H M Treasury
Parliament Street London SW1P 3AG
Switchboard 01-233 3000
Direct Dialling 01-233 5627

P E Middleton
Deputy Secretary

10 February 1982

J Fforde Esq
Bank of England
Threadneedle Street
LONDON EC2

Dear John,

I attach a copy of a note on which we have had a preliminary discussion with Treasury Ministers. Their strong inclination is for something on the lines of Option A.

The Chancellor will certainly want to talk about this with the Governor. What I suggest is that we should have a discussion at official level prior to a meeting between the Chancellor and the Governor, before the Governor goes to India.

Yours ever
Peter.
P E MIDDLETON

Enc

This contains a revise of Annex A since the Chancellors meeting yesterday - but the same Annex B+C. There are a few slight changes to the introductory section. But this still needs looking at very closely

PEM 9/2

cc Sir D Wass
Mr Burns
Mr Monck
Mr Britton
Mr Cassell
Mrs Lomax
Mr Walters (No 10)

From: RACHEL LOMAX
Date: 5 February 1982

1. MR MIDDLETON
2. CHANCELLOR

MTFS: MONETARY GUIDELINES

Since your meeting on the MTFS last week, we have had a meeting with Professor Walters to try and resolve our differences about the appropriate growth in M1 over the next few years.

2. We argued that it would be unsafe to set a guideline for M1 which left no room for it to rise, relative to money incomes, as inflation and interest rates come down. We also suggested that Professor Walters' 5-6% growth rate implied a more ambitious objective for inflation over the period of the MTFS than the Government now has in mind. If we were to ignore the effects of falling interest rates altogether, the growth of M1 consistent with the pre-Budget forecast would be about 9 or 10% a year over the next three years.

3. Professor Walters remains opposed to publishing high M1 figures. He accepted that falling interest rates were likely to inflate M1 growth for a time, but stressed the great difficulty of making a reliable estimate of the size of this effect, and the problems of predicting M1 growth during a period of increasing financial innovation and competition in the banking system. His principal worry is that rapid M1 growth will fuel future inflation rather than reflect a change in velocity. But we may be able to still this anxiety if we can find some international precedents for the sort of shift in M1 velocity which we are predicting.

4. We could all agree about the hazards and difficulties of making annual forecasts of M1 and the need to enter a strong note of caution into whatever was said about M1 in the MTFS. Bearing in mind the preferences expressed at your last meeting, we identified three main options for further consideration:

Option A One range of numbers, covering all three aggregates, in each of the three years, based on our forecasts for £M3 and PSL2, and our estimate of M1 growth before taking account of interest rate effects. The text would explain the reasons for expecting a temporary acceleration in M1 growth outside these ranges, without being specific about the probable size or timing of this effect.

Option B Illustrative ranges for the broad aggregates only, showing some deceleration in annual growth rates over the three year period. Some less precisely quantified comment about the prospects for M1 in the text. (In the attached example, we have referred to the average growth rate in M1 over the whole 3 year period).

Option C Separate ranges for both narrow and broad aggregates, with relatively high figures for M1.

5. These options are illustrated in the three alternative versions of the mock-up attached to this note. To put the section in context, I am also attaching the preceding section on Recent Financial Conditions, which is unchanged from the last version you saw; comment on these lines would be common to all three options. The figures are, of course, still very provisional. They are based on a guess at the post-Budget outcome, given the package discussed at the second overview meeting. The central view for the monetary aggregates implied by that forecast are as follows:-

	1982/83	1983/84	1984/85
% change on previous year			
M1	11¼	13½	14
£M3	11¾	9	9
PSL2	10¼	8¼	8¼

R.L.

RACHEL LOMAX
5 February 1982

(2)

Recent Financial Conditions

10. Sterling M3 has grown more rapidly than other measures of money in each of the past three years. This followed a three year period, from 1976-79, when £M3 grew slowly relative to both broader aggregates such as PSL2 and narrower measures of money, such as M1. Short run movements in £M3 were of course seriously distorted by special factors, notably the operation and abolition of the SSD Scheme. Year to year divergencies in the rates of growth of different aggregates, and in the relationship between particular measures of money and nominal incomes have also reflecte changes in the structure of interest rates and the effects of changes in savings behaviour of total financial asset holdings. However, taking the last six years together, the growth in different measures of money has been fairly similar, with M1 averagi about 11% a year, PSL2 around 12% a year, and £M3 around 13½%.

11. The growth in £M3 at an annual rate since February 1981 is now put at 16 %, compared with a target of 6-10%. The velocity of other broad monetary aggregates has also fallen, though not so much. PSL2 rose by nearly 14% over the same period, compared with a growth in total money GDP of around 10-11%. The narrow aggregates have reflected the effect of high short term interest rates and continue to point to much tighter monetary conditions, with M1 rising by less than 9%, at an annual rate, up to February 1981. The Civil Service dispute made interpretation of all the aggregates difficult throughout the year, but it probably made little contribution to the growth over the year as a whole, adding up to 1% to £M3 and less to the other aggregates.

