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Thanks.

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MONETARY TARGETS AND A FINANCIAL PLAN: LBS ECONOMIC VIEWPOINT

In the latest issue of their Economic Outlook, which is to be published on 26th November, and has been embargoed until that date, the LBS has now included articles advocating a medium-term monetary and fiscal plan, in addition to its regular forecasts on which LADM is commenting separately. This, then, is the final published version of the earlier draft, which I reported and criticised in my earlier note of 24.10.79, with the addendum of 30.10.79 reporting that the draft would be revised. The publication of this article advocating such medium-term financial planning is not likely to cause much excitement, and the interest that it will generate will probably relate more to their views about appropriate fiscal targetry and the relationship between the PSBR and monetary growth than to their advocacy of a medium-term monetary target. For one thing the question of whether, or not, to adopt a medium-term monetary target, has effectively been shelved for the time being, it having been decided not to adopt any such medium-term targetry on 15th November. Furthermore, the LBS has now softened the paper (as Terry Burns and Alan Budd agreed that they would do), in particular the article appears less absolute and confident about the exact quantitative nature of the targets that should be set.

The actual Economic Viewpoint article discussing monetary targets and a financial (fiscal) plan is signed by Alan Budd alone, pages 11-14 (attached): however the accompanying, supporting, briefing paper on the role of the PSBR in controlling the monetary supply, pages 26-30 (attached), is signed by both Alan Budd and Terry Burns, and commentators will quickly realise that both of them are effectively jointly responsible for both papers.

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Returning to the content of the Economic Viewpoint, partly perhaps since the paper has been softened in tone, their case for having a medium-term monetary target seems less than convincing to me. The author(s) argue that a reduction in monetary growth will simply "result in a rapid rise in unemployment if it is generally feared that there is no long-term commitment to controlling inflation". They seem to believe that publishing a set of numbers would make the Government's commitment somehow more explicit and firm in itself. Since it is deeds rather than words that will ultimately convince, this argument does not seem strong to me. Moreover, and properly, the LBS now admit to some uncertainty about such questions as the future velocity of circulation, and so realise that the target rate of monetary growth might need to be adjusted for unforeseen events. But, if so, how much does the publication of dubious quantitative targets actually add to the strengthening of an underlying commitment?

One point which they make here which I thought valid is that, if one should extend a monetary target into the medium-term, it would be better to express the target in terms of an actual level of the money stock, rather than in terms of rates of growth until the target period is achieved, because of the wide range that would otherwise result from extending upper and lower percentage rates of growth far into the future. Two other minor points are worth noting. The first is that they regard M3 (£M3?) as "the preferable measure amongst those available because of its direct link with the Government's fiscal and financial policy". The second point is that they claim that the monetary overshooting in 1977/78 "was not helped by data errors that only became evident at the end of the financial year". This latter charge is, of course, wrong. There were no data errors. They are presumably confusing these with revisions to seasonal adjustments.

The second, and perhaps more interesting, part of their work is that relating the (medium-term) monetary target to a fiscal target. They certainly believe that medium-term monetary control must imply having a "medium-term" control of expenditure and tax rates, and therefore the PSBR, for that purpose. In their paper (page 13) they argue that inflation is "the ultimate objective of macro-economic policy. Provided that the policy is successful the fluctuations in the inflation rate should be small. At any rate the PSBR is not greatly sensitive to fluctuations in inflation". In consequence, they seem to believe that fiscal planning can be undertaken simultaneously in both nominal and real terms. They wish to undertake such fiscal planning in relationship to a medium-term trend. They argue that the PSBR will be a function of unforeseen and uncontrollable output variation in the short run but should be capable of control in the medium run. The PSBR, and within it Government expenditure and tax rates, should be related to the medium-term trend of monetary growth as an intermediate objective, but more fundamentally beyond that with the desired rate of inflation and the trend rate of output. Of course, they still have to deal with the problem of what happens if the expected trend rate of real output fails to occur; a point which they do not really consider sufficiently on page 13, though again they note that things can go wrong and relationships change, so that any medium-term plan needs to be capable of alteration.

In the Economic Viewpoint paper, the author(s) simply assert that the medium-term trends in the PSBR are the central dominating feature in determining the medium-term trends in monetary growth. This assertion is supposed to be supported by the further work done in the briefing paper on this subject (pages 26-30). The general idea is that in the short run, with the 'fiscal structure' determined, the PSBR varies inversely with output. But that inverse variation need not and <u>should not</u> be offset, in large part because the variation in the PSBR in response to short-term output changes is, according to their work, virtually entirely offset by changes in the other direction in public sector debt sales and bank lending. In the longer run, however, the authors claim that there is a long run stability in the relationship between debt sales and also in bank lending on the one hand and in nominal incomes on the other. So if nominal incomes and monetary growth are to be reduced, the medium-term instrument to do so must be via changes in the medium-term trend in the PSBR. The supporting evidence, however, which the authors bring forward in their briefing paper on this point seems to me to be remarkably weak. There was an apparently quite steady and stable trend movement in the ratio of public sector debt to nominal GDP from 1963 till 1975, but since then the trend has changed sharply. Their own figures show clearly that at least during the 1970s the ratio of bank lending to nominal GDP has varied very widely indeed. Their argument that there is a longer run stability to the desired ratios in which bank loans and public sector debt will be held seems remarkably shaky, and certainly not one on which an actual operational policy over the next few years could be firmly based.

In conclusion, although the Economic Viewpoint paper on Targetry has been quite successfully neutered, the supporting briefing paper on the role of the PSBR in controlling the money supply still seems to me to be rather shoddy work.

CAEG

20th November 1979.

C.A.E.Goodhart