opportunity for making a half-yearly statement on the monetary stance of the authorities, so that the market could see any particular actions in the correct context;

iii. to get over the problem which could arise with targets for individual financial years, and did arise last year, that if monetary growth became badly out of line with the target in the middle of the year, drastic action might be required to get the absolute level of the money supply back within the target range by the end of the year, while lesser action sufficient to get the underlying rate of growth back to the desired rate might be more appropriate to the overall objectives of macro-economic policy.

<u>The Basis of the Existing Target</u>

4. The range of 8-12% for the growth of £M3 in 1978-79 was chosen as being compatible with the real forecast published in the FSBR and in particular with a PSBR of £8½ billion, and an assumed rate of growth of earnings of 7% in the current pay round. On this basis it was expected that the growth of the money supply might be at the top end of the range in the first half of the year, but at the bottom in the second half, since if the earnings assumption were fulfilled, expectations about the rate of inflation would fall as the pay round progressed, and it would be relatively easy to secure substantial sales of gilts in the second half.

5. In the event, in the first half year, real growth has been somewhat faster than expected and the rate of price increase slightly slower, partly because of the appreciation of the exchange rate. Gilt sales have been higher overall than expected but there has also been a faster growth in the demand for bank credit: initially this took the form of increased bank lending, but following the imposition of the corset in early June some of this has spilt over into other forms such as acceptances.

6. We expect the growth of the money supply in banking October to be about 1¼%. This will bring the annualised rate of growth of the £M3 statistic to about 8%. But to some extent this reflects the effect of the corset causing "disintermediation" from the banking system: while we would not accept all of Greenwells' recalculation, we would accept that the underlying rate of monetary growth is currently somwhere near

the top end of the range. Looking at it another way, we currently expect the rate of monetary growth in banking November to be about ½%, largely due to a low CGBR: this would bring the rate of growth in the 3 months ending in that month to close to 12% per annum.

The Prospect

7. The October forecast shows the real economy slowing down fairly soon with little increase in real GDP between the second half of 1978 and the first half of 1979. The balance of payments on current account is expected to be, if anything, in deficit from the quarter just ended onwards. The 11% increase in earnings assumed in the main case is now a reasonably central expectation within the Treasury about the outcome - the markets' expectation may be slightly higher than that. The combined prospects on inflation and the balance of payments mean that we would expect sterling to be under pressure and requiring some support. Equally, the prospects for gilt sales from now on, in what may be a continuing period of uncertainty, are worse than we had earlier expected: the forecast includes average sales of some £250 million a month in the second half year. The expected public debt sales (gilts and other) for the year as a whole is now about £1 billion lower than expected at the time of the Budget. On this basis, the forecasts show monetary growth of some 6% absolute over the second half of this financial year, but this is only achieved with higher interest rates than in the recent past. Because of intervention in support of the exchange rate, the DCE growth may be more of a problem than £M3: DCE is expected to grow significantly faster than recently so that the outturn for the year will be about £7 billion, rather than less than £6 billion, as stated in the Budget Speech.

8. The scenario for the next 6 months is therefore one of monetary growth likely to be at the top end of the present target range, with our being badly exposed to being thrown off course by adverse developments on the pay front or worse pressure than expected on the foreign exchange side, and indeed with the risks of the latter increased by the high level of DCE.

[redacted]

Financial Forecasts (Summary)
(on "banking months basis")

£ billion

	1978/79			1979/80
	1st Half (Provisional Outturn)	2nd Half	Total	1st Half
PSBR	3.5	4.3	7.8	4.5
Less				
Gilt sales outside banks	-2.9	-1.6	-4.5	-2.0
Other public sector debt	-0.8	-1.4	-2.2	-1.6
Plus				
Bank lending to private sector and in £ to overseas	+2.7	+3.1	+5.8	+2.3
DCE	2.5	4.4	6.9	3.2
External factors	-0.5	-1.1	-1.6	-0.5
Other adjustments	-0.7	-0.4	-1.1	-0.5
Increase in £M3	1.4	2.8	4.2	2.2
%(annual rate)	8	12	10	19

(NB Figures do not all add because of roundings.)

