5) MONETARY TARGETS – PART E: 16TH NOV 1977 - 17TH NOV 1977

35/213/01

[redacted]

cc: Mr. Wiggins

MR BRIDGEMAN

MONETARY TARGETS 1978-79

The Chancellor would be grateful for comments on the attached paper by the Bank. I should be grateful if these could reach this office by 1 p.m. today.

K.J.

F.K. JONES
17th November, 1977

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 insufficien 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 specificall at our policy stance, more attention to M1, which turns earlier and more responsively to interest rates, would probably have made unncessary 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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17/11

Principal Private Secretary

cc Sir Douglas Wass
Mr Littler
Mr Bridgeman

MONETARY TARGETS IN 1978-79

May I add an additional comment to Mr Bridgeman's minute. I was rather amazed to read the references in the Bank's paper to 1973. Throughout this year the Bank drew the market's attention to M1 as a more reliable indicator than M3 without any noticeable impact on the trend of comment which not surprisingly latched on to the fastest growing indicator, M3. Emphasising M1 certainly cannot be said to have restrained the increase in interest rates. The rise in MLR from 7½% to 9% and again to 11½% in July was prompted primarily by the external situation together with rising interest rates abroad. Had we published targets for M1 and M3 it is difficult to believe that the result would have been much different.

To quote:

a. The Governor of the Bank of England at the Mansion House in October 1972:

> "To put our own experience in perspective, M1, the narrower definition of the money stock, which I regard as less subject to bias, has been rising in the last six months at about the same rate as in France and Western Germany."

b. The Deputy Governor in a talk intriguingly called "Does the Money Supply Matter" in April 1973:

> "M1 potentially more useful?
>
> Now it will no doubt have struck you that some, at least, of the distorting elements which I have described particularly affect deposit accounts (including therein sterling certificates of deposit), as distinct from current accounts. And this suggests that M1 which, you will remember, is confined to current accounts, might be a better indicator than M3."

c. The Governor at the Mansion House in October 1973:

> "Many commentators appear to pass judgment on monetary policy almost exclusively by reference to the behaviour of the broader definition of money supply which we call M3. This is placing more weight on a single yardstick than it is capable either in principle or in practice of bearing. .... There are other indicators, and they do not all tell

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the same story. The narrow definition of the money supply, M1, which is the main focus of attention in the United States for example, has grown much less fast."

In 1973 M1 grew by 5%, DCE by 32% and M3 by 27%.

P E MIDDLETON
17 November 1977

55/08

#61

17/11

[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 o

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 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. Monetary 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 being 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 th 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 feasibl 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.

35/08

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Principal Private Secretary

TREASURY
27 FEB
H.F.C.S.

cc Sir Douglas Wass
Mr Littler
Mr Bridgeman

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the same story. The narrow definition of the money supply, M1, which is the main focus of attention in the United States for example, has grown much less fast."

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P E MIDDLETON
17 November 1977

Sent to No 10 35/[illegible]
(cc Bank; CDL; Cabinet Office)

Chancellor
Can we send the paper at Flag A to No 10, with the covering letter at Flag B? [illegible] 18.11

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[redacted]

1. ~~SIR DOUGLAS WASS~~ I agree. AW 18/11

2. PRINCIPAL PRIVATE SECRETARY [illegible] 18/11

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

TREASURY
23 FEB 1979
H.F.C.S.

MONETARY TARGETS: ROLLING TARGETS

I attach a submission by Mr. Bridgeman, with which I agree. I have however made some further editing and reshaping changes to the paper for No.10, which I attach in this revised version (being sent separately to those who received copies of Mr. Bridgeman's submission direct).

I recommend that the paper should now be sent to No.10 under cover of the draft letter attached to Mr. Bridgeman's minute.

(J.G.LITTLER)
17 November, 1977

20. 17. 11

[redacted]

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

No 10 have asked for a paper on rolling targets. I therefore attach an edited version of thepaper which the Chancellor took at his meeting yesterday. It differs from that in

i. omitting the section on the choice of variable. As you know the Bank now want to put forward the proposition for targets for <u>both</u> M1 and £M3. We do not want to pre-empt them on this, although on both economic and political/constitutional grounds I am strongly opposed to it. Also I would hope that the choice could be resolved without a No 10 seminar;

ii. omitting the section on the IMF; and

iii. strengthening the arguments against a medium term target, in the light of yesterday's discussion.

2. I also attach a draft Private Secretary letter which, if the Chancellor approves, Mr Battishill might send to No 10. I have deliberately put in a reference to a possible speech by the Chancellor on this: we must get away from the situation in which all the extended references to the rules of the game are made by the Governor, in a way over which we have little effective control.

3. The draft assumes that the Chancellor will have confirmed with the Governor that he is content - we understand that he is.

[redacted]

4. I have sent copies of the paper (but not this minute) to Mr Fforde.

J.M.B.

