PO-CH/NL/0239

PART A

Part. A.

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(Circulate under cover and
notify REGISTRY of movement)

Begins: 15/5/85.
Ends: 11/4/86.

PO -CH /NL/0239

PART A

Chancellor's (Lawson) Papers:

SPEECH TO THE LOMBARD
ASSOCIATION

DD's: 25 Years

[signature]

20/12/95.

PO -CH /NL/0239
PART A

ON YELLOW

✓ POSS
Just date

from David Baillie
date 15.5.85

Mr Battishill

SPEECH COMMITTEE : LOMBARD ASSOCIATION

The Chancellor would be grateful if Speech Committee could consider the attached invitation at its next meeting.

Many thanks

David Baillie

cc Mr Folger
~~Mr M. [illegible]~~
Mr Page
Mr Murphy
Mr P. Edwards
Mr P. Lilley M.P.
Mr Cropper
Mr M. Davies

Note,

The Chancellor sees this invitation as a possible opportunity for a major speech early in 1986.

DB

Standard Chartered

Standard Chartered Merchant Bank Limited

33-36 Gracechurch Street London EC3V 0AX
Telephone 01-623 8711 Telex 884689 Cables Stacharmer London EC3

poss Mayor sp
SW1?

MM/cm

The Rt. Hon. Nigel Lawson, PC, MP,
Chancellor of The Exchequer,
The Treasury,
Parliament Street,
London, SW1P 3AG.

7th May 1985

C,
S.C.?

Dear Mr Lawson,

LOMBARD ASSOCIATION

I am writing to you in my capacity as Chairman of the Lombard Association, which is a dining club for senior international bankers in the City, which meets six times a year between October and April. The Association is acknowledged as an influential grouping in the City, based upon the seniority of its membership in the spheres of the City's money, exchange and capital markets, and individual bank representation in the membership is strictly vetted and limited in order to ensure the status of the Association in the City.

One of my principal duties, as the Chairman of the Association, is to propose an interesting and important discussion theme for the six meetings of the Association and to arrange for six individual guest speakers, one guest speaker per meeting, to address the chosen theme and to field questions subsequently. The venue of the meeting is the Great Hall of the Institute of Chartered Accountants in Moorgate Place, EC2, and the format of the meetings is that we meet at 6.00 pm for informal drinks, with dinner commencing at 6.15 pm. The guest speaker begins his address at about 8.00 pm and speaks for about thirty minutes, which permits twenty to thirty minutes for questions and the meeting terminates at about 9.00 pm. Attendance at the meetings ranges from 150 to 250 persons, with the average attendance for the past year being roughly 200 persons. Press reporting is not permitted, in order to allow frank and open discussion, though of course the guest speaker may release his or her text to the Press if they so wish.

The discussion theme which I have selected for the October 1985/ April 1986 meetings of the Association is based upon the conclusion of your televised post budget address to the nation, namely that the economy is on the right track. This conclusion is turned into a question, in order to provide for a range of views and opinions, and the title of the theme for the October 1985/April 1986 meetings of the Association is:-

THE UK - AN ECONOMY ON THE RIGHT TRACK?

.../2

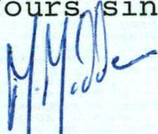
The Association would be extremely appreciative if you would agree to address this theme at one of our 1985/86 meetings, and to take questions subsequently, and presuming that this invitation is accepted by you, may I suggest that you are the Guest of Honour and Speaker to the Association at the meeting on Wednesday, 8th January, 1986. If this date is not convenient, I would, of course, endeavour to arrange for you to speak to the Association on one of the other meeting dates shown in the attachment to this letter.

I trust that you will be able to accept this invitation and to give your valued views to an informed and interested audience.

It would be most helpful if you could inform me as quickly as possible, as to whether the invitation is acceptable to you, so that I may finalise the list of guest speakers and relevant dates and advise the membership of the Association accordingly.

I look forward to hearing from you.

Yours sincerely,



M. Madden
Director.

LOMBARD ASSOCIATION

DATES OF MEETING: OCTOBER 1985/APRIL 1986

Wednesday, 2nd October 1985 — Abroad (CFM)

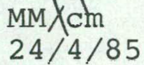
Tuesday, 12th November 1985 — A/S

Wednesday, 8th January 1986 — OK

Wednesday, 12th February 1986 — Dundalk

Wednesday, 12th March 1986 — "

Wednesday, 16th April 1986 — OK



MM/cm
24/4/85

LOMBARD ASSOCIATION

GUEST SPEAKERS: 1980 - 85

1980 - 81

The Rt. Hon. Gordon Richardson	Governor of Bank of England.
Mr Gordon Borrie	Director General of The Office of Fair Trading.
Mr John Garnett	Director of The Industrial Society.
The Rt. Hon. Edward Heath	
Sir Richard O'Brien	Chairman of Manpower Services Commission.
Mr Joe Gormley	President of National Union of Mineworkers.

