23.10.79.

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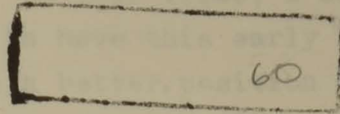
Financial Secretary

cc Chancellor of the Exchequer
Chief Secretary
Sir Douglas Wass
Sir Fred Atkinson
Sir Anthony Rawlinson
Sir Lawrence Airey
Mr Littler
Mr Bridgeman
Mr Unwin
Mr Cassell
Mr Odling-Smee
Mr Riley
Mrs Lomax
Mr Sedgwick
Mr Ridley
Mr Mower



MONETARY TARGETS AND THE FINANCIAL PLAN: LBS VIEWS

1. Alan Budd has kindly sent me the attached copy of an article to be signed by him for the next LBS Policy Viewpoint which will appear in mid November. His purpose in doing so is to check whether it makes any untoward use of the Treasury seminar. I am sure that it is all right on this account; it will be one of several pieces prepared by outsiders. Gordon Pepper is preparing a piece for the next Greenwells Bulletin and the City University are also planning to circulate a note.

2. The LBS piece is in a somewhat different category because, though he will not be s signatory, it will be generally assumed that Professor Burns has been closely associated with it and that it will correspond to the advice that he will give to the Government. You might therefore like to glance at the table on P5 which sets out the path they see for the money supply and inflation. The money supply comes down from 14% to 4% over 4 years. The corresponding PSBR is £5¾ billion by the end of the period - equivalent to 2.7% of GDP.

3. A deceleration in the money stock of this order is pretty sharp - particularly in relation to the current upward pressures. The transitional costs might be expected to be severe and there is little - if any - prospect of growth above the LBS' assumed trend rate of 1½% at the end of the period; what growth there is depends on the assumption that velocity will stay high over the plan period - a proposition which may not be very firmly based,

CMEC, 23/10"

particularly if the plan envisages taking some of the current pressure off interest rates.

4. The LBS are not however asking for comments on the text, and subject to your views, I do not propose to offer any. It is helpful to have this early statement of their views. We shall be in a better position to comment on them when we have the forecasts to which they relate - perhaps in the course of this week. Meanwhile their views can be taken into account in the process of deciding on what sort of medium term plan - if any - to publish.

P E MIDDLETON
23 October 1979

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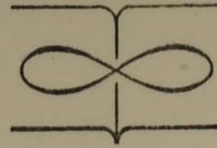

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P. Middleton Esq.,
H.M. Treasury,
Treasury Chambers,
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London SW1

18th October 1979

Dear Peter,

I enclose a copy of the Policy Viewpoint that will be appearing in the Economic Outlook in mid-November. It will only have my name on it although it is really a joint piece of work.

Could you please check that it makes no untoward use of the discussion at the Treasury meeting.

We are of course, delighted at Terry's canonisation.

All best wishes,
Yours sincerely,

Alan

Alan Budd

564/10

Economic Viewpoint

MONETARY TARGETS AND A FINANCIAL PLAN

Alan Budd

In the Economic Outlook for October 1977 we set out our ideas for a medium-term financial plan. This issue is now being more generally debated and has gained some support. This Viewpoint considers some general issues in relation to such a plan and suggests how it could be integrated with the government's medium-term public expenditure plans.

A financial plan provides the essential background to the government's economic strategy, particularly to its objective of lowering the rate of inflation by reducing the growth of the money supply. The control of inflation is the necessary accompaniment to the measures the government is introducing to improve the "supply side" of the economy - the shift from direct to indirect taxes, the reduction of the public sector etc. We do not know yet whether the supply side measures will work; but it is certain that they will not work if there are fears of recurrent bursts of inflation and financial crises.

A financial plan of the kind proposed here should be clearly distinguished from previous attempts at "National Planning". A financial plan does not make bold and unrealistic promises about other peoples' actions; it sets itself the far more modest objective of describing the degree of financial restraint that the government seeks to impose on the economy and on itself.