12. During the first half of 1981/82, the exchange rate fell back from the exceptionally high levels reached in Febrary 1981. Since th autumn of 1981 it has remained fairly firm, only slightly above its level in May 1979. The excessive rise in UK costs over the last two years, relative to other countries, has not been offset by depreciation, and the resulting loss in competitiveness has been a continuing source of financial pressure.

CONFIDENTIAL

13. In the light of the behaviour of the exchange rate and of money GDP, as well as the monetary aggregates, the evidence suggests that financial conditions have been moderately, restrictive during the last year. The growth in £M3 has been outside the target range, but some of this excess growth reflects institutional changes and is without wider economic significance. The removal of artificial constraints on money and credit markets (eg. the SSD Scheme, exchange controls) has had far-reaching effects on bank behaviour. The most obvious example has been in the area of mortgage lending but there has also been a rapid growth in other forms of lending by banks to the personal sector. To the extent that this lending is not additional, but reflects a transfer of business from other financial institutions, it will raise the growth of £M3 relative to other measures of money. While financial markets are still in the process of adjusting to these structural changes, the underlying trend in broad money may be better represented by PSL2, which includes deposits with non-bank financial institutions, as well as banks.

14. All the broad measures of money have grown more strongly relative to money GDP, than might have been expected, given the high level of interest rates and the past upward trend in velocity. The recession increased the size of the PSBR (and an allowance was made for this in the 1981 Budget) but, unlike previous recessions, the private sector's demand for bank credit has been buoyant. The growth in the broad aggregates has also been related to a very sharp rise in the private sector's holdings of net financial assets, especially in 1980/81. This may have been a reaction to uncertainty and also to the earlier erosion in the real value of financial assets by inflation. There was a large and probably involuntary fall in the ratio of financial holdings to total income, when inflation accelerated in the early 1970's. As inflation comes down this may be reversed, and the demand for liquid balances as a medium for saving rather than spending, may continue to rise relative to money incomes. If this happens monetary targets based on the past relationship between money and income would risk imposing an unduly severe squeeze on the economy.

(3)

Option A

The Monetary Guidelines

15. The Government believes that monetary conditions must remain tight enough to maintain progress in reducing inflation. In judging the rate of monetary growth which is consistent with this objective, it has taken account of the sharp deceleration in money GDP that has already taken place, and the behaviour of a range of other indicators, including the exchange rate. The Government will be looking for a rate of growth of the monetary aggregates during 1982/83 in the range 8-12%, close to the expected growth in money GDP.

16. For the later years a moderately restrictive monetary stance is likely to require a progressive deceleration in the underlying rate of monetary growth. Table 1 shows illustrative ranges for 1983/84 and 1984/85. Guidelines for these years will be set nearer the time, and will take full account of structural and institutional changes which may affect the economic significance of the different aggregates.

Ranges for Growth of the Money Stock (M1, £M3 and PSL2

	1982/83	1983/84	1984/85
% change during year	8-12 7-11	7-11 6-10	5-9 4-8

17. These ranges imply a significant reduction in recent rates of growth of the wide aggregates - PSL2 and £M3 - though they are above the illustrative ranges suggested for £M3 in last year's MTFS. The new ranges allow for the possibility that the velocity of the broad aggregates, especially £M3, will be lower than was previously thought, for the structural and institutional reasons discussed above. While the banks are still in the process of adapting to the abolition of direct controls, the growth of £M3 is likely to remain above that of PSL2.

18. The ranges for monetary growth should be interpreted as guidelines, rather than precise targets. It is not to be expected that the growth of all three aggregates will fall within these ranges in every year. During the past three years, the narrow monetary aggregates have grown much more slowly than £M3 and PSL2, largely as a consequence of high inflation and high interest rates. Steady progress in reducing inflation is likely to lead to some acceleration in the rate of growth of M1, over the next three years. As inflation and interest rates come down, there may be a shift back into non-interest bearing forms of money, and a consequent fall in M1 velocity, reversing the pattern of the recent past. On the other hand, if interest bearing transactions balances become more widespread, there could be far-reaching changes in the relative size and economic significance of narrow and broad measures of money. The size and timing of these effects is extremely uncertain, but they will be taken into account in assessing the relative performance of the different monetary aggregates.

19. Interpretation of monetary conditions and decisions about policy will continue to take account of all the available evidence, including the behaviour of the exchange rate. In setting the monetary guidelines the assumption is made that there will be no major changes in the exchange rate from year to year. The Government has no target for the exchange rate.

OPTION B

The Monetary Guidelines

15. The Government believes that monetary conditions must remain tight enough to maintain progress in reducing inflation. In judging the rate of monetary growth, which is consistent with this objective, it has taken account of the sharp deceleration in money GDP that has already taken place and the behaviour of a range of other indicators, including the exchange rate. As explained in the Budget Speech, the Government will be looking for a rate of growth in the wider measures of money - £M3 and PSL2 - within the range 9-13% and close to the expected growth in money GDP. M1 may grow at a similar rate.