1981 - 82

Mr Gordon Pepper	Joint Senior Partner of W. Greenwell & Co.
Mr Jock Bruce-Gardyne	Minister of State (Commons), Treasury.
Sir Nicholas Goodison	Chairman of The Stock Exchange.
Mr Kenneth Fleet	City Editor, Sunday Express.
Mr W. Peter Cooke	Head of Banking Supervision, Bank of England.
Mr Gordon Brunton	Managing Director of The Thompson Organisation.

1982 - 83

The Earl of Gowrie	
Professor Ralph Dahrendorf	Director of the London School of Economics.
The Rt. Hon. Leon Brittan	Chief Secretary, Treasury.
Dr Jurgen Ruhfus	Ambassador, Federal Republic of Germany.
Mr Lloyd Cutler	Senior Partner, Wilmer, Cutler & Pickering.
Dr. Fritz Leutwiler	Swiss National Bank & Bank for International Settlements.

1983 - 84

Mr Deryk Vander Weyer	Deputy Chairman of Barclays Bank PLC.
Sir John Read	Chairman of Trustee Savings Bank.
Mr Christopher W. McMahon	Deputy Governor of Bank of England.
Mr Harry Taylor	President of Manufacturers Hanover Corp.
Mr Leif Mills	General Secretary of Banking Insurance and Finance Union.
Sir William Rees-Mogg	

1984 - 85

Sir Peter Middleton	Permanent Secretary, Treasury.
Mr A.R.F. Buxton	General Manager, Barclays Bank PLC.
Mr Rupert N. Hambro	Hambros Bank Ltd
Sir Nicholas Goodison	Chairman of The Stock Exchange
Mr R.R. St.J. Barkshire	Chairman of Mercantile House Holdings plc.
Mr Robin Leigh-Pemberton	Governor of The Bank of England.

MM/cm
24/4/85

LOMBARD ASSOCIATION

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Mr R.R. St.J. Barkshire	Chairman of Mercantile House Holdings plc.
Mr Robin Leigh-Pemberton	Governor of The Bank of England.

MM/cm
24/4/85

5.18

16/4/86

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

3 June 1985

M Madden Esq
Director
Standard Chartered Merchant Bank Limited
33-36 Gracechurch Street
LONDON
EC3V 0AX

Dear Mr Madden,

The Chancellor of the Exchequer has asked me to thank you for your letter of 7 May in which you invited him to address the Lombard Association.

The Chancellor is happy to accept your kind invitation. However, of the dates you offered, only Wednesday, 16 April 1986 is convenient for the Chancellor.

I would be grateful if you could confirm that you would be happy to have the Chancellor to address your Association on 16 April 1986.

Yours sincerely
David M. Baillie

D M BAILLIE
Diary Secretary

cc ON YELLOW TO

Mr Folger
Mr Murphy
Mr P. Edwards
Mr Cropper
Mr Davies
Mr P. Lilley M.P.

BAILLIE
MADDEN
3/6/85

Standard Chartered

Standard Chartered Merchant Bank Limited

33-36 Gracechurch Street London EC3V 0AX
Telephone 01-623 8711 Telex 884689 Cables Stacharmer London EC3

MM/cm

D.M. Baillie, Esq.,
Diary Secretary to the
Chancellor of The Exchequer,
Treasury Chambers,
Parliament Street,
London, SW1P 3AG.

5th June 1985

Dear Mr Baillie,

LOMBARD ASSOCIATION

Thank you for your letter dated 3rd June, 1985, concerning the invitation which I addressed to The Chancellor to be the Guest of Honour and Speaker to the Lombard Association and, in response to your letter, I hereby confirm that the 16th April, 1986, is acceptable to the Association as the date upon which we shall receive The Chancellor as our Guest of Honour and Speaker. Indeed, we are delighted to do so, and I have confirmed our pleasure directly to The Chancellor.

May I take this opportunity of thanking you for your assistance in this matter and we shall, of course, be in touch with you in the month prior to the 16th April, 1986, to finalise all relevant details relating to the Chancellor's presence at the Association 's meeting on that date as Guest of Honour and Speaker. I shall also be sending to the Chancellor, in the next week or so, the complete list of Speakers to the Association for the October 1985/April 1986 session.

Thank you once again for your assistance and courtesy.

Kind regards.

Yours sincerely,

Michael Madden

M. Madden
Director.

MADDEN → BAILLIE 5/6/86

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Standard Chartered Merchant Bank Limited

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MM/cm

Rt. Hon. Nigel Lawson, PC, MP,
Chancellor of The Exchequer,
Treasury Chambers,
Parliament Street,
London, SW1P 3AG.

5th June 1985

Dear Mr Lawson,

MADDEN → CH/EX 5/6/85

LOMBARD ASSOCIATION

I was most pleased to hear from your Diary Secretary, David Baillie, that you have accepted the Association's invitation to be their Guest of Honour and Speaker, subject to agreement that the chosen date is the 16th April, 1986. Please know that I have today confirmed to your Diary Secretary that the 16th April, 1986, is acceptable to the Association and I look forward to seeing you and listening to your address on the evening of that date.

