

28. 1.80

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25.1.80
YOUR DRAFT ON MONETARY POLICY

I. I have one really serious comment to make but am not so foolish as to suppose that it can be accommodated within any likely consensus. My (relatively few) less serious comments may be rather more helpful.

The serious comment relates to the first sentence of your draft. What it says is perfectly true; namely, that we take what you say about 'thrust' as our starting point. This begs the question whether we are right to do so, or right to rely unquestioningly on what has become over the past decade a Bank dogma.

It is perhaps unkind to place much precision on a very general statement about the thrust of monetary policy and its measurement. But if it means anything at all, does it not have to mean that the course of the money supply, whether of itself or in relation to money GDP, can reasonably be said on the evidence available to indicate whether 'monetary policy' is exercising a greater, or lesser, or unchanged pressure on something else (? aggregate demand); and that this applies over quite short periods that are relevant to the execution of monetary policy, rather than over the long term when some sort of correspondence between the growth of money and the growth of incomes is uninterestingly the case. One is of course aware of the quantity theory of money. One is also aware of Goodhart and Crockett, and the proposition that in times of high and fluctuating inflation movements in the money supply are a better guide than nominal interest rates to movements in real interest rates, and hence to the 'thrust' of policy. But one also has to reckon with the proven absence of any reliably stable relationship between most UK monetary aggregates and either money GDP or the rate of interest (however measured) over operationally relevant periods of time. Unending econometric research has failed to discover such relationships except perhaps, and

for a time, with regard to M1 whose economic 'meaning' is itself however of rather doubtful value. In the absence of usefully stable relationships, we cannot sustain the proposition that the course of the money supply measures anything at all with a useful degree of accuracy. This reduces us simply to setting targets in back-of-an-envelope fashion that look restrictive in relation to some forecast growth in money GDP, hoping that some right amount of good will result, and to adjusting our unpredictably-effective policy instruments whenever the target aggregate diverges notably from its desired path.

The resulting monetary policy, with its somewhat haphazard effects on nominal interest rates and the rate of exchange, tends to produce 'conflicts' which people find worrying, and not without reason. This is because the so-called 'thrust' of monetary policy is measured sensibly enough by everybody else, in terms of the perceived weight of interest rates and the perceived favourableness of the rate of exchange; and because people do not easily accept that developments in these two things should be governed, through official policy, by reference to statistically complex monetary magnitudes, single or various, that seem to bear no reliable short run relationship to anything much else.

To question, let alone deny, the usefulness of monetary aggregates in the conduct of monetary policy is unfashionable if not actually blasphemous. Nonetheless, someone had better do it; and who better than myself who had doubts about the money supply from the start? This is not however to deny the political usefulness of monetaristic thinking during an age of inflation. For it can give to orthodox deflationary policies an additional moral respectability and persuasiveness which they would not otherwise have, and thereby make them more likely to affect expectations in the right way. References to the avoidance of recourse to 'the printing presses' do help to make less unpalatable the imposition of fiscal stringency, uncomfortably high interest rates and an over-valuation of sterling that are collectively intended to deflate the economy. In all the same old ways, in the hope that the inflationary demons will be exorcised for good. Moreover, although political convenience is a matter primarily for politicians, it cannot altogether be ignored by central banks who anyway have a political position of their own where inflation is concerned. But this should not mean that we are compelled even

among ourselves, to maintain an intellectual position about the money supply which does not conform to the facts. Nor should it debar us from considering alternatives to a money supply target if continuing to pursue it gets us into an increasingly difficult technical jam. What, for example, would be the advantages and disadvantages of moving to an exchange rate target instead of a money supply target? Or, again, is it possible that we can now in practice measure or judge the real short-term rate of interest much better than we could some years ago, simply by subtracting the 6-month forecast rate of inflation from the nominal rate of interest? And if this is the case, what would be the merits of pursuing a real interest rate policy, possibly aligned with an exchange rate target, and allowing the money supply to come out in the wash? The counter-inflationary results, and the public understanding of monetary policy, might well be a great deal better. Heresy such as this, I suspect, underlies the division between the M1-ites and the M3-ists.

II. Let me now concentrate, more helpfully I hope, on the rest of your draft.

I do not dissent from your paragraph 4, though I would omit the word 'ultimately' from its position next to interest rates, but think that the distinction should be made between publicly maintaining in suspense a system of direct controls and privately maintaining up our sleeves a scheme of direct control that is not known outside. For we must recognise the problem of forestalling, which experience over the past five years should have taught us makes a suspended scheme self-imposing as and when any sustained excess of bank lending occurs. It is no use retaining something for use in an emergency if the effect of such retention is to create factitious emergencies at every available opportunity.

On your paragraph 7, I think that incomes policy deserves a mention alongside fiscal policy, even though we are not supposed at the moment to have an incomes policy, or at least admit to having one. Also, I would again omit the word 'ultimately' in reference to policy working through interest rates.

On your paragraph 10, I do not quite recognise the stronger feeling mentioned in the second sentence. As I recall the argument, it is that a substantial degree of automaticity regarding changes in the price at which cash is created would oblige investors in long-dated

gilt to 'make up their own minds' about the prices at which they might be prepared to buy rather than wait breathlessly for some package of official measures, which in the ordinary course might be delayed for some weeks. The thought then was that the market might, or might not, stabilise rather earlier under 'automaticity' than it does under 'discretion'. Perhaps, therefore, the sentence might better read -

"And there is a rather stronger feeling that such faster movement in short-term rates would be the more beneficial if they assisted prompt adjustments in longer-term rates."

The discussion of potential incompatibilities in paragraphs 12 - 14 seems to me to be very fair to the various points of view but more on a close reading than at first sight. I think it may give the reader the impression that the majority are on balance 'soft' on money when the exchange rate begins to hurt competitiveness. This may be so, of course, but my own understanding was that the majority have in mind something like the Swiss case. There, it was manifest that the deflationary effect of exchange appreciation far outweighed any inflationary effect that was likely to result from pegging the exchange rate and accepting a faster growth in money supply. This was not a 'soft' position.



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