As a broad test of performance over the years to come we need to compare our record with that of other countries. In the first place we have had slower growth and more inflation (see table). Since 1969, as shown in the 'Briefing Paper' we have narrowed the absolute growth gap but the inflation gap has increased substantially. The test of the success of the government's strategy will be whether it succeeds in closing the inflation gap without sacrificing output performance relative to the rest of the world.

		1963-69	1970-78
Inflation	- UK	4.3	12.0
	- world	3.6	7.7
Growth	- UK	3.1	1.8
	- world	4.5	2.9

Inflation and the money supply

The government has frequently stated its firm resolve to reduce inflation progressively. For example, in the Chancellor's speech to the IMF :

> "The present UK government is firmly committed to policies designed to reduce inflation and inflationary expectations. It is committed to a strict monetary policy in the form of a target increase in the money supply for the current financial year and to a progressive reduction in the size of that target in the years ahead."

So far, however, the government has chosen not to present longer-term targets either for inflation rates or for the growth of the money supply. It has been argued that it would be unwise if not impractical for the government to commit itself to targets for monetary growth beyond twelve months and that the present step-by-step approach is adequate so far.

Experience since 1977 when Mr. Healey first announced a money supply target suggests otherwise. The most serious case of over-shooting occurred in 1977-78, large because of the government's failure to let the exchange rate rise earlier in 1977. It was not helped by data errors that only became evident at the end of the financial year. But there has been a persistent tendency, more in evidence recently, for the growth of the money supply to press against its ceiling. This has been because fiscal policy was over-expansionary and the control of the money supply has required additional restraints in the form of "the corset" and high interest rates. At the same time, from its trough in 1978, the rate of inflation has crept steadily upwards. The step by step approach has produced little deceleration in the growth of the money supply and hence has had no permanent success in reducing inflation. The case for a longer-term commitment to reducing monetary growth seems clear. Such a commitment would not only increase the chance that monetary growth would be reduced; it would also make the reduction a more powerful anti-inflationary weapon.

The link in the longer-term between inflation and the growth of the money supply is widely recognised. The success of the policy in the short run depends fundamentally on how rapidly expectations about inflation are adjusted. This in turn depends on the degree of belief in the government's resolve to control the money supply. A sharp reduction in the growth of the money supply at a time of accelerating inflation (as in 1973/74) simply results in a rapid rise in unemployment if it is generally feared that there is no long-term commitment to controlling inflation. Confidence that inflation is to be reduced will only emerge if people believe that the government's policies are going to change permanently.

A simple announcement of a medium-term target for the reduction of inflation would not be enough. In the first place, in the current economic system the rate of inflation is not directly under the government's control and it would be wrong for it to promise what it cannot be sure of providing. In the second place, past history provides no confidence that government's policies would be consistent with lowering inflation; the commitment to the policies would have to be explicit.

The government should set out an inflation objective and a money supply target. In emphasising the growth of the money supply it is not suggested that its link with inflation is simple and instantaneous; but the rate of inflation will not be reduced permanently unless the growth of the money supply is reduced. In the short run, changes in monetary growth can be absorbed by major changes in the velocity of circulation but in the longer term the velocity of circulation returns to its trend value and the full impact is felt on prices.

Our calculations suggest that the underlying rate of inflation is approximately equal to the rate of growth of the money supply. (The trend growth of output of about 2 percent a year is offset by the tendency for money demand to grow 2 percent less rapidly than output.)

If for example the long-term target for the inflation rate is 5 percent the long-term growth of the money supply will also have to be about 5 percent.