The complete list of speakers is now more or less finalised and I shall forward this to you in the next week or so. I shall also be in touch in the month prior to the 16th April, 1986, in order to confirm and advise on all relevant details relating to the Association's Meeting on that date and to your presence as the Association's Guest of Honour and Speaker.

On behalf of the Lombard Association and myself as Chairman, may I thank you once again for accepting our invitation, and we are all looking forward, with considerable interest, to the evening of the 16th April, 1986.

Kind regards.

Yours sincerely,

Michael Madden

M. Madden
Director.

HM TREASURY — MCU
REC'D. 06 JUN 1985
ACTION

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(16/4) 86

cc ON YELLOW 25/6

Mr Folger
Mr J. Page
Mr Murphy
Mr P. Edwards
Mr Cropper
Mr Last
Mr H. Davis

MM/cm

MADDEN → CH/EX 24/6/85

Rt. Hon. Nigel Lawson, PC, MP,
Chancellor of The Exchequer,
Treasury Chambers,
Parliament Street,
London, SW1P 3AG.

24th June 1985

Dear Mr Lawson,

LOMBARD ASSOCIATION

Further to my letter dated 5th June, 1985, I now enclose as promised a complete list of speakers and dates for the October 1985/April 1986 meetings of the Association.

I shall, as already indicated, be in touch with you again, just prior to the date of your talk to the Association on Wednesday, 16th April, 1986, to finalise and clarify any outstanding details.

Kind regards.

Yours sincerely,

Michael Madden

M. Madden
Director.

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LOMBARD ASSOCIATION

MEETINGS: OCTOBER 1985/APRIL 1986

THEME: "THE UK - AN ECONOMY ON THE RIGHT TRACK?"

Wednesday, 2nd October, 1985:	Professor Richard Layard, Head of Centre for Labour Economics, London School of Economics. and Chairman, Executive Committee, The Employment Institute & The Charter for Jobs.
Tuesday, 12th November, 1985:	Sir Peter Tapsell, MP, Partner, James Capel & Co. and Member, Steering Committee of Conservative Centre Forward.
Wednesday, 8th January, 1986:	John Caff, Economic Director, Confederation of British Industry.
Wednesday, 12th February, 1986:	Norman D. Willis, General Secretary, Trades Union Congress.
Wednesday, 12th March, 1986:	Professor Sir James Ball, Professor of Economics, London Business School.
Wednesday, 16th April, 1986:	Rt. Hon. Nigel Lawson, PC, MP, The Chancellor of The Exchequer.

****

MM/cm
21/6/85

45/3602-2

CONFIDENTIAL

cc Mr Ross-Goobey

FROM: DAVID PERETZ
20 March 1986

SIR PETER MIDDLETON

cc Sir T Burns
Mr Cassell
Mr Odling-Smee
Mr Scholar
Mr Kelly
Mr Walsh
Mr Hannah
Mr Wood
Mr H Davies

CHANCELLOR'S LOMBARD ASSOCIATION SPEECH ON MONETARY POLICY

I attach a possible scheme for this speech. I am conscious that it is more than a synopsis, but I have tried to signpost the different sections clearly. Some sections - including a couple of quotes - I have fleshed out more than others.

2. Worked up, this material would make for quite a substantial speech in terms of length. But other aspects that could be covered include:-

(a) Funding policy, overfunding, etc. This would come in Section C. I have left it out on the grounds that it was fully dealt with in the Mansion House speech.

(b) Techniques of influencing interest rates. This seems a bit technical. But, for example, some of the arguments against Harold Rose's proposed return to MLR could be rehearsed. (This would fit in after Section J.)

(c) There is nothing on the ERM. This could be tackled head on. 3A suggests a way of avoiding the issue, by discussing the prospects for worldwide exchange rate stability instead.

cc Ms Lomax

See p 5.

DLP 14/4

D L C PERETZ
(dicated by Mr Peretz and
signed in his absence)

45/3602

DRAFT SYNOPSIS FOR CHANCELLOR'S SPEECH ON MONETARY POLICY

A. Why a firm financial framework is needed (and What has happened when there hasn't been one)

1. Stressed in Budget - as Government has in every Budget since 1980 - the crucial importance of setting and sticking to a firm financial framework for policy. Role of MTFS.

2. Experience of need for financial discipline of course goes back much further, not just in the UK.

- for most of the post-war period, Bretton Woods system provided external financial framework for all major countries except US
- 1971-76 (UK) and up to 1979 (US) show how things go wrong when there is no framework.

3. Since 1979, the second oil shock, the major industrialised countries have a shared experience of operating within firm financial guidelines which have <u>not</u> (except within EMS) involved fixed exchange rates. Short term framework has in most countries been articulated in terms of monetary targets. Has proved successful. Inflation in major countries reduced [figures]. Now good prospect of declining nominal interest rates and sustained growth in world economy.