9. Another major problem is that the PSBR for 1979-80, to be published in the Bray Forecast, is bound to cause concern in the markets, whichever variant of the October forecast is used. There will be distinct fears that such a PSBR would be incompatible with the Government's monetary targets, fears which could grow as the next Budget approaches, and so adversely affect the prospect for gilt sales in the meantime.

The Target

a. The Base Date

10. There are two decisions to be made - the choice of the base date for the new target, and the numbers for the range. While rolling forward the target by 6 months implies that the period must end with the end of banking October next year, it would be possible to specify the range either for the 12 months from October this year to October next year, or for the 18 months from April this year to October next year. Given the low rate of growth in the 6 months since April, the 12 months formulation would be slightly tighter, for the same numbers for the target expressed as an annual rate) than the 18 month one. A possible justification for adopting the latter would be to acknowledge that the recent figures are distorted by the corset, and we were avoiding that. However, the fact that it produced an easier result would be noted by the commentators, and would generate accusations of gimmickery which would detract from the intended effect of the target of reassuring markets. It could lead to questions as to whether so wide a range (ie 4% pa between top and bottom) was appropriate for an 18 month period whose end was only 12 months away and also lead to problems at the next roll-forward. The balance of argument points clearly to sticking to a 12 month period.

b. The Choice of the Target Range

11. An increase in the target range would run directly counter to all that has been said in the recent past by the Prime Minister and the Chancellor about using monetary and fiscal policy to support counter-inflation policy. The effective choice is therefore between continuing

with the present 8-12% range, or reducing the range to, say, 7-11%, as the Chancellor indicated in April that he would consider if events went as he hoped on counter-inflation policy.

12. The main argument for a lower target must be that, provided the Government were prepared to take the necessary policy measures to make it credible, it would be a stronger indication of the Government's resolve in relation to inflation. It would avoid two possible criticisms of continuing with the 8-12% range, first the fact that the Chancellor was not reducing the range because counter-inflation policy was not going as well as he had hoped, meant that he was thereby accommodating inflation, and second that it allowed an increase from the rate in the last 6 months.

13. The main difficulty is that if the target were rolled forward at 7-11%, it would make it virtually inevitable that the target for 1979-80, announced at the next Budget should be 7-11% at, or even less:this could impose a very considerable restraint on the Chancellor's freedom of action. Indeed, it is doubtful whether the market would find 7-11% credible even now unless the Chancellor gave some indication that, unless the forecast changed in the meanwhile, he would be taking action in the Budget to produce a PSBR significantly lower than that included in the Bray Forecast. Putting it another way, the 7% earnings case in the forecast shows money GDP growing by about 11% pa and the 11% earnings case shows it growing at 12% pa or slightly over: a target range for the money supply centred on 9% rather than 10% therefore involves a significantly greater degree of monetary tightness, if the difference between the intended rates of growth of money GDP and the money supply is used as an extremely crude indicator of the intended monetary stance. The possible criticism of not changing the target range referred to above could be answered on two counts. First the monetary stance would still be restrictive, in terms of comparing the expected growth of money GDP in the 7% earnings case with the permitted growth of the money supply, and the Government did not want to be more restrictive than that, unless and until developments on the pay side meant that further weight had to be put on that leg of the Counter-Inflation Tripos. Second, the adoption of the October 1978 base meant

that the 8-12% range now adopted would involve some tightening since the absolute levels of the money supply implied would be below those implied by the 8-12% range announced in the Budget.

14. Overall, it would appear that the Government is more likely to gain credit for its resolve in respect of monetary policy from announcing a target range of 8-12% which will probably appear credible, and is supported by any immediate monetary measures required to give effect to it, than from a tighter target which would probably only be made credible in relation to the PSBR forecast by some commitment, sooner rather than later, to cut that PSBR by fiscal action in the next Budget.

Immediate Supporting Measures

15. The fact that the underlying rate of growth of the money supply at present appears to be about 12%, compared with the 10% middle of the recommended range, points to the need for some action to counteract this and to bring it back towards the mid-point of the range.