J M BRIDGEMAN
16 November 1977

DRAFT LETTER TO:

Corresp. [redacted]

N Wicks Esq
No 10 Downing Street

TREASURY
23 FEB 1979
H.F.C.S.

ROLLING MONETARY TARGETS

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

2. I now attach a paper which the Treasury have prepared in consultation with the Bank. The Chancellor and Governor have agreed in principle that a change should be made, with the target for calendar 1978 being announced in the 1978 Budget.

3. 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 ~~considers~~ 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.

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

(A M W. BATTISHILL)

Internal copies with a copy of the paper to Sir D Wass; Mr. Airey; Mr. Atkinson; Mr. Littler; Mr. Bridgeman; Mr. Kaan; Mr. Middleton.

[redacted]

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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. Monetary 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.

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[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 being the whole system into disrepute.

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Timing and Other Features

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[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.

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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

35/108

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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 Littler
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.

7. It is clear from what we have heard that <u>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</u>.

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.

<u>Conclusion</u>

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 shoul 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.

JMB

J M BRIDGEMAN
17 November 1977

1) Mr Williams
2) Mr Matthews
3) Miss Boden

Mr [redacted]
Mr Bell

CHANCELLOR OF THE EXCHEQUER

35/08

TREASURY
5 JAN 1979
H. F. C. S.

Mr Bridgeman
Mr Wiggins
To see.

NOTE OF A MEETING HELD AT NO.11 DOWNING STREET AT 2.30 pm ON THURSDAY 17th NOVEMBER, 1977

Present

Chancellor of the Exchequer
Chancellor of the Duchy of Lancaster

Sir Douglas Wass
Mr Littler
Mr Scott

Governor of the Bank of England

Mr. Fforde

MONETARY POLICY AND TARGETS

In the debate in the House of Commons on 10th November the Chancellor, referring to the growth of sterling M3, stated that it was the trend which was important and that high figures for a few months did not matter provided the authorities were maintaining control so that the growth of sterling M3 subsequently came back into line with the desired trend. There was general agreement with this approach. Against that background three issues remained to be considered:

(a) the desirability of moving to some form of rolling target;

(b) the choice of target or targets; and

(c) the prospect of short run monetary problems.

Rolling Targets

2. It was agreed that to shift from fixed annual monetary targets to some form of rolling target was a desirable aim of policy. As to frequency, there were advantages in rolling forward at about six monthly rather than shorter intervals. A half-yearly timetable would fit in best with existing arrangements: the budget and autumn forecasts were

[redacted]

[redacted]

naturall change points; and more frequent changes would be less resilient to transient market pressures. The US experience of frequent changes was not altogether a happy one. There was, therefore, a general disposition in favour of a system of annual targets rolled forward at six monthly intervals . As an alternative the Chancellor of the Duchy strongly advocated serious consideration to year on year targets monitored on a regular monthly basis.

Choice of targets

3. IMF The Fund Mission were expected to concentrate again on DCE, despite its reduced suitability in conditions of balance of payments surplus. It was unlikely they would wish to suggest an M3 target, though the Managing Director himself was thought to be more sympathetic to it. No-one other than the IMF attached much importance to DCE in current circumstances. Their view need not constrain the choice of appropriate monetary targets for domestic policy.

4. Merits Of the various monetary aggregates it was agreed that sterling M3 was the most satisfactory single monetary indicator to steer by. The question was whether addition of a second indicator would on balance prove helpful or not. In favour of adopting dual targets the Governor argued that this would give added flexibility, reducing pressure on the authorities to react as soon as a sole indicator moved slightly off target. A complementary target for M1, more susceptible to control through interest rate changes, would also correct for certain weaknesses in M3. Whilst the probable movement of M1 and M3 seemed broadly compatible next year, adopting dual targets would enable the authorities to point to the total development of the monetary situation, not just to a single imperfect indicator.

/Against this,

[redacted]

Against this, the Chancellor of the Duchy argued that dual targets were a "Morton's fork". He found M1 the least convincing of the monetary aggregates. The Chancellor agreed. In his view, a second target would double the risk of being off course and invite critics to focus attention on whichever indicator happened to be performing worse at the time - as in 1973 when a moderate growth in M1 failed to deflect criticism of a rapid expansion in M3, to which the Conservative Government had eventually to respond. If two indicators converged then arguably one of them was unnecessary; if they diverged, then having dual targets could become increasingly embarrassing. Nor, in Sir Douglas Wass' view, was M1 necessarily a very good indicator of total liquidity given the size of interest-bearing near liquid funds not contained within it. A weighted-average of several monetary indicators, even if theoretically possible, would in practice be quite unrealistic as a practical target. Finally there was no expectation that the IMF would wish to see a move to dual targets.

