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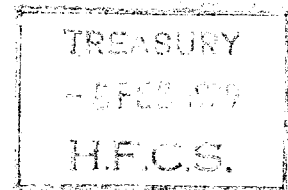
MONEY SUPPLY AND WIDER ISSUES

- PART C

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INTERNAL MONETARY TARGETS

Report by a Treasury/Bank Working Group

During the last two or three months there have been extensive discussions, both inside and outside the Government, on whether the United Kingdom should publish a target for the rate of growth of one of the monetary aggregates - usually M3. It was decided in discussions between the Chancellor and the Governor prior to the 7th June statement that it would be wrong to do so at this stage. However, it was then agreed to revert to the question of the use of internal monetary targets as an aid to decision making within Government, which had been raised earlier in the year but not carried to a conclusion. This Group were therefore given the remit of reporting on how an internal monetary target might be set and used, and on what monetary targets for the rest of 1976-77 and 1977-78 would be consistent with the Chancellor's statement of his objectives for monetary policy. We were finally asked to report on what the implications of such targets might be for the PSBR and interest rates. This report is therefore in two parts, Part I dealing with how monetary targets might be used, and Part II with the implications for policies of what could be regarded as "acceptable targets" for 1976-77 and 1977-78. (Part I is summarised in paragraph for those who wish to pass on to Part II).

Purpose of an Internal Monetary Target

2. An internal monetary target would have distinct functions at different stages of decision making. First, when it was set as part of the determination of the overall strategy for the economy, such as is done at the time of forming the Budget judgement, it would be



an opportunity for the Chancellor and the Governor to consider explicitly the monetary consequences of other macro-economic policies, to decide whether they were acceptable, and whether the balance which had been struck in preparing the forecast between containing the money supply and interest rates was correct. Subsequently, it could be used in at least some of the succession of monetary policy decisions which have to be taken between major macro-economic reassessments, such as open market tactics and tap stocks, calls for special deposits and setting IBEL's guidelines when the "corset" is in operation. Finally, if it proved impossible to keep to the target with the use of monetary controls on the scale which had been foreseen at the time of the last macro-economic assessment, it would act as an advance warning that there was a need to reconsider that reassessment, and possibly to take fiscal action.

The Setting of the Target

3. The setting of a monetary target can only usefully be done as part of the determination of the overall stance of macro-economic policy, such as customarily takes place at the time of the Budget and the occasion of the other NIF forecasts during the year. This linkage is both desirable and inevitable. Monetary objectives are not ends in themselves, but means of achieving the major objectives of macro-economic policy such as reducing the rate of inflation, reducing unemployment, correcting the balance of payments: to a significant extent, because of the different time lags involved, what are sometimes presented as conflicts between monetary objectives and the more fundamental objectives of macro-economic policy are in reality conflicts between the latter objectives in the long term and in the short term.



Conversely, for as long as the PSBR is of the order which we have had in recent years, monetary conditions will be determined far more by "non-monetary" decisions than by the use of specific monetary policy instruments.

4. That said there are strong grounds for preferring, *ceteris paribus*, the growth path of the monetary aggregates to be relatively stable from year to year, and to be at a rate related to the secular growth of output and some view of the inevitable or acceptable level of inflation, unless one is prepared to take the position that changes in the monetary aggregates have, of themselves, no economic significance. The monetarists would argue this on the grounds set out in the recent paper by Mr Couzens. The Working Party do not accept the monetarist position, but do consider that the monetary aggregates can have some effects on subsequent levels of activity and prices, although the relationships are not well established and the lags may be long and variable. But, precisely because of this ignorance, it seems safer to assume that the risks of monetary policy being de stabilising will be minimised if the growth of the money stock is held to a fairly smooth path from year to year - this is essentially a "risk minimisation strategy in conditions of uncertainty".

5. In some years, it may be possible to adopt a monetary target in line with the "stable growth" approach without significant conflict with other objectives. But in other years, the conjunctural situation may be such that it will be necessary to strike a balance between the risks involved particularly for future policy in departing significantly from



such an approach and the costs to other objectives, at least in the short term, in adhering to it. Where this balance is struck will depend on the Chancellor's assessment at the time of the risks involved and on the relative importance which he then attaches to the various objectives.