16. Two courses of action appear to be ruled out. There is no case for restrictive fiscal action at this stage in relation to the forecast state of the economy. Moreover, quite apart from the economics, the politics are clearly against any further fiscal action this year unless and until there is a serious breakdown on the pay side.

17. Equally, we could not recommend a tightening of the corset (to put it formally, reducing the guideline for the rate of growth of interest bearing eligible liabilities under the Supplementary Special Deposit scheme). This has to be regarded as a fairly unsatisfactory "safety-net" on the monetary side. Tightening it would probably just add to the distortions without having much effect on the underlying monetary situation: the instrument is probably taking as much weight now as it can reasonably bear. The market are well aware of its limitations and would not find a change very reassuring - quite possibly the reverse.

18. That leaves a change in interest rates. The movement in market interest rates, with the 3 month rate already nearly 11½%, means that on normal grounds an increase in MLR of at least1½% is already required to bring it back into line with the market, to make it an effective rate again. (If the roll-forward had not been imminent, there would have been a case for acting on it on 2 November). Our considered view is that some further tightening beyond that is almost certainly going to be necessary, and the question is whether to make that further increase now, as part of a package announced at the time of the roll-forward, or to defer it until later.

19. The arguments for making the discretionary policy increase now, rather than waiting until later are that:-

i. action sooner rather than later will help the credibility of the Government's overall policy stance - it will be seen to be acting effectively and speedily;

ii. insofar as action to control the monetary aggregates does feed through into inflation, it would seem desirable that it should feed through earlier rather than later;

iii. the Prime Minister has committed the Government to a three-fold attack on inflation, through direct action, through fiscal policy and through monetary policy. If at this point of time direct action is not proving as effective as might be hoped, and fiscal action is ruled out, prompt action on the monetary side will help;

iv. to the extent that action is delayed, the markets may again carry up interest rates, and the "discretionary action" by the authorities would have to be on top of that higher level: prompt action could well mean that a lower peak level of interest rates would suffice if it were reached early enough - this is one of the lessons of 1976;

v. as mentioned above we are entering into a relatively "high risk" period - in some ways it may already be upon us with the pay situation at home, the action taken last week by the United States to steady the dollar, and the uncertainties about the effect on sterling of our position in relation to the EMS.

At the present stage, it is our judgement that an increase in MLR of 2½% would be sufficient - roughly1½% to bring it into line with the market, and 1% on top of that. But the exact figuring will clearly have to be reassessed in the light of developments in the financial markets between now and the point of announcement.

20. It is impossible to be categoric about the effects on building societies. At present, their inflows are being maintained at a higher level than we would normally expect, given that there is already more than a 1% differential against them. But, even if there were no further upward movement in interest rates, there must be a strong chance that societies would decide to increase their interest rates some time in the first few months of next year. An upward move of MLR - even only to bring it into line with the market - would almost certainly bring this forward, since societies would politically want their action to be seen to be following MLR. The BSA would probably decide in December to increase rates from 1 January. It is difficult to be categoric about the likely scale of change, but there must be a strong chance that building societies would move the mortgage rate to 11%, or possibly 11½%, if MLR rose by 2 or 2½%.

<u>Timing</u>

21. We had originally envisaged that the roll-forward might be announced on Thursday 16 November, to coincide with the publication of the October money supply figures, and that any complementary action should be announced at the same time. However some recent developments now point to a change next Thursday, 9 November:-

i. the economic debate is now fixed for that day, which would provide the Chancellor with a natural opportunity to set out the reasons for his choice of target;

ii. recent market movements following the US monetary package, including the changes in clearing bank base rates, may make it difficult to delay beyond the 9th a change in MLR at least to bring it into line with the markets;

iii. the market pressure could be increased by the October eligible liability and clearing bank figures, to be published on Tuesday 7th, which will give a clear lead to the October money supply figures;

iv. even if it were possible to delay, there would be a risk that market rates would continue to drift upwards in uncertain conditions, so that by the 16th a larger increase would be needed to get the same effect.

