

MONETARY POLICY

Your last meeting killed over-funding as an instrument of monetary policy. Tuesday's meeting is the funeral and the reading of the will.

If we fund less, without raising interest rates, the crucial questions are:

- Will £M₃ carry on rising rapidly?

Probably in the short run. But in the long run, companies might at last come back to the capital markets for funds, and borrow less from banks.

- Will the City care?

Not much. £M₃ now has little weight as a measure of financial conditions. The exchange rate is more important.

- Will it threaten higher inflation?

Probably not. After the crucial turning point in January, sterling continues to strengthen. A stronger pound is essential for the politically crucial objective of getting inflation well below 5% by the next Election. So we should be very cautious about reducing interest rates - but because of the exchange rate, rather than £M₃.

It then remains to decide whether the £M₃ target should formally be abandoned now, or whether a final decision should be taken at the next Budget. Publicly abandoning it now would be an unnecessary gesture. The market is at last beginning to understand the Chancellor's policy of a Nelsonian eye. He can stick with that.

But ending over-funding will not end the problem of structural shortages in the money markets. Simply turning over the existing stock of £17 billion of commercial bills as they mature guarantees money market shortages from here till kingdom come.

The Chancellor's preferred course is for nationalised industries and local authorities to raise more of their funds from the NLF so that there are lower money market shortages for any given level of gilt sales. But it is unclear whether this will be enough on its own.

So the Chancellor also needs to pursue his second option of unloading the existing stock of bills back onto the private sector. This would probably increase banks' balance sheets, but would not represent a relaxation of monetary conditions, as it would merely be a shift in ownership of lending that has already taken place.

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