[3A. Possible aside on improving prospects for return to more stable exchange rate regime between major currencies: prospects improving, but not there yet. This would be a way of ~~stressing~~ finessing the EMS point.]

B. MTFS Framework

4. The framework within which we operate policy is set out in the MTFS. Medium term aims for steadily reducing growth of money GDP. After 6 years, have seen the benefits, Inflation being slowly but steadily squeezed out of system. Steady and

sustained growth. [Figures]. Money demand pledge. [Relative roles of micro and macro policy.]

C. **Policies to implement the strategy**

5. In operating policy within this framework, there are two main aspects to policy:-

(a) Fiscal policy. Reviewed each year at Budget. Need to set borrowing requirement at prudent level, to keep a proper balance between fiscal and monetary policy. (Dangers of not doing so now recognised, even in US.)

(b) Monetary policy. Short term interest rates are the essential instrument; they can be adjusted during the year. Aim is to keep monetary conditions tight enough to exercise steady downward pressure on inflation.

In medium term both fiscal and monetary policy are directed towards keeping money demand, as measured by GDP in cash terms, on a downward path.

D. **Guidelines for operating policy**

6. But money GDP does not provide a useful short term guide. Information on money GDP is only available with a considerable lag, and subject to substantial revisions. And it contains no forward looking content.

7. Others suggest that the level of interest rates itself is or should be a sufficient objective for short term policy. But the level of nominal interest rates is a poor indicator of whether policy is tight or not. The degree of pressure exerted by any level of nominal rates depends on the rate of expected inflation, and the extent to which individuals and companies take account of expected future inflation in their financial decisions. It can also depend on the relative level of interest rates abroad in the other major countries.

E. Need for monetary targets (and why their operation is complicated in practice)

8. So other guides are needed to the operation of policy in the short term. The growth of the money supply is a good guide. For it is excessive monetary growth that leads to inflation. [Used in UK since 1976.]

9. But in itself this does not provide a simple or unambiguous rule. For in countries with developed financial systems there are many different possible definitions of money, each with different characteristics. Moreover the task of monetary management is complicated further by the rapid changes that are taking place in financial institutions and markets, and increasing internationalisation of financial business. [Examples: securitisation, swaps, etc].

[Possible repeat of quotation from Chancellor's 1981 speech, as quoted in Mansion House speech.]

F. Choice of target aggregates

10. Description of characteristics of ideal target aggregate for narrow money. [Set out as in MTFS]. Merits of M0. [Stability of velocity trend; unambiguous reaction to interest rates; timely information]. Relatively stable velocity trend means it continues to be appropriate to set out illustrative ranges for M0 for future years, as well as setting target for year immediately ahead.

11. Case for looking at broader measures of money and liquidity. [Reasons for choice of £M3 in 1976 and 1980?] They can give warning further in advance of potential pressures for future spending. If we could be sure of velocity trends. But it is precisely these measures that have been most affected by institutional change, and by the high level of real interest rates. Nevertheless, believe it continues to be useful to set a target for a measure of broad money, £M3, alongside a measure of narrow money, M0. But the uncertainties about its velocity

trend are too great for it to be sensible to set out illustrative ranges for years further ahead.

G. Reasons for taking exchange rate into account

12. First, given uncertainties about behaviour of different measures of money, exchange rate can give useful further reading. But its message also needs interpreting with care [reference to oil prices?]. Secondly, movements in the rate if left unchecked can sometimes gain an undesirable momentum of their own. [Illustrate both points with reference to January 1985 and January 1986.]

13. I have recently had drawn to my attention what I believe to be the earliest recorded reference to the importance of taking the exchange rate into account in judging monetary conditions. I quote from the report of the 1810 Select Committee of the House of Commons on gold bullion. The Committee was examining the question of whether the money supply of the day was or was not excessive. They concluded:-

> "The committee beg leave to report to the House their most clear opinion that ... the price of gold bullion and the general course of exchange with foreign countries, taken for any considerable period of time, form the best general criterion from which any inference can be drawn regarding the sufficiency or excess of paper currency in circulation; and the Bank of England cannot safely regulate the amount of its issues without having reference to the criterion presented by these two circumstances."

The English language has deteriorated since 1810. And the price of gold no longer has the significance it had then. But sterling's value on the exchanges does. I commend the report of this Committee to their present day successor, the House of Commons Treasury and Civil Service Select Committee.

H. So operation of policy is inevitably complex....

14. So as in the past (and as in other countries) we have found

it important to look at a range of evidence alongside the growth of the chosen monetary target aggregates. Perhaps I could be permitted two further quotations. I will tell you in advance I have altered two key words. Both quotations are from the same recent text.

