

**4) MONETARY TARGETS – PART D:
16TH NOV 1977 - 17TH NOV 1977**

35/213/01

NFCS

TREASURY
17 NOV 1977
H. F. C. S.

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MR LITTLER

cc Mr Barratt
Mr Hancock
Mrs Hedley-Miller
Mr Middleton
Mr Dixon
Mr Wiggins

Copies attached for:

Principal Private Secretary
PS/Chancellor of the Duchy
Sir Douglas Wass
Mr Airey
Mr Atkinson
Mr Couzens (OR)

MONETARY TARGETS: ROLLING TARGETS

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J. M. B.

J M BRIDGEMAN
16 November 1977

DRAFT LETTER TO:

N Wicks Esq
No 10 Downing Street

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[REDACTED]

MONETARY TARGETS 1978-79

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The Present Situation

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- 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 12 banking months corresponding approximately to the financial year (ie from mid-April to mid-April) and were set in the Budget speech.

3. This situation has a number of disadvantages:-

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- 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 freak 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. There would seem to be no reason why, if we are now presuming that monetary targets will have a role to play in macro-economic policy for at least some years to come, we should not shift onto a more permanent system which would overcome some of these disadvantages. In particular it seems worth considering how far we should adopt the American system of having targets for more than one monetary aggregate, and rolling those targets forward.

Rolling Targets

5. The rolling target system is essentially directed to avoiding the third and fourth problems. Under it the target is specified for, say, a year ahead. The target is however rolled forward after a significantly shorter period than the period for which the target was

specified - if the target period is 12 months, the roll forward could be after, say, 3, 4 or 6 months. 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 over a longer period than that for the original target, as may be considered desirable.

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9. 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.

Timing

10. 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.

11. On this basis, one time for decision and announcement of the rolled forward targets would clearly be the Budget each year. The other date or dates in the year would need to be ones at which fiscal action could be taken, if thought necessary, although it would not necessarily be so. This could be achieved with a roll forward pattern of either:-

- a. Budget, July and November; or
- b. Budget and October/November.

On balance there would seem to be advantage in only committing the authorities to two rolls forward each year - b. would fit in reasonably well with the cycle of economic forecasts and assessments, (including the "Bray" publication.)

12. It would be possible to get over the first two of the difficulties listed in paragraph 3 if the monetary targets related to, broadly, the calendar year rather than the financial year and related to the growth between 3 month averages, a year apart. On this basis the target announced in the 1978 Budget would be for the calendar year 1978, measured by the growth between the 3 months average centred on the make-up day January 1978 and that centred on January 1979. (The former would be published on 16 March 1978, so it would be a "known base" at any likely date for the Budget.) The first roll forward would be to the year from the 3 months centred on July 1978 to that centred on July 1979.

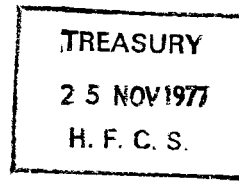
Conclusions

13. There appears to be a strong case for introducing a system of rolling targets - the first for calendar 1978 to be announced in the Budget, and to be rolled forward to mid-July 1978 - mid-July 1979 next autumn. While there would be advantage in coupling this system with an objective for the growth of, say, £M3 in the medium term, it is unrealistic to expect inflationary prospects to be sufficiently clear to make the choice of such an objective possible. But this switch must be seen and presented as a sensible means of operating a continuing system of monetary targets: it would only bring disrepute on the system to attempt to use it to get over an excess in the next few months - the attempt would be vain anyway.

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.

35/213/01

1. Mr Roche.
 2. to use psc HFC S
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cc Mr Bridgeman
 Mr Middleton
 Mr Dixon
 Mr Wiggins
 Mr King
 Mr Matthews

MR PAGE

ROLLING TARGETS

on rolling targets

We spoke earlier today. You asked whether I had any background papers which you could use to inform yourself against questions from journalists. We have no suitable papers available, but I have prepared the attached note which I hope covers the ground that you have in mind.