However, given the uncertainties - including developments on the pay side - it would be prudent to defer the final decision on timing until the 8th.

H M Treasury
Bank of England
3 November 1978

[redacted]

10 DOWNING STREET

THE PRIME MINISTER

Personal Minute

No. M31/77

CHANCELLOR OF THE EXCHEQUER

You said at the last seminar on monetary policy that the Treasury and the Bank of England were considering the possibilities of introducing more flexible forms of monetary targets, perhaps involving some form of rolling targets. I am sure that we should pursue these possibilities urgently and I should be grateful if you could keep me in touch with the work.

I am sending a copy of this minute to the Chancellor of the Duchy of Lancaster, the Governor of the Bank of England and Sir John Hunt.

9 November 1977

[redacted]

SECRET AND PERSONAL until 2.30pm on 9.11.78, then CONFIDENTIAL until 5.00pm on 9.11.78

Mr Williams

One change. Pl. have typed.

TREASURY
13 NOV 1978
H.F.C.S.

NEW MONEY SUPPLY TARGET

Factual

(i) The Chancellor announced in debate on Queen's Speech target for growth of sterling M3 (£M3) in year from mid-October 1978 is 8-12 per cent (same as for year from mid-April 1978).

(ii) Recent movements in monetary aggregates in Annex.

Positive

(i) New target range in effect reaffirms the Government's monetary stance, and supports the Government's other policies to reduce inflation and increase real growth.

(ii) October 1978 base means some tightening as money supply currently growing below 8-12 per cent range (full banking October figures published on 16 November but rate of first 6 months of year likely to be nearer 7 per cent per annum than 8 per cent).

(iii) CGBR in October was negative (£268m) – ie repaid to central government. See Treasury Press Release of 2.30pm on 9.11.78

(iv) Target allows for real economic growth as well as inescapable future price rises. Allows sufficient room for meeting industry's needs for finance to support the rising level of productive investment (detailed Industry Act forecast published shortly).

(v) Interest rates should fall if wage settlements [illegible] [illegible] present interest rates appropriate to current market [illegible] [illegible] the prospects and uncertainties on [illegible] [illegible].

[redacted] 12.30pm on 9.11.78
[redacted] until 5.00pm on 9.11.78

(vi) Rolling forward gives opportunity to review systematically domestic and external monetary policy and fiscal policy. There has been no change in stance of monetary policy.

(vii) Target also focuses on trend (see Chancellor's speech).

(viii) Path of DCE has been consistent with limit of £6 billion for 1978-79, as agreed with IMF.

Defensive

(i) Tighter target would require fiercer action on interest rates (or reduction in PSBR). But no economic justification for this.

(ii) Authorities pay regard to other measures of money supply (e.g. ~~Wider liquidity~~ DCE and M1). Targets for these would over-determine system and tend to confuse.

(iii) Future targets will depend on progress of economy, and especially counter-inflation policy.

(iv) Accept that lower ~~growth in recent~~ money supply growth in recent months must be contrasted with excessive growth preceding it (see Chancellor's speech).

(v) Our determination to stick firmly to the monetary guidelines (as confirmed by today's decisions on MLR and the target) will contribute towards the objective of continuing stability for the exchange rate.

MONETARY AGGREGATES: RECENT CHANGES AND OBJECTIVES

(seasonally adjusted)

	Increase since mid-April 1978			Increase in 12 months to mid-April 1978		Increase in 12 months to mid-April 1977	
	5 months*	Annual Rate	Objective	12 months	Objective	12 months	Objective
Sterling M3	2.5%	6.1%	8-12%	16.3%	9-13%	7.8%	9-13%
DCE	£1.9bn	-	£6.0bn (limit)	£4.4bn	£7.7bn (limit)	£4.6bn	£9.0bn (limit)
M1	4.5%	11.1%	-	23.5%	-	10.0%	-

* Figures for banking October published on 16 November.

[redacted]
(until after 1230pm on 9 November 1978)

INCREASE IN MLR

Factual

Increase in MLR from 10 per cent to [ ] announced by Bank at 12.30pm on Thursday 9 November.