> "A more pointed question .... has been the lasting significance of the sizeable increase in £M3. We are well aware ... of the long history and of the economic analysis that relate excessive monetary growth to inflation over time. The operational question remains as to what, in specific circumstances, is in fact excessive in the light of recent velocity behaviour. That question is greatly complicated ... by the ... composition of £M3 which ... includes accounts that receive interest close to market levels and clearly have a large "savings" as well as a "transaction oriented" component."
>
> "Monetary policy is implemented day by day and week by week ... in the light of monetary growth, judged in the context of the flow of information about the economy, the outlook for prices, and domestic and international financial markets, including the value of sterling in the foreign exchange markets."

As many of you will already have guessed, the text is that of Paul Volcker's statement to the US Congress this February. I have only substituted "£M3" for "M1"; and "sterling" for "dollar".

15. There is, then, nothing especially peculiar about the difficulties we have faced in operating policy in recent years.

16. I sometimes hear it said that the operation of monetary policy is too complicated to understand; or that it allows the Government to do whatever it wishes. Others tell me that the policy is really very simple: it is just that I refuse to admit what my secret targets are.

17. The answer is there are no secret targets. And that the operation of policy <u>is</u> complicated, and necessarily so. So it

has to be operated with a degree of discretion. But there should be no doubt about how such discretion will be used. Policy is operated with the MTFS objectives constantly in view: gradually declining money demand and inflation.

I. **How policy is operated: how interest rates are set**

18. The way we operate policy is thus as follows. There is a presumption that if either M0 or £M3 were to move outside its target range, then we would take action on short-term interest rates. But that presumption has to be tested against the other evidence, including the exchange rate. Since different indicators do not always point in the same direction, it is very often a question of weighing movements in one against movements in another. There is no simple mechanical rule for this, nor can there be.

19. There is also an important operational difference between the target for M0 and the target for broad money. For a while movements in short-term interest rates can be expected to have a relatively fast acting and unambiguous effect on the growth of narrow money, and on the exchange rate, their effect on £M3 is less certain and slower acting. Thus a rise in interest rates triggered by a rise in the growth of £M3 outside its range would certainly tighten monetary conditions; but it would be unlikely to cause £M3 to return to its range within the target period.

20. Operation of policy thus involves a continuous process of weighing all the evidence of monetary conditions: growth of target aggregates, movement of the exchange rate, and movement of other aggregates and indicators. [There is a regular procedure for this in the Treasury and Bank of England.]

J. **How market conditions can also affect interest rate decisions**

21. It can also be necessary to take account of market circumstances in interest rate decisions. It is not just the foreign exchange market that can gain an unhealthy momentum of its own. On occasion the timing, scale and form of action on interest rates has to be designed to help reassure markets about the Government's purpose. [And on other occasions it would be

wrong to resist market originated moves in interest rates, even if the balance of evidence suggested that such a move might not be needed. To resist a market led move in some circumstances can risk being misinterpreted as a weakening of policy.]

K. Guiding rule: the essence of policy

22. But however complicated is the operation of monetary policy, in practice there remains one guiding rule. I will act on short-term interest rates - and do so promptly where necessary - so as to keep steady downward pressure on inflation.

From: SIR PETER MIDDLETON
Date: 20 March 1986

CHANCELLOR

Only 30 mins

cc Sir T Burns
Mr Cassell
Mr Odling-Smee
Mr Scholar
Mr Peretz
Mr H Davies

MIDDLETON
CH/EX
20/3

LOMBARD SPEECH

... I attach a scheme for the speech by Mr Peretz. We are not however quite sure what you want. So I have had a go at a rather different outline which could incorporate much of Mr Peretz's work.

2. My approach is more broad-brush. The first part would need to be pretty general. But I see great advantages in explaining in a historical context how we arrived at your policy of creating a nominal framework for the economy, how this policy has been completed while removing controls which would have been inconsistent with its general philosophy, and how we have developed tools to control it, and of course that it is succeeding. The more technical aspects of monetary control make much more sense in this context.

KF Murphy
(Private Secretary)

pp P E MIDDLETON

1. 10th Anniversary of IMF.
   Turning point in economy.

2. 10 years before that based on belief that spending increased real output and wealth

   - spending controlled in volume terms

   - greater borrowing thought to lead to greater output

   - interest rates directed to controlling real variables

   - controls and interference thought also to increase output.

3. Finance ignored

   - constraints such as Bretton Woods regarded as inconvenience

   - monetary growth regarded as irrevalent

   - thought that end of system an opportunity to have whatever level of output we wanted

   - got the rate of inflation we deserved.

4. At this time in 1976 heading clearly to IMF visit later in year.

5. IMF turning point

   - belief that public spending, monetary expansion, depreciating exchange rate created output exploded

   - began painful move to nominal framework for economy

   - monetary targets, expenditure constraint, PSBR constraint

   - move haltingly to belief that Government's could create inflation not output

- move from attempting to control nominal to control real variables.