6. The requirement to fix a monetary target as part of any overall macro-economic assessment would have the merit of institutionalising the arrangements for the monetary implications of any macro-economic policy change to be assessed and for the trade-off between monetary objectives and other objectives to be struck explicitly before the final decisions were taken. It would also ensure that the Chancellor and Governor explicitly endorsed the monetary stance emerging from the "post-decision" financial forecast - this failed to happen at the time of this year's Budget. In theory, the present arrangements for forecasts, with the financial forecast following closely on the heels of the NIF, already enable this to be done. The reasons for it not happening are in part technical - the present state of the art in forecasting, and in particular the problems of taking into account unquantifiable factors such as confidence, does not permit full iteration between the NIF and the financial forecast before the latter is finalised. They are in part fortuitous - it has not been necessary to take explicit monetary measures in recent packages. This treatment of monetary conditions very much as an "also ran", has not so far had serious consequences, because we have been at a stage in the economic cycle where a moderate growth path for the monetary aggregates could be achieved with a relatively accommodating monetary policy. But the situation is now changing: it will almost certainly be difficult to achieve an acceptable rate of growth of the monetary aggregates in 1977-78 without



either a lower PSBR or higher interest rates than would appear desirable in relation to the more immediate objectives of macro-economic policy, and it seems essential to take explicit decisions as to where the balance of advantage lies.

The Form of the Target

7. The Group would suggest that the target should be for M3, although a subsidiary target would be set for DCE, that it would be set for a year starting from a firm base period in the recent past, and that it would be "rolled forward" as part of the reassessment following each NIF, and that it would be expressed as a range on either side of a preferred figure. The reasons underlying the recommendations are set out in Annex I. They are based on the presumption that while the targets would be initially intended only for internal use, their existence might become public, quite apart from the possibility that we might have to state such targets in any letter of intent in respect of further IMF drawings.

8. No single aggregate can give a complete description of monetary conditions, nor does empirical research suggest that M3 can be more closely related to subsequent developments in the economy. But M3 has the operational advantage that it can be most directly related to the counterparts of money supply - CGBR, debt sales, bank lending to the private sector and the external deficit - which are of policy interest and which can be influenced to varying extents by Government policies. However, there are strong arguments for looking at M3 in conjunction with DCE, which differs from it primarily to the extent that external finance flows into the public and banking sectors. A situation could well develop in which a satisfactory growth rate was being achieved for M3,



only because of a worsening external position: it would then be necessary to consider how to bring DCE back to an acceptable level.

The Use of the Target

9. Monetary policy, unlike fiscal policy, requires a continuous series of ad hoc decisions from week to week (eg whether to intervene on MLR, how quickly to introduce a new tap, and what signal, if any, to give by the choice of terms) and even from hour to hour (eg how to conduct open market operations in both the gilt-edged and money markets). This means that most monetary decisions have to be taken between major reappraisals of economic policy based on full macro-economic forecasts and the evaluation of variants on those forecasts. In some market conditions the authorities may have little choice as to how they react. But in others, for example when there is an upsurge in demand for gilt-edged, there may be scope for choice, say, between the speed with which interest rates fall and the volume of debt sold during the course of the fall. In such circumstances an explicit monetary target with some prior view of the acceptable course for interest rates, might pose a useful guide.

Monitoring the Target

10. There now exist arrangements for a monthly review by Treasury and Bank officials of the most recent out-turn, and the immediate prospects for monetary conditions. This would provide a natural forum for considering developments in relation to the target, and what further monetary actions, if any, might be appropriate to bring the path closer to the target.



11. To some extent the actions taken in response to monitoring the progress against targets will have been anticipated when the forecasts were prepared - for example calls for special deposits to contain a build-up of liquidity in the banking system which had been expected. The timing of such measures has to be left to be decided in relation to market developments. To the extent that monetary measures had to go further than expected at the time of the decision on overall policy stance, in response to unforeseen developments, they would tend to be stabilising, bringing the economy back towards the intended path. For example if money supply grew more rapidly because of prices rising more rapidly than expected, the rise in interest rates taken to check the growth of money supply would also tend to be deflationary and so correct the increase in prices. (It might not be clear at the time what deviation from expectation in the underlying economy was causing the money supply to grow in this way). It would thus tend to be a fail-safe policy.