Positive

(i) Significant part of increase validates recent increases in other short term rates.

(ii) Other rates pushed up by external uncertainties ($ exchange rate, US interest rates) as well as domestic pay prospect.

(iii) Increase slightly above market as prudent to err on side of caution by establishing a new somewhat higher level of short term interest rates (after 5pm see Chancellor's speech in Queen's Speech debate)

(iv) Interest rates should fall if wage settlements kept to 5 per cent (after 5pm see Chancellor's speech in Queen's speech debate).

(v) Output and employment would be worse if we surrendered to inflation (see Chancellor's Mansion House speech).

(vi) New monetary target to be announced in Chancellor's speech this afternoon (see separate brief).

Defensive

(i) As today's rise shows, Government ready to use all monetary instruments to make sure (monetary) targets are kept.

[redacted]

[redacted] 9 November 1978)

(ii) Changes in MLR unlikely in themselves to have a major impact on investment and real activity. Upward and downward adjustments inevitable as conditions change in domestic and external financial markets.

(iii) MLR rise is sufficient adjustment of short-term rates to meet present situation.

(iv) If prospects for inflation deteriorate further, then further action, which might be fiscal or monetary, would be necessary. But if pay rises are modest some fall may be possible - see positive (iv).

(v) Can't predict effect on long term rates, but should help confidence in Government's determination to stick to counter inflation policy and maintain financial stability.

(vi) Timing and extent of change in building society rates matter for Building Societies Association, and will reflect their assessment of what is required in relation to the movement in market rates since they last decided to change rates (on 9 June, when 3 month inter bank rate $10\frac{1}{16}$%, compared with $11\frac{1}{2}$% on 8.11.78).

(vii) MLR increase announced at normal time rather than in Chancellor's speech as otherwise market would act on assumption of no increase, and incur losses. Not insult to Parliament.

[redacted]

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

21st November 1977

ROLLING MONETARY TARGETS

Thank you for your letter of 10th November asking for a paper on rolling targets.

I now attach a paper which the Treasury have prepared in consultation with the Bank. The Chancellor and Governor having discussed the matter, the present intention is that a change should be made, with the target for calendar 1978 being announced in the 1978 Budget.

The Chancellor considers that it would be desirable to explain in advance the decision to switch and the reasons for it, just leaving the actual announcement of the range for 1978 to the Budget Statement. Some of this could be done by press briefing, but the Chancellor thinks that there would probably be advantage in his taking some suitable opportunity in the New Year to set out the Government's views on the role of monetary targets, to announce the intended change to rolling targets and to explain the reasons for it.

I am sending copies of this letter to David Allen (Chancellor of the Duchy of Lancaster's Office), Ian Plenderleith (Bank of England) and Martin Vile (Cabinet Office).

(A.M.W. BATTISHILL)
Private Secretary

N.L. Wicks, Esq.

[redacted]

ROLLING TARGETS FOR MONETARY AGGREGATES

This note discusses the idea of rolling targets for monetary aggregates, in which the Prime Minister recently expressed interest. It concludes that rolling targets would be an improvement on our present arrangements, recommends making the change early next year and suggests what the main features of the system should be. The arguments and proposals would apply equally, whether the chosen aggregate were DCE or M3 or other similar variable or combination of variables. This note does not deal, however, either with the choice of variable or with the numbers which might be appropriate for 1978, which under the system suggested below would be a matter for decision as part of the Budget judgment.

The Present Situation

2. The present form of our monetary targets is the product of the particular circumstances ruling at the various times, starting in July 1976, when we have progressively adopted monetary targets. We now have

(a) a formal DCE limit specified in the Letter of Intent to the IMF; and

(b) a range of £M3 - originally described as the estimated equivalent to the DCE limit on certain assumptions about the balance of payments, and which has never been called a target range by the Chancellor, but de facto has become one

Both relate to the period of 12 banking months corresponding approximately to the financial year (i.e. from mid-April to mid-April). For the current year, the DCE limit was published in the Letter of Intent to the IMF in December, and the equivalent £M3 range was stated in the Budget.