The note is only background briefing for yourself, and *I hope that you can avoid discussing the issue that it summarises* with the journalists. If you are asked about Treasury thinking on rolling targets you should say no more than:

1. We are thinking about how best to express monetary policy objectives in 1978
2. Before coming to a decision the Chancellor will want the benefit of the IMB's views.
3. We do not expect to announce an early decision.

m l williams

M L WILLIAMS

16 November 1977

The present situation

Our present target (a formal DCE limit, and a "range" - not a target - for £M3) relate to the 12 banking months corresponding to the financial year (ie from mid-April to mid-April). They were set in the budget speech. There are a number of disadvantages with a fixed target of this form:

1. We do not know at the time of fixing the targets for the coming year what the base will be.
2. The base figure can be affected by a freak monthly figure at the end of the previous year. This could mean that the annualised growth rate based on each month's figures throughout the year could be misleading. In addition a freak monthly figure at the end of the ^{target} year could make the apparent annual rate of growth misleading.
3. The fluctuation in the figures from month to month mean that there is every likelihood that in the earlier part of the year we will appear (when the growth rates are annualised) to be outside our target range.
4. If a divergence from a target range occurs towards the end of the year, it may be too late to correct it in the remainder of the period, or require an oversharp reaction in order to bring it back.
5. If we appear to be missing the target, the market's expectation of the authorities' likely reaction could remove any chance there is of hitting the target. In particular, if we appeared to be over-shooting the target, the expectation of increases in interest rates would affect our ability to sell gilts.
6. 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 proceeding year.
7. The thrust of monetary policy over time is judged by comparing one year's target with the next. There can therefore be difficulty in setting a new target which will appear ^{to be} consistent with a policy of progressively reducing the rate of inflation, while allowing sufficient increase in money supply ~~to~~ growth for ^{an} the expansion of real activity. For example, over the last 18 months or so the

income-velocity of EM_3 has been high by historical standards. This suggests that monetary policy has been exerting a downward pressure on activity over this period, and there could be a danger that a recovery in activity would be choked-off as a result. *But how would the market react to a target above 9-15%?*

A rolling target

The rolling target system is essentially directed to avoiding the fourth ~~and~~ ^{and sixth} fifth, ^{and} problem. A target could ^{be} specified for, say, a year ahead, but rolled forward after a significantly shorter period. The new target would explicitly take account of any over- or under- shoot, permitting either the acceptance of a once-for-all divergence or its correction, but if necessary over a longer period than for the original target. The rolling target means 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. It would therefore be important that it should be introduced at a time that would not enable commentators to say that the only reason for the shift was to allow the authorities to avoid taking action in respect of an over-shoot that was occurring. American experience, however, suggests that it is not quite such a soft option as it might appear. Commentators still compare what has happened over the last 12 months with what the ~~Fed~~ ^{Fed} was saying 12 months ago that it wanted to happen (see below).

The first three problems mentioned above could be overcome by two other devices:

1. A moving average base period: for example, a target range measured from the average of a three month period to the average of the period 12 ~~years~~ ^{months} hence would have considerable advantage in smoothing fluctuations. It would avoid a freak month being used as the base period.
2. An earlier base period: if the range was measured from a base period at some recent point in the past to a point 12 months from that time, we would have the advantage that of knowing whether our performance to date was comfortably within the chosen range, *or what policy corrective was needed. Freely monthly figures would produce less distortion in the annualised rate.*

The American experience

The recent articles in the UK press have tended to assume that "rolling targets" also means the adoption of the two devices described above. This is because they are taking the US as an example.

446
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The US has operated published monetary targets since 1974. Targets are announced for M1, M2 and M3 each quarter, although little importance is attached to the M3 figures. They are based on the average figures of the proceeding quarter and cover ~~4~~ quarters. Thus the targets fixed earlier this month were for Q3 1977 to Q3 1978. It has been the intention of the ~~US~~ Fed that successive targets should at worst be equal to the proceeding one and should in general be reduced. This has been possible to achieve in the past, but the US monetary aggregates (especially M1) are presently growing above their target ranges and it is unclear how the possible conflict between the objectives for money supply growth (insofar as it acts on inflation) and interest rates (insofar as they act on real activity) will be resolved.