12. However, one advantage of having an internal target, rather than a published one, is that the authorities are not committed to adhering to it, regardless of the cost to other policy objectives. It would therefore be necessary to have some fairly explicit understanding at the time of setting the target of how far it would be acceptable to go in taking monetary measures to try to keep to it, without calling in question the overall economic assessment. If it appeared that it was unlikely that it would be possible to adhere to the monetary target without taking monetary measures going beyond this, it would be a signal that the economy was not developing as expected and that a wider reassessment was desirable. That reassessment might lead to a decision to accept these further measures, or to take other action, say in the



fiscal field, or to redefine the target, or some combination of those. This would, in effect, ^{be} using the growth of M3 and DCE as indicators of the state of the economy - a role which many who deny them a causal significance would be prepared to accept.

13. The variability of money supply figures from month to month, and the customary swings in gilt sales from quarter to quarter means that it would be necessary to work with three-monthly moving averages: the reappraisal would be triggered if the recent out-turn figures, and the best estimates for the next two months or so, showed that the moving average was moving away from the desired trend and that there was no reasonable prospect of bringing it back to that trend using only the acceptable range of monetary measures. [The Bank and Treasury will be examining whether there is any reasonable prospect of getting data, from at least the clearing banks, to improve the frequency and timeliness of the monetary indicators, since this would clearly improve the quality of the monitoring.]



PART II

Monetary Targets for 1976-77 and 1977-78

15. It is not possible to deduce from the existing forecasts what the monetary targets for 1976-77 and 1977-78 should be, since the external capital position is not sustainable without, at the least, some announcement soon of policy changes. Both that announcement and any resultant changes in the external capital position will have implications for domestic monetary developments. Moreover, as said above, it would be very imprudent to fix finally a monetary target out of the context of the determination of the overall stance of macro-economic policy, with some view of the PSBR that is likely to result from that stance, and of the implications for other policies of accepting that target. It is however possible to answer:

- a) what rate of growth of the monetary aggregates would be consistent with the approach outlined in paragraph above, namely that the growth of the money supply should be fairly stable and in line with the secular rate of growth of real national income and what the Government considers to be an "acceptable" rate of inflation?
- b) what rate of growth would be generally accepted publicly as being consistent with the Chancellor's own statements on monetary policy?

It is then possible to give some idea of the order of the change which would be necessary in the PSBR, or in interest rates, or both, as compared with the present forecast, in order to achieve such monetary growth targets for 1976-77, and 1977-78. This may be helpful now in giving a



view of the size of the problem which may arise over reconciliation of objectives at the time of the next Budget, and also provide some basis for those decisions, notably on public expenditure, which have to be taken well before then.

16. On the first approach, the secular trend in the gross domestic product would be of the order of 3%. Presumably, given the Chancellor's statement of his objectives for counter-inflation policy, the acceptable rate of inflation must be 7% or less. This approach would therefore point to a rate of growth of money supply not exceeding 10%. (This presumes that the income elasticity of demand for money is not far from unity). Given that the actual rate of growth obtained in the last two years was a little over 8%, those who advocate this approach might consider a 6-10% range as the desirable one for both this year and next. This is almost certainly the view held by the IMF, and some of our influential creditors, including Germany and the United States.

17. The Chancellor's statements so far on monetary policy have been deliberately drafted to avoid being equivalent to a precise monetary target, in order to avoid the drawbacks of publishing such a target. His comments on some of Sir Keith Joseph's statements have explicitly rejected the full monetarist approach, namely that the growth of the money supply in one year will be the major ^{ant}determinant of the rate of inflation a year or two later. On the other hand, he has made it quite clear that he believes that monetary conditions did fuel inflation in 1972-73 and he said in this year's Budget speech:-

"It remains my aim that the growth of the money supply should not be allowed to fuel inflation as it did under my predecessor. To this end, I aim to see that the growth of the money supply is consistent with my plans for growth and demand expressed in current prices..... After two years in which M3 has grown a good deal more slowly than money GDP, I would expect their respective growth



rates to come more into line in the coming financial year".

Although the words "consistent with" were deliberately used to avoid undue precision, it is clear that the Chancellor would face criticism that he was not achieving his own objectives if the rate of growth of the money supply either in this financial year or in next exceeded the rate of growth of money GDP by more than 2 or 3%. The respective growth rates for that in the post-Budget forecast were [13%] and [8.7%]. Because of the more rapid depreciation in sterling than expected, the revised NIF is likely to show slightly higher figures. But the Chancellor's statement that the rate of growth of the monetary aggregates should be related to his plans for the growth of money national income would point to not increasing the target on this account for this year. (This would be an example of monetary policy tending to correct deviations from the path: a slightly tighter monetary stance would seem to be an appropriate reaction to a depreciation in the exchange rate). This approach would point to a monetary target range of 10-15% for this year, and 6-10% for next year.