3. The arrangement of fixing the target annually for the year just beginning or beginning in two or three months' time has a number of disadvantages:-

(i) we do not know at the time of fixing the targets for the coming year what the base will be;

[redacted]

(ii) the growth is measured from the level at one mid-April make-up day to the level at the next mid-April make-up day which means that it can be affected by fresh monthly figures at the beginning and the end of the year;

(iii) if a divergence occurs towards the end of a period, it may either be too late to correct it in the remainder of the period, or require an over-sharp reaction in order to bring it back in time;

(iv) moreover there is no ready mechanism for subsequently adjusting the target for the next year to allow for an over-shoot or under-shoot at the end of the preceding year

(v) the thrust of monetary policy over time is judged by comparing one year's target with the next: on this basis we may face in 1978-79 or 1979-80 difficulty in fixing targets which both appear consistent with a policy to reduce progressively the rate of inflation, and allow scope for sufficient increase in the growth of money and credit to allow for the expansion of real activity.

4. Montary targets, however expressed, are likely to have a role to play in macro-economic policy for at least some years to come, and it would be helpful to develop a system which would overcome some of these disadvantages. The American system of rolling targets forward has considerable attractions in principle, although in some details it would be more sensible to translate the system into terms more appropriate to the UK.

Rolling Targets

5. The rolling target system is essentially directed to avoiding the third and fourth problems listed in paragraph 3 above. Under it the target is specified for a period running into the future, but is rolled forward for a new period at a point significantly before the original period has ended. Thus, if the normal target period is 12 months, the roll forward could be after, say, 3, 4 or 6 months.

[redacted]

The new target explicitly takes account of any over-shoot or under-shoot so far, permitting either the acceptance of a once-for-all divergence, or its correction, but with a longer period allowed for correction than would be available in the remainder of the original target period.

6. The rolling target system therefore deals with the end period and carry-over problems by arranging that the authorities never get to the end of the period to which their current target applies. To that extent, it may be criticised as a soft option: indeed, it would be very important that it should not be introduced at a time, or in a way, which would enable commentators to say that the only reason for the shift was to enable the authorities to avoid taking action in respect of an over-shoot which was occurring - to do so would bring the whole system into disrepute.

7. American experience would suggest that in practice it is not quite as soft an option as it might at first sight appear. Commentators still compare what has happened over the last 12 months with what the Fed was saying 12 months ago it wanted to happen. Nevertheless, care in the timing and presentation of a change in the arrangements will be important.

Timing and Other Features

8. The timing and form of any rolling forward would have to be geared to the United Kingdom situation. Decisions here about future monetary targets have so far been linked to fiscal and other macro-economic decisions as part of overall assessments of the economy. It would seem essential that they should remain so. On the one hand the Government's fiscal stance is a major determinant of monetary conditions, and on the other hand monetary conditions, and the authorities' monetary actions, can either reinforce or nullify fiscal action, so that the two can only sensibly be considered together. Moreover, the constitutional relationship between the Chancellor and Governor, in contrast to the corresponding relationship in some other countries, makes such joint decision making both feasible and appropriate.

[redacted]

9. The natural period for any single target in a sequence of rolling targets would be 12 months. One time for decision and announcement of the targets would clearly be the Budget each year in the spring. The other date or dates in the year would need to be ones at which fiscal action could be taken, if thought necessary, and at least reviewed. This could be achieved with a roll-forward pattern of either :-

Budget - July - November; or

Budget - October/November.

On balance there would seem to be advantage in only committing the authorities to two roll-forward announcements each year, and the choice of Budget and October/November would fit in very well with the cycle of public economic forecasts and assessments.

10. The suggestions covered so far do not help with the first and second disadvantages listed in paragraph 3 above. Two additional devices could be invoked for this purpose, and both would fit well with the time-table envisaged. First, the starting-point and the finishing-point of the 12-month period could with advantage be expressed as the average of 3 months around the middle month and its anniversary 12 months later. Secondly, the starting-point could be set in the immediate past, rather than the immediate future. Putting this in specific terms, for the time-table envisaged:-

(a) The target announced in the 1978 Budget would be for the calendar year 1978, measured by the growth between the 3-month average centred on the banking make-up day January 1978 and that centred on January 1979 (the former is published on the third Thursday in March, so it would be a "known base" at any likely spring Budget date).