6. In 1979 still not got far down road

- public expenditure still not a cash system

- PSBR still used for fine tuning

- no long term perspective

- whole industrial, financial and pay system hemmed in by controls

7. First move was to

- build on existing £M3 target and PSBR constraints

- then put in medium term framework with MTFS

- monetary or nominal policies are medium term policies (explain)

- complete the move to cash control of public expenditure.

8. But also essential to remove controls

- especially corset and exchange controls

- go further and help markets work (Big Bang)

9. This inevitably complicates monetary control and result in evolution of techniques

- but principles clear

- bring about fall in money incomes by monetary restraint backed by cash control of expenditure and low borrowing

- allow economy go grow to full extent by supply measures.

10. £M3 never said to be perfect

- look at alternatives

- MBC consultations and introduction of M0

- new aggregates M2 and PSLs.

11. As well we did because

- innovation and high real interest rates with declining inflation make £M3 unreliable

- other wide aggregates not much better

- M2 still uncertain - of doubtful value at any time

- narrow aggregates apart from M0 distorted

- so given an increasing role in line with its virtues (spell out).

12. Furthermore price of controlling an increasingly uninformative aggregate also rising

- use of overfunding and long term interest rates

- bill mountain, distortions to system, difficulties of managing system while rolling over stock of assistance

- decision to end overfunding, and fund PSBR

- success to date.

13. Short term interest rates main instrument of monetary policy

- authorities range of responses following present arrangements in bill market

- signals of different degrees of authority according to role assigned to market

- weak signals to allow market to lead. Strong where authorities lead (from dealing in short bills to MLR)

- very well equipped with range of short term interest rate weapons.

14. Uncertainty about clarity of monetary indicators leads to greater role for exchange rate

- huge girations in world currencies make this essential

- target of own not a good idea

- not made 1976 mistakes on intervention - of having unilateral contest with the market

- repaid debt, some borrowing

- intervene to smooth and with others where odds in favour of success. Even then with discrimination (refer to Plaza and Interim Committee).

15. Both M0 and exchange rate move unambiguously with interest rates.

- M3 provides some further information

- but cannot control in the same way

- therefore of more indicative than operational significance.

16. Never forget that objective to keep nominal incomes on track

- the numeraire of system

- become increasingly explicit about expected path

- not target in operational sense of M0 and exchange rate (give reasons)

- but clear guide to progress.

17. Success of policy clear

- money GDP down

- output up

- inflation down

Managed evolution with success.

18. Going through period where lot of discretion in hands of authorities

- like to have clearer rules

- but here, as in other countries, need to settle down post innovation.

19. Meanwhile proof of pudding in eating etc.

45/3602-2

CONFIDENTIAL

FROM: DAVID PERETZ
20 March 1986

SIR PETER MIDDLETON

cc Sir T Burns
Mr Cassell
Mr Odling-Smee
Mr Scholar
Mr Kelly
Mr Walsh
Mr Hannah
Mr Wood
Mr H Davies

CHANCELLOR'S LOMBARD ASSOCIATION SPEECH ON MONETARY POLICY

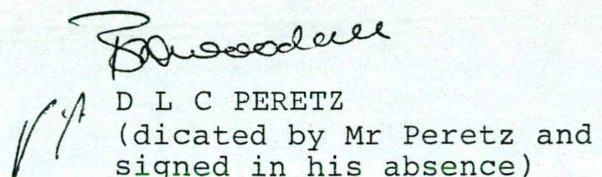
I attach a possible scheme for this speech. I am conscious that it is more than a synopsis, but I have tried to signpost the different sections clearly. Some sections - including a couple of quotes - I have fleshed out more than others.

2. Worked up, this material would make for quite a substantial speech in terms of length. But other aspects that could be covered include:-

(a) Funding policy, overfunding, etc. This would come in Section C. I have left it out on the grounds that it was fully dealt with in the Mansion House speech.

(b) Techniques of influencing interest rates. This seems a bit technical. But, for example, some of the arguments against Harold Rose's proposed return to MLR could be rehearsed. (This would fit in after Section J.)

(c) There is nothing on the ERM. This could be tackled head on. 3A suggests a way of avoiding the issue, by discussing the prospects for worldwide exchange rate stability instead.



D L C PERETZ
(dicated by Mr Peretz and
signed in his absence)

45/3602

DRAFT SYNOPSIS FOR CHANCELLOR'S SPEECH ON MONETARY POLICY

A. Why a firm financial framework is needed (and What has happened when there hasn't been one)

1. Stressed in Budget - as Government has in every Budget since 1980 - the crucial importance of setting and sticking to a firm financial framework for policy. Role of MTFS.

2. Experience of need for financial discipline of course goes back much further, not just in the UK.

- for most of the post-war period, Bretton Woods system provided external financial framework for all major countries except US
- 1971-76 (UK) and up to 1979 (US) show how things go wrong when there is no framework.