1976-77

18. The post Budget financial forecast showed money supply growing at 13%. This was on the assumption that interest rates would be increased progressively at the short end, in response to rising American rates, while interest rates at the long end allowed only to fall to about 12½%, in order to achieve sufficient gilt sales. At first sight this means that existing monetary policy is consistent with a monetary target of 10-15%, and so would meet the Chancellor's stated objectives, although it would be higher than might be thought appropriate by our overseas creditors. However, there are two major qualifications.



19. The first is that the moderate rate of growth of the money supply was the result of a substantial external financing through the public and banking sectors, including the reserve loss DCE, which does not include this external offset, was forecast to be £9 billion, compared with the latest estimate of £ $\left[5\frac{1}{2}\right]$ billion for 1975-76: it was this which was causing considerable concern to the IMF. It remains to be seen whether the revision of the NIF forecasts, and the effect of any announcement of policy measures will on balance improve or worsen the domestic monetary position. They could on the one hand reduce the contractionary effect of external factors, but on the other hand improve our prospects of sales of gilt-edged outside the banking sector; it is not possible to say in advance where the balance of the change would lie.

20. The second problem is a timing and presentational one. M3 has been growing recently at an annual rate of about 10%, and the signs are that this is likely to continue in the next few months. If the forecast of the growth in the financial year as a whole remains as 13%, this could mean that the rate of growth would accelerate to about 16% per annum in the second half of the financial year, and possibly even more in the last quarter. Although the Chancellor drew attention to the inevitable fluctuations in the growth of money supply from quarter to quarter, a situation might well arise in which M3 appeared to be on a distinctly rising trend towards the end of this financial year with rates which were manifestly inconsistent with the Chancellor's aim that the rate of inflation should continue to fall. If the coming forecast confirms that there is a real risk of this, it will be necessary to consider what action might be taken to avoid concern arising on the monetary front in the critical period of the run up to the next Budget



and of the discussions on whatever pay policy may follow on from the present one.

1977-78

21. The post Budget financial forecast, and its update for the visit of the IMF Mission showed a PSBR of somewhat over £12 billion, and money supply growing at about 13%, notwithstanding interest rates being maintained at very much their present levels at the long end. Such a rate of growth of the money supply, and the associated DCE of the order £11 billion, are clearly inconsistent with both what our creditors consider to be an appropriate rate of growth of the money supply, and the Chancellor's stated objectives.

22. We therefore considered a series of simulations, derived from the post Budget forecast to get some feel of what interest rates might be necessary to achieve rates of growth of M3 of 12½%, 10% and 7½% respectively if the PSBR was £12 billion, £10½ billion and £9 billion. The first combination, of M3 growing at 12½% and the PSBR of £12 billion, is essentially the existing forecast. But, since, as already mentioned, the external capital position in that forecast is not viable, it must therefore be regarded as a "theoretical construct" to act as a base for simulations, rather than as a scenario for a possible outcome.

23. The simulations are described in Annex II. Their results, in terms of the effects not only on interest rates but also on GDP and the current account of the balance of payments are summarised in the following table:



Summary of Simulations for 1977/78

PSBR		£12m	£10½m	£9m
M3 12½%	GDP	2.8%	1.5%	0.3%
	Current Account	-2.7	-1.8	-0.9
	Long Rate	13¼	11½	9¾
10%	GDP	1.8%	1.0%	-0.2%
	Current Account	-2.7	-1.8	-0.9
	Long Rate	16¾	13¼	11½
7½%	GDP	½% - 1%	0.5%	-0.7%
	Current Account	-2.7	-1.8	-0.9
	Long Rate	Very high	15	13¼

GDP: Forecast growth of real GDP, 1977, Q1 to 1978, Q1

Current account: Forecast of balance of payments current account in £'s billion.

Long rate: Average rate on 2½% consols during year.