There remains the question of how rapidly monetary growth should be reduced. It has to be recognised that sudden reductions in the growth

of the money supply can hit output and increase unemployment. Much of the early adjustment tends to be borne by profits but this in turn affects investment and stockbuilding. Another mechanism operates more directly through the squeeze of real money balances which may affect consumption as well as company expenditure. These effects are likely to be only temporary and the scale of the shock to output will be determined by the speed with which price expectations react to the change in monetary policy. This is an area of some doubt as our experience is largely with the acceleration of money supply rather than the deceleration but in a year's time the inflation rate should moving back towards single figures after the oil price rise and the VAT measures have worked their way through the system. It should be possible to reduce the inflation rate by 2 percent a year from then on without causing severe problems of adjustment. As a guide to policy this would require the growth of the money supply to fall by 2 to 3 per cent a year. The response of inflation would be most unlikely to follow a steady path. One would expect inflationary expectations to be far more sticky in the early stage of the process than later whilst the movement of world prices, particularly oil and commodity prices, play a crucial role, in the short-term movement of inflation (see briefing Article). On this basis we would be looking for inflation and money supply targets roughly as follows:

	Inflation	Money Supply percentage change
76/77	14.5	8.3
77/78	13.7	9.8
78/79	7.9	14.1
79/80^E	15.0	11.3
80/81	12	8
81/82	8	6
82/83	5	4
83/84	4	4

There are two further issues of detail. The first is how the target should be defined in terms of ranges and limits; the second is what measure of the money supply should be used. It seems best to allow fluctuations within a range. The current practice of setting a range of 4 per cent for an annual growth rate seems reasonable given the scope for (largely irrelevant) short-term movements between the money supply and close substitutes. However the medium-term target should be set in terms of a level of the money supply (again with a range of 2 per cent or so on either side). The implication is that any over-shooting in one year should be made up in the following years. (It would not all have to be made up in the next year). If this were not done one would be setting a five year target (for example) which implied a 20 per cent range for the level of the money supply in five years time which would allow too great a degree of uncertainty about prices.

It has been argued that if the authorities find they can bring forward the reduction in the growth of the money supply they should do so. This seems reasonable but it should be recalled that uncertainty about inflation works both ways; new borrowers suffer if inflation rates fall more rapidly than they expected and the government's policies should recognise this.

As far as the definition of the money supply is concerned, the problem of distortion should be largely avoided provided, as discussed in the next section, that the government's fiscal policy is consistent with its monetary policy. If the government, as now, is controlling M3 with an inconsistent fiscal policy and is relying on devices such as "the corset" the market will have strong incentives to avoid the constraints, for example by the growth of acceptances. But if fiscal policy is consistent, the normal relationships between M3 and other measures of the money supply and credit will hold. M3 is the preferable measure amongst those available because of its direct link with the government's fiscal and financial policy. Part of the control mechanism would be to monitor the behaviour of the various 'M's. If they were steadily shifting apart this would indicate that inconsistences were being pursued elsewhere in the economy.

Financial policy in the medium-term

The second briefing paper argues that the money supply cannot in the medium term be controlled independently of the Public Sector Borrowing Requirement. This section considers how, in practice, a consistent policy for the PSBR can be selected. Detailed calculations are not given since they would depend on the inflation and money supply targets chosen by the government.

It should be noted that the financial plan does not attempt to impose in advance a specific path for the PSBR by year over the medium-term period. It uses the PSBR as an intermediate calculation to determine the fiscal structure i.e. the public expenditure plans and the tax structure. There are two important links : the link between the fiscal structure and the PSBR and the link between the PSBR and the money supply.

The level of the PSBR can be explained in terms of the following : the fiscal structure; output; inflation and "errors".

The fiscal structure is, by definition, completely under the government's control. It includes tax rates and social security benefit rates as well as expenditure on goods and services. As far as inflation is concerned, this is itself 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. The final category "errors" covers everything from gaps between expenditure plans and outturns to unpredictable variations in receipts in payments even if everything else is known with certainty. The remaining category is output which is the major cause, for a given fiscal structure, of changes in the PSBR because of its effect on tax revenue. It can be assumed consistently with the government's attitude to short term demand management, that fluctuations in output are largely beyond its control.
Thus, on a year to year basis, the PSBR is unpredictable, although the link between short-run changes in output and short-run changes in the PSBR is well understood.