16. For the later years, the intention is to maintain the counter inflationary thrust of the strategy by progressively reducing the rate of growth of the wider monetary aggregates. Table [ ] shows illustrative ranges for 1983/84 and 1984/85. Guidelines for these years will be set nearer the time and will take full account of structural and institutional changes that may affect the economic significance of the different aggregates.

Ranges for Growth of Broad Money Stock
(£M3 and PSL2)

	1982/83	1983/84	1984/85
% change during year	9-13	7-11	6-10

17. These ranges imply a significant reduction in recent rates of growth of both PSL2 and £M3 though they are above the illustrative ranges suggested for £M3 in last year's MTFS. The

....new

new ranges allow for the possibility that the velocity of the broad aggregates, especially £M3, will be lower than was previously thought, for structural and institutional reasons.

18. Steady progress in reducing inflation is likely to lead to some acceleration in the rate of growth of M1, over the next three years. High rates of inflation and high interest rates have led to a sharp rise in the velocity of M1 since 1979. As inflation and interest rates come down, there may be a shift back into non-interest bearing forms of money, and a consequent fall in M1 velocity, reversing the pattern of the last three years.

19. The average rate of growth of M1 has been about 7% a year over the last three years: Over the period 1982-85 the Government believes that an average growth rate of between

r (9-13%) 10 and 14% a year should be consistent with its medium term objectives for inflation, and the other monetary aggregates. There could be significant fluctuation around this, if interest rates change sharply, for example as a result of changes in world interest rates, and this will be taken into account in assessing monetary conditions. In view of all the uncertainties, however, the Government does not propose to suggest guidelines for the growth in M1.

20. The Government has no target for the exchange rate. As explained in the Budget Speech, the financial guidelines presuppose a broadly flat trend in the exchange rate. Interpretation of monetary conditions and decisions about policy will continue to take account of all the available evidence, including the behaviour of the exchange rate. In keeping with this, the ranges for monetary growth should be interpreted as guidelines, rather than precise targets.

OPTION C.

The Monetary Guidelines

15. The Government believes that monetary conditions must remain tight enough to maintain progress in reducing inflation. In judging the rate of monetary growth, which is consistent with this objective, it has taken account of the sharp deceleration in money GDP that has already taken place, and the behaviour of a range of other indicators, including the exchange rate. As explained in the Budget Speech the Government will be looking for a rate of growth of both broad and narrow aggregates during next year in the range 9-13%, close to, or slightly above, the expected growth in money GDP.

16. For the later years, a moderately restrictive monetary stance is likely to require a progressive deceleration in the rate of growth of the broad monetary aggregates. As inflation and interest rates come down, the recent pattern of relative monetary growth is likely to be reversed, with the narrow aggregates growing more rapidly than broader measures of money, at least for a time. The ranges for the later years in table 1 are only illustrative. Guidelines for 1983/84 and 1984/85 will be set nearer the time and will take full account of structural and institutional developments which may affect the economic significance of the different aggregates.

Ranges for Growth of the Money Stock

% change during year	1982/83	1983/84	1984/85
Narrow Money (M1)	9-13	11-15 or 9-13	11-15 or 9-13
Broad Money (£M3 and PSL2)	9-13	7-11	6-10

...17.

17. These ranges imply a significant reduction in recent rates of growth of both PSL2 and £M3, though they are above the illustrative ranges suggested for £M3 in last year's MTFS. The new ranges allow for the possibility that the velocity of the broad aggregates, especially £M3, will be lower than was previously thought, for the structural and institutional reasons discussed above. While the banks are still in the process of adapting to the abolition of direct controls, the growth of £M3 is likely to remain above that of PSL2.

18. Steady progress in reducing inflation is likely to lead to some acceleration in the rate of growth of M1 over the next three years. Since 1979, M1 has grown much more slowly than money GDP and the price level, with the result that both velocity and real M1 have been sharply squeezed. As inflation comes down and nominal interest rates are reduced, M1 can be expected to grow more rapidly than both money GDP and prices, for a time, restoring both velocity and real M1 to more normal levels. The size and timing of any shift back into non-interest bearing deposits, like the time path of interest rates, is extremely uncertain and there may be significant short run fluctuations in the rate of growth of M1, (especially since M1 tends to be a volatile series anyhow). In assessing the behaviour of M1 account will be taken of any significant changes in the terms on which transaction services are provided by the banking system.

19. The Government has no target for the exchange rate. As explained in the Budget Speech, the financial guidelines presuppose a broadly flat trend in the exchange rate. Interpretation of monetary conditions and decisions about policy will continue to take account of all the available evidence, including the behaviour of the exchange rate. In keeping with this, the ranges for monetary growth should be interpreted as guidelines, rather than precise targets.