Germany also publishes monetary targets, but these are not rolled forward. Instead it has expressed a target in terms of a growth for the money supply average over the year and compared with the previous year. It therefore uses the two subsidiary devices mentioned above. The problem with the German system is that an above trend rate of growth in the aggregates at the end of the base period means that the figures for the early months of the target year will appear, when moving averages are compared, to be indicating a rapid monetary growth. *There are some indications that the Germans are disenchanted with their system.*

Neither the German nor the American practice helps the authorities to cope with the seventh problem mentioned above. That can only be resolved by a resolution of technical and political differences of opinion and their proper presentation of policy to the public. ^{In the 1970s it would} ~~It would~~ be possible to introduce an additional medium term target superimposed on the annual targets.

TREASURY
23 FEB 1979
H.F.C.S. Monetary Targets, 1978-79

35/08

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This note concentrates on one issue only, which is the choice of the monetary aggregates to be used as a target next year, leaving to one side other related issues, such as rolling targets.

The present effective monetary target for 1977/78 is set in terms of £M3. The choice of this aggregate as the target has several advantages, for example in its close links with the main counterparts of monetary growth, PSBR, bank lending, etc. It does, however, have some serious disadvantages. These disadvantages arise largely because £M3 includes a large volume of wholesale-type deposits, which funds can and do, shift extensively between the banking system and other substitute assets in response to interest differentials. These interest differentials depend largely on the response of the banking system to the conjuncture. During periods of strong demand for credit the banking system is generally prepared to bid up for funds in order to meet that demand. The result of this is that the movements of M3 have not only been difficult to predict, but also, more importantly, it is, perhaps, more difficult to control the rate of growth of M3 (than any of the other main monetary aggregates), particularly by means of standard monetary measures.

Another monetary aggregate, M1, exists whose characteristics in this respect are superior. Its relationship with incomes and interest rates is closer, and, being largely non-interest-bearing, its growth can be more easily controlled by the authorities' interest rate adjustments. Yet the use of M1 by itself as a target would also have weaknesses, mainly in those aspects where M3 has strengths. The growth of M1 is not directly statistically linked to the main counterparts of credit expansion, and indeed its relationship to incomes, interest rates, etc., is estimated through an econometric relationship - and these relationships can and do change ('break down' over time, as has happened to some extent in the US. Moreover control of M1, though seemingly more reliable, can only be achieved by varying interest rates, whereas the growth of £M3 can be influenced, though less surely, by a wider range of measures, e.g. fiscal as well as monetary.

Neither £M3, nor M1, in isolation provides either a fully satisfactory indicator of monetary developments or a target for policy. At this point we also rule out any alternative aggregate, (somewhat summarily, though longer arguments can be provided): DCE is only

appropriate for a country in severe balance of payments deficit; the statistical base for using either some intermediate (between M1 and £M3) aggregate (M2) or a wider liquidity aggregate (M5) is insufficient and, besides, these aggregates tend to partake of the weaker characteristics of both M1 and £M3.

The Case for a Dual Target

Instead, this paper proposes the case for having a dual target comprising targets jointly for both M1 and M3. Since these two aggregates provide a differing but, in each case, valid indication of current monetary developments, it should follow that attention to both would provide a more balanced picture. Recent events confirm this. In the spring and early summer, some monetarist critics were criticising the authorities for excessive monetary deflation. If commentators had, however, paid more attention to the growth of M1 that charge would have been seen to be unfounded. Looking more specifically at our policy stance, more attention to M1, which turns earlier and more responsively to interest rates, would probably have made unnecessary the full extent of the upward move in interest rates in both 1973 and 1976. It follows, equally, that if there had been a target for M1 in being this year, the decline in short-term interest rates could not, without infringing the target, have been quite as steep as it has been. Looking ahead it is likely to be necessary as the recovery strengthens to prevent over-rapid monetary growth by raising interest rates. For the reasons already noted, M3 may not slow down, at least for a long time, so it could be valuable to be able to point to a more marked response in M1. In general, with a more balanced perspective, focussing on M1 as well as on M3, the authorities should be able to judge their policy response better, and perhaps earlier. In particular, the elasticity of response of M1 to interest variations should serve to dampen the extreme volatility of interest rates observed in recent years while maintaining consistency with monetary targets.