3. Since 1979, the second oil shock, the major industrialised countries have a shared experience of operating within firm financial guidelines which have not (except within EMS) involved fixed exchange rates. Short term framework has in most countries been articulated in terms of monetary targets. Has proved successful. Inflation in major countries reduced [figures]. Now good prospect of declining nominal interest rates and sustained growth in world economy.

[3A. Possible aside on improving prospects for return to more stable exchange rate regime between major currencies: prospects improving, but not there yet. This would be a way of stressing the EMS point.]

B. MTFS Framework

4. The framework within which we operate policy is set out in the MTFS. Medium term aims for steadily reducing growth of money GDP. After 6 years, have seen the benefits, Inflation being slowly but steadily squeezed out of system. Steady and

sustained growth. [Figures]. Money demand pledge. [Relative roles of micro and macro policy.]

C. <u>Policies to implement the strategy</u>

5. In operating policy within this framework, there are two main aspects to policy:-

(a) Fiscal policy. Reviewed each year at Budget. Need to set borrowing requirement at prudent level, to keep a proper balance between fiscal and monetary policy. (Dangers of not doing so now recognised, even in US.)

(b) Monetary policy. Short term interest rates are the essential instrument; they can be adjusted during the year. Aim is to keep monetary conditions tight enough to exercise steady downward pressure on inflation.

In medium term both fiscal and monetary policy are directed towards keeping money demand, as measured by GDP in cash terms, on a downward path.

D. <u>Guidelines for operating policy</u>

6. But money GDP does not provide a useful short term guide. Information on money GDP is only available with a considerable lag, and subject to substantial revisions. And it contains no forward looking content.

7. Others suggest that the level of interest rates itself is or should be a sufficient objective for short term policy. But the level of nominal interest rates is a poor indicator of whether policy is tight or not. The degree of pressure exerted by any level of nominal rates depends on the rate of expected inflation, and the extent to which individuals and companies take account of expected future inflation in their financial decisions. It can also depend on the <u>relative</u> level of interest rates abroad in the other major countries.

E. Need for monetary targets (and why their operation is complicated in practice)

8. So other guides are needed to the operation of policy in the short term. The growth of the money supply is a good guide. For it is excessive monetary growth that leads to inflation. [Used in UK since 1976.]

9. But in itself this does not provide a simple or unambiguous rule. For in countries with developed financial systems there are many different possible definitions of money, each with different characteristics. Moreover the task of monetary management is complicated further by the rapid changes that are taking place in financial institutions and markets, and increasing internationalisation of financial business. [Examples: securitisation, swaps, etc].

[Possible repeat of quotation from Chancellor's 1981 speech, as quoted in Mansion House speech.]

F. **Choice of target aggregates**

10. Description of characteristics of ideal target aggregate for narrow money. [Set out as in MTFS]. Merits of MO. [Stability of velocity trend; unambiguous reaction to interest rates; timely information]. Relatively stable velocity trend means it continues to be appropriate to set out illustrative ranges for M0 for future years, as well as setting target for year immediately ahead.

11. Case for looking at broader measures of money and liquidity. [Reasons for choice of £M3 in 1976 and 1980?] They can give warning further in advance of potential pressures for future spending. If we could be sure of velocity trends. But it is precisely these measures that have been most affected by institutional change, and by the high level of real interest rates. Nevertheless, believe it continues to be useful to set a target for a measure of broad money, £M3, alongside a measure of narrow money, M0. But the uncertainties about its velocity

trend are too great for it to be sensible to set out illustrative ranges for years further ahead.

G. Reasons for taking exchange rate into account

12. First, given uncertainties about behaviour of different measures of money, exchange rate can give useful further reading. But its message also needs interpreting with care [reference to oil prices?]. Secondly, movements in the rate if left unchecked can sometimes gain an undesirable momentum of their own. [Illustrate both points with reference to January 1985 and January 1986.]

13. I have recently had drawn to my attention what I believe to be the earliest recorded reference to the importance of taking the exchange rate into account in judging monetary conditions. I quote from the report of the 1810 Select Committee of the House of Commons on gold bullion. The Committee was examining the question of whether the money supply of the day was or was not excessive. They concluded:-

> "The committee beg leave to report to the House their most clear opinion that ... the price of gold bullion and the general course of exchange with foreign countries, taken for any considerable period of time, form the best general criterion from which any inference can be drawn regarding the sufficiency or excess of paper currency in circulation; and the Bank of England cannot safely regulate the amount of its issues without having reference to the criterion presented by these two circumstances."

The English language has deteriorated since 1810. And the price of gold no longer has the significance it had then. But sterling's value on the exchanges does. I commend the report of this Committee to their present day successor, the House of Commons Treasury and Civil Service Select Committee.

H. So operation of policy is inevitably complex....

14. So as in the past (and as in other countries) we have found

it important to look at a range of evidence alongside the growth of the chosen monetary target aggregates. Perhaps I could be permitted two further quotations. I will tell you in advance I have altered two key words. Both quotations are from the same recent text.

