

*Mr Flemming*

THE GOVERNORS

*I am afraid I have  
yet got into the habit  
of putting you on to  
the circulation list!*

*Cwm*

- Copies to: Mr.Fforde
- Mr.Dow
- The Chief Cashier
- Mr.George
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Monetary Control

I am sure it would be generally agreed that there are many aspects of this subject and of the strategy and tactics of our presentation of the issues to the public which merit early discussion. I do not want to make any particular list of issues which could and should be argued. There is the major question of the relationship of any change in our methods of control to the external position - primarily the exchange rate but also the question of the development and significance of euro-sterling. But I believe these questions are being discussed in a working party, the results of which we will see shortly.

There is, however, one issue about which I do feel concerned, and urgently concerned, and this is the choice of the target aggregate. I gather from all the papers I have read that it is common ground among the home finance side of both the Bank and the Treasury that we should stick to M3 (I am not here concerned with questions as to whether it should be sterling M3 etc.). Indeed, I understand that it is the Treasury view, perhaps shared within the Bank, that the option of changing to M1 should not even be raised in a consultative paper. I must say I am disturbed by this. The Annex of the Bank paper devoted to the choice of aggregate does not seem to me at all convincing in the case it makes for M3 and I believe, though I naturally have to speak with diffidence to the experts, that there are a number of reasons for M1. I list them below as a rag bag of very different levels of importance.

- (1) As I understand it, there are some grounds for thinking that a stable equation can be found for M1 while there is very little grounds for so thinking in relation to M3.

(2) Short-term interest rate movements might be presumed to have quicker, more certain, less potentially perverse effects on M1 than M3.

(3) The argument for M3 in terms of its counterparts seems to me less strong than we originally thought it. I am not sure how far in investigating the counterparts we can establish causality rather than accounting identities; we are extremely bad at predicting the magnitudes of the counterparts; when we have them all we do not have a very good theoretical reason for relating the total to nominal GDP. (It may be that the theoretical reasons for believing in a relationship between M1 and nominal GDP are not all that strong but at least a case can be made for the influence of transactions balances on spending).

(4) The views of thoughtful people abroad seem to me to favour M1. For what it is worth, both Wallich and Lamfalussy, whom I questioned at some length on the subject in general terms, said they would certainly plump for M1 if they had to choose one aggregate. The Canadians who are as far as I know the most successful country of all in keeping to their targets use M1 because, I understand it, they think they can control this but not a wider aggregate.

(5) A choice of M1 seems to me to lead us into fewer difficulties in relation to the development of statistically unknown leakages in the euro-markets. At least this should be true if we only use non-interest bearing M1 as presumably all the euro-balances would be interest bearing.

(6) An argument that originally influenced me in favour of M3 was that through identifiable counterparts it provided a lever for us to work on the Government to reduce the PSBR. It seems to me that with this Government there is very much less need for such a lever.

(7) A very important advantage of M1 in present and prospective circumstances seems to me the distance that one can place between the management of M1 and success in the gilts market. This could considerably reduce the weakness of the authorities' position in the face of a "buyers strike". It would

not, of course, eliminate the problem but provided one was moving short rates - either automatically or discretionally - fast enough to keep M1 on track one could be more relaxed about failures to sell stock over a longer period than we can be now when everybody knows that the results of our efforts feed directly into the monthly figure for our target variable.

No doubt counter arguments can be put to all the above. Maybe we are right to stick with M3. But it seems to me highly doubtful that we are right to go public without conceding the possibility of a change.

This question seems to me more urgent of resolution than many of the others in this general area because of the apparent degree of consensus among officials in both institutions.

Cwm

9th January 1980.