Despite the advantages of providing a better balance for policy, there is some natural reluctance to shift from a single target to a dual or multiple target. A single target is more clear-cut and concrete: the greater the number of targets the more likely at least one is to go wrong - and thus invite criticism - and the more instruments of policy have to be employed in the achievement of these targets. We appreciate these arguments, but they can be used in reverse in support of dual targets. Given the uncertainties of all

48

economic relationships, (one of the reasons for having monetary targets at all), there is some advantage in having targets which, being slightly blurred in outline, require interpretation. Put another way, it is restrictive to be forced virtually to react to any short run divergence from the single target aggregate, when appreciation of a wider range of information might allow a more measured response. Whereas some may fear that a change to a dual target could make policy more restrictive, in order to hit both targets, others (some outside commentators) will fear the reverse, that it could make policy easier, because it will allow the authorities to emphasise whichever aggregate is doing 'better'. In our view whether a switch to a dual target would be more restrictive or easier depends on how it is run, interpreted and managed. There is no necessity for it to be inherently easier or tighter, but it does give the authorities some wider area of choice.

As already noted, the adoption of M1 as a target, jointly with M3, would place greater emphasis on the control of short-term interest rates for the purpose of achieving the target. This is, of course, the main instrument used in the USA, Canada and Germany for the achievement of monetary targets. It has, however, already been noted that, because of the relative interest elasticity of M1, this could involve less, rather than more, volatile movements in these interest rates. Moreover, unlike the Americans, with a dual target we would not have to rely entirely on movements in money market rates to achieve the targets, but would continue to be able to operate with a fuller range of responses, including debt management operations.

To conclude, we believe that the case for adopting a dual target, comprising M1 as well as M3, is strong. How it would actually work in practice depends in large part on its actual interpretation, which is, perhaps, one of its advantages. If the proposal was acceptable, en principe, some further work would need to be done on the presentation of the balance between the two targets (e.g. equal weight, primus inter pares, etc.), and to ensure that there are no overlooked technical difficulties. We doubt whether there would be any major difficulties in this last respect.

35/08

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49

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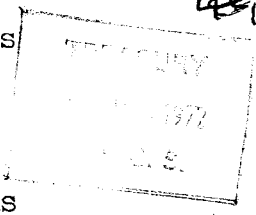
Conclusions

13. There appears to be a strong case for introducing a system of rolling targets - the first for calendar 1978 to be announced in the Budget, and to be rolled forward to mid-July 1978 - mid-July 1979 next autumn. While there would be advantage in coupling this system with an objective for the growth of, say, £M3 in the medium term, it is unrealistic to expect inflationary prospects to be sufficiently clear to make the choice of such an objective possible. But this switch must be seen and presented as a sensible means of operating a continuing system of monetary targets: it would only bring disrepute on the system to attempt to use it to get over an excess in the next few months - the attempt would be vain anyway.

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.

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[REDACTED]
MR. BRIDGEMAN

cc Sir Douglas Wass
Mr. Airey
Mr. Isaac
Mr. Middleton
Mr. Wiggins
Mr. M.L. Williams
Mr. Locke



DUAL TARGETS

I attach a copy of the paper which Mr. Fforde sent to me last night, setting out the arguments recently developed in the Bank of England in favour of dual monetary targets, £M3 and M1.