5. Summing up this part of the discussion, the Chancellor said that having reached agreement on the desirability of moving to a rolling target next year, the choice of particular target or targets could be left for further consideration. There should be further discussion between the Bank and Treasury officials about the respective merits of the alternatives suggested, so that he could reach a considered decision in good time. Once decisions had been taken, there would be advantage in preparing the markets and the media for changes in our monetary targeting.

[redacted]

Short-term outlook

6. The recent financial forecast suggested, leaving the next Budget aside, an 11.8 per cent growth in £M3 in 1978/79, significantly below the likely corresponding change in 1977/78, on the assumption that short interest rates will rise by 3 - 3½ percentage points in the coming weeks and long rates by 1 to 1½ points. Leaving aside the realism of these assumptions, the Chancellor of the Duchy could see no way in which the Bank would be able to achieve the required gilt sales in Q1 1978 consistent with a 12½ per cent rate on 20 year Government stock. The difficulty was to ensure consistency between policy on interest rates and the Chancellor's general fiscal stance.

7. In discussion, it was generally felt that market reaction would be muted to publication of the banking October money supply figures that afternoon. The increase of 1¾ per cent brought total growth since mid-April to nearly 7 per cent, or 14¼ per cent at an annual rate, outside the 9 to 13 per cent preferred range. In the Bank's view, however, the M3 total had been largely discounted by the market: it reflected to some extent previous high inflows on which action had been taken by de-capping the exchange rate. The Governor thought the market would be more concerned at the growth in sterling bank lending within the total. (Indications were that the increase had mainly gone to agriculture, retailing and in personal borrowing rather than manufacturing which had benefited from inflows). Anticipation of a continued growth in bank lending would lead the markets to expect some movement in interest rates before long. The prospect now was that M3 would be above the 9 to 13 per cent range for a run of months, at least until January 1978.

8. Against this background, the Chancellor asked what steps he should take if bank lending kept up and the market reacted strongly to the money supply figures in December. Should we act by raising interest rates or by resorting to direct controls on banks (e.g.

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applying the corset), or by a combination of both? Sir Douglas Wass said that to the extent that the problem was generated by increased bank lending, it would need to be tackled by raising MLR, if necessary by administering a change if the market failed to take interest rates up of its own accord.

9. The Governor emphasised the urgent need to get gilt sales moving: we could not afford to allow the market to become becalmed given monetary prospects to the end of the year. In defending the exchange rate, we had allowed interest rates to fall 2 per cent below a prudent level. The Chancellor of the Duchy argued in favour of using variable rate stocks in preference to putting up rates at the long end. It would be extremely difficult for the Chancellor to reconcile a restrictive policy on interest rates with the expansionary fiscal action he had just taken: it was a contradiction in terms to stimulate the economy and then immediately restrain bank lending when the stimulus began to work.

10. The Chancellor of the Duchy then went on to suggest that the market would continue to be nervous so long as it thought the authorities were worried about the money supply. He believed the market needed to re-assured. We had created an unreal anxiety by tying our monetary targets artificially to the financial year. His solution was to move at once to rolling targets, concentrating on the moderate growth in money supply over the past twelve months and playing down the high October and prospective November/December figures. So presented, M3 would remain well within the 9 - 13 per cent target range at least until January, thus providing the sort of conditions needed to break the present stagnation in gilt sales. Against this, the Governor and Mr. Fforde both argued that a lack of firmness, if seen by the market as a sign of uncertainty on the part of the authorities, would be even more damaging to market confidence, particularly once the banklending figures were properly digested. It would be fatal to allow the market simply to drift downwards. Even if the market could be convinced, Mr. Lever's approach would merely postpone the

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point of decision to February on present forecasts.

Briefing

11. In a brief discussion before the meeting closed, there was complete agreement on the importance of co-ordinating press briefing in this area. Press reports the previous day speculating on a rise in interest rates had badly affected prospects for the new long tap and were to be deprecated.

(A.M.W. BATTISHILL)
21st November, 1977

Circulation:

Those present
Mr. Atkinson
Mr Airey
Mr Bridgeman
Mr Middleton

[redacted]

35/08 ?

1) Mr Williams to see

2) Mr Wiggins OS

own pps

[redacted]

1. **SIR DOUGLAS WASS**

2. **PRINCIPAL PRIVATE SECRETARY**

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

TREASURY
5 JAN 1979
H. F. C. S.

MONETARY TARGETS: ROLLING TARGETS

I attach a submission by Mr. Bridgeman, with which I agree. I have however made some further editing and reshaping changes to the paper for No.10, which I attach in this revised version (being sent separately to those who received copies of Mr. Bridgeman's submission direct).

I recommend that the paper should now be sent to No.10 under cover of the draft letter attached to Mr. Bridgeman's minute.

(J.G.LITTLER)
17 November, 1977

[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 o

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 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. Monetary 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 being 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 th 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 feasibl 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.

HMTREASURY.
17 November 1977