cMr Burns!
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cc: Mr. Britton
Mr. Monck
Mr. Turnbull

MR. MIDDLETON

MONETARY TARGETS AND MONETARY CONTROL

One or two thoughts following the Friday evening meeting.

2. I think we need to give a much fuller explanation why the monetary statistics have turned out so different from what seemed likely last spring. How good a story can we tell based on stock adjustment models where

(i) the personal sector aims at a stock of real financial wealth, and

(ii) keeps a certain proportion of the stock in "liquid" assets?

(The same stock adjustment point would in principle apply to PSL2, £M3 & M1.)

3. Can we argue that personal sector holdings of £M3 are below an "equilibrium" level? If so, what sort of increase would be expected in 1981-82, given the probable course of inflation and real incomes?

4. If there is anything in this line of argument, we should in effect be saying that the MTFS looked mainly at prospective flows, on the assumption that the world remained much as it had been in the 1970s: now, having seen that we were in a rather different world, with a larger personal sector surplus and a larger company sector deficit, we were re-specifying the numbers which seemed likely to be consistent with given inflation objectives.

5. If this sort of argument will run, can we use it to explain a reasonably high "expected increase" (not a target) in M1 as

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well as, say, 10 per cent for £M3 in 1981-82?

6. If we do mention stock adjustment models, we should emphasise the uncertainty about the speed at which they operate, and the implications for the growth ranges for each of the aggregates mentioned.

7. We should try to disabuse people of the idea that there is a simple relationship between the PSBR and interest rates; to the extent we try to reduce the PSBR when the economy is in deep recession, a good deal of the reduction in the personal sector surplus is likely to be reflected in larger overseas (= higher current balance of payments surplus) and company sector deficits rather than in a lower PSFD. Moreover, even if we ignore the effects on the financial surplus/deficit, of the overseas and company sectors, the action taken to reduce the public sector's need to borrow automatically reduces the private sector's need to invest. It seems fashionable now to ignore this latter point.

8. I should like the point to be made explicitly in the Budget that, with the sectoral imbalances likely to be associated with an effective exchange rate remaining in the range [102-106], increases of

(i) [8-12] per cent in £M3

(ii) [6-14] per cent in M1

were likely to be consistent with the Government's inflation objective, i.e. 10 per cent RPI in 1981 Q4 and single figures around the turn of the year.

9. The Budget would also indicate that some further reductions in interest rates were to be expected, consistently with the reduction in inflation in prospect. To the extent that inflation fell faster/slower than the forecast suggested, the prospects for lower interest rates would be better/worse. We should, however, avoid any precise commitment to the relation-

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ships between interest rates and the inflation and effective exchange rates: too clear a commitment to short run relationships in these areas could make financial markets very unstable.

10. The specification of the monetary target would then be on the following lines:

(i) a rather faster increase in the broad monetary aggregates than the MTFS suggested;

(ii) some recovery also in the rate of growth of the narrow aggregates;

(iii) [depending on what happens in the meanwhile] some reductions to be looked for in short and long-term interest rates, but with the timing and amounts to be decided in the light of trends in inflation and the current balance of exchange rate;

(iv) the "operating range" for short-term interest rates to be set from time consistently with this approach, with the authorities leaving the markets to determine the rate within the range.

11. It is implicit in all this that, while reasserting the MTFS framework - and in particular a cyclically adjusted path for the PSBR as a percentage of GDP - we should be setting rather different numbers for monetary growth; and to the extent that commitment to a "cautious" fiscal policy would provide an alternative reassurance, we should reduce the degree of commitment to particular monetary statistics in particular years.

R.I.T.
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A.J. WIGGINS
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