2. A few immediate comments on substance:

- I am not at all impressed by the argument for adopting dual targets in public. The attempt to balance the risk of failing to meet both targets at once against the advantage of being seen to succeed with at least one seems to me to be academic: it overlooks the fact that Government policies are not judged in such a dispassionate way.
- Retaining my preference for £M3 as the single target, I entirely accept that we ought to monitor also M1 and all other relevant indications. There could indeed be occasions on which we would want ourselves to draw public attention to one or more such indications in explanation of a divergence from the £M3 target or a reason for believing that the future evolution of £M3 would go in the desired direction (e.g. on the time-lag between M1 and £M3 on which the Bank put some weight, where that may seem in practice to operate).
- I suspect and would like to explore what seems to me to be an ambivalent attitude in the paper on the relative importance of M1 and £M3. On the one hand, there is an argument that M1 is more responsive to interest-rate control: this would be important if we were merely engaged in a charade whose object was to inspire confidence by demonstrating ability to control, rather than to get the right answer. On the other hand, I know that some in the Bank of England are more interested in M1 than £M3 for other reasons: either because they think that form of money is what matters most, or

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because they regard it as a more prompt and responsive measure of what is happening to money and will be reflected in $\text{\pounds}M3$ later. I do not share these views, although I do think we should remain interested in the course of $M1$ as one indication of things that are happening, and there may be occasions when we shall want to give weight to this indication.

3. I would aim to agree with the Bank of England: that we certainly want to pay close attention to both $\text{\pounds}M3$ and $M1$ (and other variables); that for the reason given in my first comment we shall find a single target much less embarrassing than dual targets; and that our present understanding points strongly to the selection of $\text{\pounds}M3$ as the single target, without by any means ruling out references to other variables in support of actions we may take from time to time or divergencies from the single target from time to time. On the last point, indeed, if we are moving the Chancellor to speak generally about monetary targets at some early stage in the new year, as a preface to the introduction of a rolling $\text{\pounds}M3$ target, I would think it quite sensible for him to say that there is no ideal single target, that $\text{\pounds}M3$ is his choice of the best guide, but that it is in a sense a proxy for the reality of money supply which we want to control and that in operating the target other factors and other measures of money and credit will constantly have to be borne in mind.

4. As to procedure, I think there would be advantage in pursuing our discussion with the Bank of England at a meeting between me and John Fforde, and our supporters, because my private conversations with him suggest that he will be much more receptive than some of his technical people to the political kind of argument which seems to me to be decisive against published dual targets. Perhaps when you and others have had the opportunity to study the paper we could as a preliminary have an in-house talk.


(J.G.LITTLER)

17 November, 1977

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Monetary Targets, 1978-79

This note concentrates on one issue only, which is the choice of the monetary aggregates to be used as a target next year, leaving to one side other related issues, such as rolling targets.

The present effective monetary target for 1977/78 is set in terms of £M3. The choice of this aggregate as the target has several advantages, for example in its close links with the main counterparts of monetary growth, PSBR, bank lending, etc. It does, however, have some serious disadvantages. These disadvantages arise largely because £M3 includes a large volume of wholesale-type deposits, which funds can and do, shift extensively between the banking system and other substitute assets in response to interest differentials. These interest differentials depend largely on the response of the banking system to the conjuncture. During periods of strong demand for credit the banking system is generally prepared to bid up for funds in order to meet that demand. The result of this is that the movements of M3 have not only been difficult to predict, but also, more importantly, it is, perhaps, more difficult to control the rate of growth of M3 (than any of the other main monetary aggregates), particularly by means of standard monetary measures.

Another monetary aggregate, M1, exists whose characteristics in this respect are superior. Its relationship with incomes and interest rates is closer, and, being largely non-interest-bearing, its growth can be more easily controlled by the authorities' interest rate adjustments. Yet the use of M1 by itself as a target would also have weaknesses, mainly in those aspects where M3 has strengths. The growth of M1 is not directly statistically linked to the main counterparts of credit expansion, and indeed its relationship to incomes, interest rates, etc., is estimated through an econometric relationship - and these relationships can and do change ('break down') over time, as has happened to some extent in the US. Moreover control of M1, though seemingly more reliable, can only be achieved by varying interest rates, whereas the growth of £M3 can be influenced, though less surely, by a wider range of measures, e.g. fiscal as well as monetary.