24. It was necessary to make a number of simplifying assumptions in order to carry out the simulations, which together mean that the results should be regarded/^{only}as giving some feel for the orders of magnitude involved in the task of balancing the objectives which will have to be carried out between now and the 1977 Budget. The first arbitrary assumption which was made was in respect of the mix of measures taken to reduce the PSBR. It was assumed that this would fall as to 40% on central Government expenditure on goods and services, as to 40% on transfers to persons, and as to 20% on increases in VAT. Allowanc^{was} / made for the effect on the PSBR of changes in interest rates. Clearly, the effect would be somewhat different if the mix of measures to change the PSBR was different, but with one exception they would probably only make the odd percentage point difference to the figures given in the table. The exception would be if essentially monetary measures were taken to reduce the PSBR as opposed to tax and public expenditure measures: import deposits and some version of the investment funds could both make a substantial contribution to reducing the PSBR, without any significant demand effect.

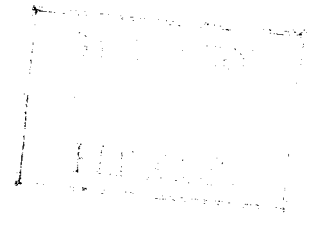
25. The forecasts of GDP allow both for the effects of changes in the PSBR and changes in interest rates. It is possible that the simulations over-state the reduction in the rate of growth of GDP on two counts. First, it is quite possible that the new NIF will show that the economy is really recovering faster than previously forecast, and that the PSBR on existing policies next year will be lower than currently forecast. If this is the case, then less corrective action on the PSBR will be required to achieve particular figures next year, and they will be applied to a higher starting point.



Moreover, the "real" side of the simulations does not allow for the effects on industrial confidence which might flow from a cut in the PSBR and the prospects of lower interest rates: they may therefore make insufficient allowance for a pick-up in industrial investment in those cases which involve a fall in interest rates compared with the base case.



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REVISED DRAFT

INTERNAL MONETARY TARGETS

Report by a Treasury/Bank Working Group

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PART I

Purpose on an Internal Monetary Target

2. An internal monetary target would have distinct functions at different stages of decision making. First, when it was set as part of the determination of the overall strategy for the economy, such as is done at the time of forming the Budget judgement, it would be an opportunity for the Chancellor and the Governor to consider explicitly the monetary consequences of other macro-economic policies, to decide whether they were acceptable, and whether the balance which had been struck in preparing the forecast between containing the money supply and interest rates was correct. Subsequently, it could be used in the succession



of monetary policy decisions which have to be taken between major macro-economic reassessments, such as open market tactics and tap stocks, calls for special deposits and setting IBEL's guidelines. Finally, if it proved impossible to keep to the target with the use of monetary controls on the scale which had been foreseen at the time of the last macro-economic assessment, it would show an immediate need to reconsider that reassessment, and possibly to take fiscal action.

The Setting of the Target

3. The setting of a monetary target can only usefully be done as part of the determination of the overall stance of macro-economic policy, such as customarily takes place at the time of the Budget and the occasion of the other NIF forecasts during the year. This linkage is both desirable and inevitable. Monetary objectives are not ends in themselves, but means of achieving the major objectives of macro-economic policy such as reducing the rate of inflation, reducing unemployment, correcting the balance of payments: to a significant extent, because of the different time lags involved, what are sometimes presented as conflicts between monetary objectives and the more fundamental objectives of macro-economic policy are in reality conflicts amongst the latter objectives and between the same objectives in the long term and in the short term. Conversely, for as long as the PSBR is of the order which we have had in recent years, monetary conditions will be determined far more by tax and expenditure decisions than by the use of specific monetary policy instruments.

4. The requirement to fix a monetary target as part of any overall macro-economic assessment would have the merit of ensuring that the monetary implications of any macro-economic policy change were assessed and the trade-off between monetary objectives and other objectives struck before the final decisions were taken. It would also ensure that the Chancellor and Governor explicitly endorsed the monetary stance emerging from the "post-decision" financial forecast - this has not always happened in the past, notably at the time of this year's Budget. On present prospects it will almost certainly be difficult to achieve an acceptable rate of growth of the monetary aggregates in 1977-78 without either a lower PSBR or higher interest rates than would appear desirable in relation to pay and employment policies, and it seems essential to take explicit decisions as to where the balance of advantage lies.



Monitoring and Use of the Target

5. There now exist arrangements for a monthly review by Treasury and Bank officials of the most recent out-turn, and the immediate prospects for monetary conditions. This would provide a natural forum for considering developments in relation to the target, and what further monetary actions, if any, might be appropriate to bring the path closer to the target.