We turn now to the link between the PSBR and the money supply. The main influences on the growth of the money supply are : the PSBR, interest rates, the balance of payments, inflation, output and errors.

We have discussed the role of the PSBR in Briefing Paper 2. For reasons we present there, changes in interest rates cannot be used except in the short run to achieve a money supply target for a given PSBR. Not only is there the problem of exceptionally high real interest rates if the PSBR is too large there is also the disturbance to confidence caused by frequent changes to interest rates. For similar reasons, the balance of payments is at best a very short-term control device. Inflation should be under the government's control. The main factor, as with the PSBR, is changes in the level of output. It will be recalled that the main difference between the PSBR and the money supply is lending by banks to the private sector and sales of public sector debt to the private sector. Both tend to be related to the level of output. (For forecasting purposes we find it best to combine the two as a single variable "net lending"). Net lending tends to be low when output is below trend and high when it is above trend.

There remains, of course, the category of "errors" which are inevitably large in financial markets in which expectations play a major part. however . our conclusions by saying that the main systematic influences on the money supply appear to be the fiscal structure and output. Since output is not under the government's control the problem seems rather severe. It may perhaps seem that frequent changes in the fiscal structure will be necessary to keep the money supply on the desired path. Fortunately this is not the case. Fluctuations in output tend to raise the PSBR while leaving the underlying growth of the money supply unchanged. In other words, if output is lower than expected the rise in the PSBR is close to the fall in "net lending". In a recession, demand for bank loans (mainly by the company sector) fall and sales of government debt rises. As a result the PSBR rises while leaving the growth of the money supply unchanged. As an approximate rule of thumb, if output falls 1 per cent below trend, the PSBR rises by 0.6 per cent and net lending falls by the same amount.

This result suggests that provided the fiscal structure is consistent with the money supply target when output is growing at its trend rate, short run deviations in the PSBR due to short-run fluctuations in output do not matter. This does, however, leave two important problems: first, how are we to forecast trend output; second, how should the system deal with errors from other sources.

In constructing the medium-term financial plan we want, as far as possible, to avoid subsequent changes in the fiscal structure. The forecast of trend output should therefore be the best possible. It should not, as has happened in earlier Public Expenditure White Papers, be based on dreams of an ideal world. A reasonably cautious assumption would be to assume that the starting year is on trend and that thereafter output will, on average, grow at the rate achieved over the previous five years.

Our proposed system sets the fiscal structure and allows the PSBR to adjust in response to changes in output. There have been some suggestions that the medium-term plan should apply to the actual level of the PSBR year by year. This proposal would be very dangerous. In the first place it would require the finest of fine tuning. The fiscal structure would certainly have to be changed each year but further changes would be required in the course of each year. It would introduce a wholly wasteful uncertainty into all economic decisions involving taxation (and almost all economic decisions do involve taxation). In the second place, if our analysis is correct, it would de-stabilise the financial sector. If output were below trend, adherence to a rigid PSBR target would require a tightening of the fiscal structure - an increase in tax rates and/or a cut in public expenditure. But net lending would fall i.e. the demand for bank loans would fall and the demand for government debt would rise. The money supply would "undershoot" unless the government took steps to lower interest rates. Quite apart from the possible problems for the exchange rate, the markets would face greatly increased uncertainty. (All this is quite apart from the issue of whether such policies would de-stabilise output). The "built-in stabilisers" of the fiscal system perform a valuable function in stabilising financial conditions and it would be extremely unwise to over-ride them. (There is a separate question of whether the built-in stabilisers could be better designed but we are not concerned with that here).

Our conclusions therefore are that having set the medium term strategy there is no need to tune changes in the PSBR due to output changes; these are taken care of by the complementary behaviour of bank lending and gilt-edged sales.