Neither £M3, nor M1, in isolation provides either a fully satisfactory indicator of monetary developments or a target for policy. At this point we also rule out any alternative aggregate, (somewhat summarily, though longer arguments can be provided): DCE is only

appropriate for a country in severe balance of payments deficit; the statistical base for using either some intermediate (between M1 and £M3) aggregate (M2) or a wider liquidity aggregate (M5) is insufficient and, besides, these aggregates tend to partake of the weaker characteristics of both M1 and £M3.

The Case for a Dual Target

Instead, this paper proposes the case for having a dual target comprising targets jointly for both M1 and M3. Since these two aggregates provide a differing but, in each case, valid indication of current monetary developments, it should follow that attention to both would provide a more balanced picture. Recent events confirm this. In the spring and early summer, some monetarist critics were criticising the authorities for excessive monetary deflation. If commentators had, however, paid more attention to the growth of M1 than charge would have been seen to be unfounded. Looking more specifically at our policy stance, more attention to M1, which turns earlier and more responsively to interest rates, would probably have made unnecessary the full extent of the upward move in interest rates in both 1973 and 1976. It follows, equally, that if there had been a target for M1 in being this year, the decline in short-term interest rates could not, without infringing the target, have been quite as steep as it has been. Looking ahead it is likely to be necessary as the recovery strengthens to prevent over-rapid monetary growth by raising interest rates. For the reasons already noted, M3 may not slow down at least for a long time, so it could be valuable to be able to point to a more marked response in M1. In general, with a more balanced perspective, focussing on M1 as well as on M3, the authorities should be able to judge their policy response better, and perhaps earlier. In particular, the elasticity of response of M1 to interest variations should serve to dampen the extreme volatility of interest rates observed in recent years while maintaining consistency with monetary targets.

Despite the advantages of providing a better balance for policy, there is some natural reluctance to shift from a single target to a dual or multiple target. A single target is more clear-cut and concrete: the greater the number of targets the more likely at least one is to go wrong - and thus invite criticism - and the more instruments of policy have to be employed in the achievement of these targets. We appreciate these arguments, but they can be used in reverse in support of dual targets. Given the uncertainties of all

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economic relationships, (one of the reasons for having monetary targets at all), there is some advantage in having targets which, being slightly blurred in outline, require interpretation. Put another way, it is restrictive to be forced virtually to react to any short run divergence from the single target aggregate, when appreciation of a wider range of information might allow a more measured response. Whereas some may fear that a change to a dual target could make policy more restrictive, in order to hit both targets, others (some outside commentators) will fear the reverse, that it could make policy easier, because it will allow the authorities to emphasise whichever aggregate is doing 'better'. In our view whether a switch to a dual target would be more restrictive or easier depends on how it is run, interpreted and managed. There is no necessity for it to be inherently easier or tighter, but it does give the authorities some wider area of choice.

As already noted, the adoption of M1 as a target, jointly with M3, would place greater emphasis on the control of short-term interest rates for the purpose of achieving the target. This is, of course, the main instrument used in the USA, Canada and Germany for the achievement of monetary targets. It has, however, already been noted that, because of the relative interest elasticity of M1, this could involve less, rather than more, volatile movements in these interest rates. Moreover, unlike the Americans, with a dual target we would not have to rely entirely on movements in money market rates to achieve the targets, but would continue to be able to operate with a fuller range of responses, including debt management operations.

To conclude, we believe that the case for adopting a dual target, comprising M1 as well as M3, is strong. How it would actually work in practice depends in large part on its actual interpretation, which is, perhaps, one of its advantages. If the proposal was acceptable, en principe, some further work would need to be done on the presentation of the balance between the two targets (e.g. equal weight, primus inter pares, etc.), and to ensure that there are no overlooked technical difficulties. We doubt whether there would be any major difficulties in this last respect.

Bank of England,
16th November 1977.