(b) The first roll-forward would then be announced in October/ November and would apply to the year from the 3 months average centred on July 1978 to the similar average centred on July 1979.

[redacted]

A Medium-Term Context

11. The rolling target system is almost certainly both strengthened and made more flexible if there is also specified a desired medium-term trend for the rate of growth of the monetary aggregate concerned. The existence of the medium-term target would enable the authorities to explain targets for a year by reference to that trend and to the particular circumstances of the year, including any preceding target over-shot and under-shot; the numerical assessment of the authorities' stance is not confined therefore to the figures for the particular year. This approach could well help with the fifth problem, since it might enable the targets covering, say, a period of upturn in the economy to be increased appropriately without causing concern that the authorities were relaxing their stance, and so providing for a higher rate of inflation.

12. On the other hand, given the present uncertain outlook for inflation, it may in practice be virtually impossible to fix a medium-term target, even nearer the time of the Budget. If the role of monetary policy is to continue to be seen as supporting counter-inflation policy, rather than giving it the outright monetarist role of determining the future level of inflation, the monetary targets for 1979-80 and 1980-81 cannot be invariant to what happens in wage settlements between now and the beginning of those years.

Conclusions

13. The introduction of a system of rolling targets would ease a number of awkward problems which arise on the present arrangements and does not appear to have relative disadvantages, provided that the transition is handled in such a way as to avoid criticism about the Government's immediate intentions. As far as can be foreseen, a satisfactory opportunity for making the transition should arise early next year, on the basis that the present target of April 1977 to April 1978 would be replaced at the time of the Budget by a new target representing calendar 1978 and measured as indicated above, to be replaced in its turn some 6 months later.

14. Once there is agreement in principle, it will be necessary to consider further the precise mechanics, and also whether any preliminary announcement should be made of the change of system, leaving to the Budget just the specification of the numbers.

HM TREASURY
17 November 1977

[redacted] 35/05

TREASURY
8 DEC 1978
H. F. C. S.

CHIEF SECRETARY TO THE TREASURY

MR BRIDGEMAN
MR JEREMIAH
MR DYER - PARLIAMENTARY SECTION

cc Principal Private Secretary
PS/ Financial Secretary
PS/ Minister of State
Sir Douglas Wass
Sir Lawrence Airey
Sir Anthony Rawlinson
Mr Atkinson
Mr Littler
Mr Lovell
Mr Kitcatt
Mr Unwin
Mr Rayner
PS/Inland Revenue

CHIEF SECRETARY'S SPEECH FOR DEBATE ON PAY POLICY AND SANCTIONS THURSDAY 7 DECEMBER.

Further to my minute of 1 December, the Chief Secretary would be grateful for additional material as follows:-

(i) A copy of the Contract Clause;

(ii) Copies of Acts giving the Government their discretionary powers over grants, ECGD facilities and any other measures we have used in the context of pay sanctions;

(iii) Examples of Acts put on the Statute Book by the previous Government that provided discretionary powers. We have noted the Industry Act as a useful example, but he would like some more examples, preferably including Acts introduced by Sir Geoffrey Howe.

(iv) Information on how many firms subject to pay sanctions have agreed that their names can be published and how many we have asked about this to date;

(v) A brief summary of West German "Concerted Action" approach to wage bargaining - in particular, do they give guidelines?

(vi) Brief comments on the pay assumptions made when the monetary targets were set, eg. in excess of what pay outturn would there be a monetary squeeze?

I should be grateful if Mr Bridgeman would deal with item (vi), Mr Jeremiah with items (i), (ii), (iv) and (v) (Mr Rayner already has work in hand on some of these) and Mr Dyer with item (iii).

It would be helpful to have as much of this material as possible by close of business today.

A C PIRIE

4 December 1978