But other things could go wrong. In particular the relationships may change. The fiscal structure may fail to deliver the revenue whilst the PSBR may fail to deliver the money supply. Both are legitimate areas for the operation of control theory. If the fiscal structure fails to deliver the money supply growth with reasonably stable interest rates, or the various measures of the money supply begin to deviate substantially, this is a time to rework the fiscal structure. Changes in the plan will no doubt be necessary but it will be a far cry from the tradition of "fine-tuning". In the past the fiscal structure has been changed whenever the Treasury has believed it could discern a change in short-term behaviour; the fiscal plan would only be altered in response to changes in underlying behaviour. Such changes should be small and infrequent.

The Policy Framework

The foregoing analysis suggests that medium-term plans for fiscal policy must be made within the following framework :

a) The government can make a judgement on how rapidly it wants to reduce inflatio and hence the growth of the money supply.

b) That decision determines the feasible size of the PSBR in the medium term

c) Within that constraint the government is free to choose the fiscal structure i.e. the tax rates and public expenditure plans consistent with the PSBR.

It should be emphasised that the control of inflation need not be the prior objective if the government does not want it to be. If a given target for the reduction of inflation generates constraints on the PSBR and the fiscal structure that it does not like, it can go back to (a) and adjust its target. It must however recognise that in the medium term the choice is inexorable; a higher PSBR will generate a higher rate of inflation with all the economic costs associated with it.

If the government does intend to operate within a medium-term financial framework it follows that nay decisions about future public spending imply decisions about future taxation and vice-versa. It is customary for the government to announce medium-term plans for public expenditure. If at the same time it announces inflation and money supply targets it should be possible to show the implications for the overall level of taxation.

The last Public Expenditure White Paper (Cmnd 7439) included a table (5.13) which showed expenditure and revenue together. The revenue forecasts were based on a growth rate of about 2½ per cent and assumed that personal tax allowances, bonds and specific duties would be adjusted in line with inflation. The table only went as far as 1980/81. It included a forecast of the PSBR (at constant prices) but since there was no path for the money supply or inflation it was impossible to judge whether the fiscal structure was consistent with the government's objectives. (In fact other parts of the White Paper implied that inflation was completely beyond the government's control.)

If the table had included targets for inflation the PSBR could have been expressed in current prices. The estimate of the associated growth of the money supply depends on the "model" used. The Treasury's estimate would no doubt differ from our own but we would not expect the disparity to be very great. For the medium-term plan the table would have to be extended to cover the five years of the public expenditure plans.

The revenue forecasts and hence the figures for the PSBR would, of course, be conditional on the assumptions about the growth of output. The success of the strategy would not therefore be judged by whether the outcome for the PSBR matches the forecasts year by year. However provided the fiscal structure is correctly chosen, on the basis of a realistic estimate of the trend growth of output, the actual PSBR should be consistent with the target for the growth of the money supply.

The ultimate test of the strategy will be whether monetary growth and the rate of inflation come down in line with the government's objectives. Adjustments will have to be made, but success will be far more likely if we are given an open guide to the steps the government intends to follow in restoring financial stability.

The Fiscal Structure

- the underlying inflation rate will follow the path set out in section
- the underlying growth of output is 1½ percent per annum
- the ratio of the stock of bank lending (private and overseas) to GNP will be 30 per cent.

- the ratio of the stock of nominal public sector debt to GNP will be 40 percent.
- the change in non-deposit liabilities is a constant share of GDP in current prices
- external financing is zero

The result of this set of calculations is that for the year 1983/84 monetary growth would be 4 per cent, DCE would be £4.5 b and the PSBR £5.7 b. As a percentage of GDP the PSBR would be falling from 5.9 this year to 2.7 by the end of the planning period.

This configuration is consistent with stock equilibrium at the end of the day for money, government debt and bank lending. Clearly if the view of the underlying demand is incorrect this will change the numbers. But the principal remain the same; as long as there are stable demand functions for assets and the government does not wish to produce large changes in effective yields the PSBR is dependent upon the desired rate of monetary growth.