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PRINCIPAL PRIVATE SECRETARY

cc PS/Chancellor of the Duchy
PS/Minister of State
Sir Douglas Wass
Mr Airey
Mr Atkinson
Mr Couzens Mr Little -
Mr Isaac
Mr Middleton

CHOICE OF TARGET VARIABLE FOR 1978-79

Your note (not copied generally) asked for comments by lpm today on the paper just sent over by the Bank advocating a dual target approach - with M1 and £M3 as the variables - rather than just £M3.

2. This choice is not just a technical matter - it is one of considerable economic/political importance, affecting the relative priority given to monetary targets over other aspects of economic policy, and the degree of autonomy given to the Bank in monetary policy. I must recommend very strongly that the Chancellor should reject the proposal unequivocally. (I think that Sir Douglas Wass, Mr Littler and Mr Middleton would agree.)

3. The main technical pros and cons of the respective indicators were set out in the middle section of the full note on rolling targets - extract attached for ease of reference. It may be useful to go into these with the Bank at official level. We had in fact been expecting a discussion with the Bank on their econometric work on M1, which we have not yet seen, before this was discussed with the Chancellor. It was for this reason that we reserved their position on the choice of targets in the paper on rolling targets etc which I put to the Chancellor last week-end, and omitted it entirely from the version to go to No 10. However, the question of how good the econometric work is relevant to my mind not to the question of whether M1 should be a target, but how far it should be regarded as a useful lead indicator.

4. As the Chancellor will see we are sceptical about several of the Bank's points:-

- i. we doubt whether M1 is very relevant in the sense that changes in it lead to changes in incomes, rather than vice-versa;

- ii. we agree that no one indicator is a sufficient description of the monetary situation, but we would attach as much, if not more, importance to DCE and M5 than to M1;
- iii. on a monthly basis M1 can be more erratic than £M3;
- iv. it may have a role to play as a "lead indicator" but we need to be convinced on the basis of their econometric work - at first sight M1 can move in a very different way from M3: eg in 1972/73 and 1973/74 it grew by 10% and 3% while M3 grew by 27% and 25%.

5. But the two key points are:-

- i. would having two targets lead to more sensible decisions? and
- ii. would having two targets help presentationally?

6. On the first we are ^{not} convinced by what the Bank say - to the extent that M1 can give advance warning, that is an argument for it being used as a lead indicator rather than as a target. On the other hand, the implication of having a target which can only be influenced by short-term interest rates would mean that short-term interest rate policy would have to be subordinated to that target alone - the Chancellor would find himself faced with the choice of accepting the Bank's advice on short term interest rates regardless of the implications for other policies - industrial and housing policy, the exchange rate and even the M3 target - or of breaking the target. The £M3 target is not so automatic a constraint. Moreover while there are reasonably good grounds for presuming that a policy response to a divergence from a £M3 target will help economic management generally, there are no such grounds in respect of a response to an M1 one - we doubt whether M1 of itself much affects incomes, since there is a choice of instruments for dealing with it.

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7. It is clear from what we have heard that one of the main attractions to the Governor of having M1 as a target in that it will give the Bank a much stronger say in interest rate policy.

8. On the second issue, our judgement is that it makes it worse to have two targets rather than one. Governments are blamed more for not achieving targets than they are praised for achieving them. We doubt whether it will help if M3 is off target, to point to M1 being on target. (The Heath government tried that unsuccessfully - Mr Middleton is putting up some more material on that.) The inevitable costs and risks of having a target are justifiable where there are gains to confidence in the Government's policy which justify those risks and costs. Having one monetary target brings significant gains. Having two will bring little, if any, ^{more} gain in terms of confidence, but substantially increased costs.

Conclusion

9. We think that the proposal to have dual targets for M1 and £M3 is of doubtful economic validity and is presentationally disadvantageous. But most important of all, it would pre-empt the use of short-term interest rates for the management of M1, distorting economic management in a disastrous way. Tactically the Chancellor may want to let the Governor down lightly by suggesting further technical talks on the role of M1. But it seems important that these should be on its use as a lead indicator, and that the Chancellor should leave the Governor no hope that he would abdicate short-term interest rate policy to the Bank in the way that would be involved in adopting an M1 target.

J M. B.

J M BRIDGEMAN
17 November 1977