6. Monetary policy, unlike fiscal policy, requires a continuous series of ad hoc decisions from week to week (eg whether to intervene on MLR, how quickly to introduce a new tap, and what signal, if any, to give by the choice of terms) and even from hour to hour (eg how to conduct open market operations in both the gilt-edged and money markets). This means that most monetary decisions have to be taken between major reappraisals of economic policy based on full macro-economic forecasts and the evaluation of variants on those forecasts. In some market conditions the authorities may have little choice as to how they react. But in others, for example when there is an upsurge in demand for gilt-edged, there may be scope for choice, say, between the speed with which interest rates fall and the volume of debt sold during the course of the fall. In such circumstances an explicit monetary target should provide a useful frame of reference.

7. To some extent the actions taken in response to monitoring the progress against targets will have been anticipated when the forecasts were prepared - for example calls for special deposits to contain a build-up of liquidity in the banking system which had been expected. The timing of such measures has to be left to be decided in relation to market developments. Measures taken beyond those would depend on what was thought to be cause of the divergence, in the light of the development of other indicators. One advantage of having an internal target, rather than a published one, is that the authorities are not committed to adhering to it, regardless of the cost to other policy objectives. It would therefore be necessary to have some fairly explicit understanding at the time of setting the target of how far it would be acceptable to go in taking monetary measures to try to keep to it, without calling in question the overall economic assessment. If it appeared that it was unlikely that it would be possible to adhere to the monetary target without taking monetary



measures going beyond this, it would be a signal that the economy was not developing as expected and that a wider reassessment was desirable. That reassessment might lead to a decision to accept these further measures, or to take other action, say in the fiscal field, or to redefine the target, or some combination of those.

8. The variability of money supply figures from month to month, means that it would be necessary to work with, say, three-monthly moving averages: the reappraisal would be triggered if the recent out-turn figures, and the best estimates for the next two months or so, showed that the moving average was moving away from the desired trend and that there was no reasonable prospect given expected market conditions of bringing it back to that trend using only the acceptable range of monetary measures. The Bank and Treasury are considering whether whether there would be most advantage in getting additional data, to improve the frequency and timeliness of the monetary indicators, since this would clearly improve the quality of the monitoring.

The Form of the Target

9. The Group suggest that the target should be for M3, that it would be set for a year starting from a firm base period in the recent past, and that it would be "rolled forward" as part of the reassessment following each NIF, and that it would be expressed as a range on either side of a preferred figure. The reasons underlying the recommendations are set out in Annex I. They are based on the presumption that while the targets would be initially intended only for internal use, their existence might become public, quite apart from the possibility that we might have to state such targets in any letter of intent in respect of further IMF drawings.

10. No single aggregate can give a complete description of monetary conditions, nor does empirical research suggest that M3 can be more closely related to subsequent developments in the economy. But M3 has the operational advantage that it can be most directly related to the counterparts of money supply - CGBR, debt sales, bank lending to the private sector and the external deficit - which are of policy interest and which can be influenced to varying extents by Government policies. However, in setting the target for M3, account should be taken of the prospect for monetary conditions generally, particularly for DCE because of its implications for external flows.



11. To sum up, we recommend that the main features of a system for internal monetary targets should be:-

- i. the targets would be set as part of overall assessments of macro-economic strategy, normally during the formation of the Budget judgement and the reviews of economic strategy following subsequent NIF's - this would ensure that the Chancellor specifically accepted the potential monetary implications of such decisions;
- ii. a judgement would be formed at that stage both as whether the use of monetary policy instruments underlying the forecast were acceptable next reassessment, and the extent to which it would be acceptable to go beyond that in using such instruments, if necessary, to keep the growth of the money supply within the target range without calling in question the whole economic assessment;
- iii. thereafter the monetary targets would provide a frame for reference for day to day decisions on monetary policy;
- iv. progress would be monitored regularly, and if it appeared that the rate of growth for the money supply was both moving away from the desired trend and that there was no reasonable prospect of bringing it back to that trend using only the range of monetary measures which have been indicated as acceptable, this would act as a trigger for a general review of macro-economic policy;
- v. the target would set a range for M3;
- vi. the target would be for a year, starting from the most recent period for which firm figures were available;
- vii. the target would be rolled forward at each review of macro-economic policy.