> "A more pointed question .... has been the lasting significance of the sizeable increase in £M3. We are well aware ... of the long history and of the economic analysis that relate excessive monetary growth to inflation over time. The operational question remains as to what, in specific circumstances, is in fact excessive in the light of recent velocity behaviour. That question is greatly complicated ... by the ... composition of £M3 which ... includes accounts that receive interest close to market levels and clearly have a large "savings" as well as a "transaction oriented" component."

> "Monetary policy is implemented day by day and week by week ... in the light of monetary growth, judged in the context of the flow of information about the economy, the outlook for prices, and domestic and international financial markets, including the value of sterling in the foreign exchange markets."

As many of you will already have guessed, the text is that of Paul Volcker's statement to the US Congress this February. I have only substituted "£M3" for "M1"; and "sterling" for "dollar".

15. There is, then, nothing especially peculiar about the difficulties we have faced in operating policy in recent years.

16. I sometimes hear it said that the operation of monetary policy is too complicated to understand; or that it allows the Government to do whatever it wishes. Others tell me that the policy is really very simple: it is just that I refuse to admit what my secret targets are.

17. The answer is there are no secret targets. And that the operation of policy <u>is</u> complicated, and necessarily so. So it

has to be operated with a degree of discretion. But there should be no doubt about how such discretion will be used. Policy is operated with the MTFS objectives constantly in view: gradually declining money demand and inflation.

I. How policy is operated: how interest rates are set

18. The way we operate policy is thus as follows. There is a presumption that if either M0 or £M3 were to move outside its target range, then we would take action on short-term interest rates. But that presumption has to be tested against the other evidence, including the exchange rate. Since different indicators do not always point in the same direction, it is very often a question of weighing movements in one against movements in another. There is no simple mechanical rule for this, nor can there be.

19. There is also an important operational difference between the target for M0 and the target for broad money. For a while movements in short-term interest rates can be expected to have a relatively fast acting and unambiguous effect on the growth of narrow money, and on the exchange rate, their effect on £M3 is less certain and slower acting. Thus a rise in interest rates triggered by a rise in the growth of £M3 outside its range would certainly tighten monetary conditions; but it would be unlikely to cause £M3 to return to its range within the target period.

20. Operation of policy thus involves a continuous process of weighing all the evidence of monetary conditions: growth of target aggregates, movement of the exchange rate, and movement of other aggregates and indicators. [There is a regular procedure for this in the Treasury and Bank of England.]

J. How market conditions can also affect interest rate decisions

21. It can also be necessary to take account of market circumstances in interest rate decisions. It is not just the foreign exchange market that can gain an unhealthy momentum of its own. On occasion the timing, scale and form of action on interest rates has to be designed to help reassure markets about the Government's purpose. [And on other occasions it would be

wrong to resist market originated moves in interest rates, even if the balance of evidence suggested that such a move might not be needed. To resist a market led move in some circumstances can risk being misinterpreted as a weakening of policy.]

K. Guiding rule: the essence of policy

22. But however complicated is the operation of monetary policy, in practice there remains one guiding rule. I will act on short-term interest rates - and do so promptly where necessary - so as to keep steady downward pressure on inflation.

Photo

Monetary Speech

[Mon Conditions

(1) Track Record
(2) Mon Cond P

(1)

Background

24/3/86.

AI. 1. Approach towards fiscal and monetary policy was set out at the beginning of this Govt's term of office in the MTFS. The aims of that policy were:

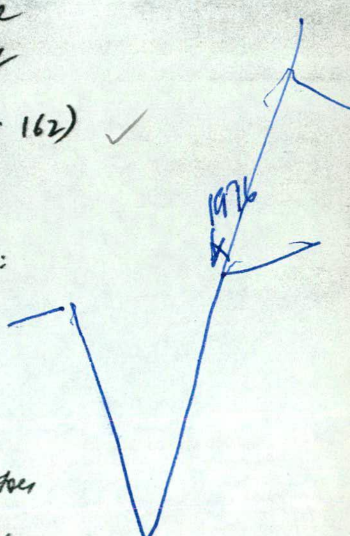
- to direct policy towards the defeat of inflation by imposing a financial discipline in the form of monetary policy.
- to set policymaking in a medium term perspective in contrast to the traditional emphasis on shorter term considerations (answer 163)
- to bring fiscal and monetary policy together within a framework to avoid the kind of conflict that so easily arises.

Success Other Countries

No reputation establish track record

2. Other important characteristics of the MTFS were

- to focus on the things that government could do. And hence avoid the problems of failure and lack of credibility that comes from attempting the impossible
- to set out government role so that the private sector can take it into account rather than be caught in a position of reacting to the behaviour of the private sector (see answer 162) ✓
- to try to be consistent and clear. It is important in setting the rules of the game to react in a consistent manner: and it helps if those rules can be readily understood.



UK.

3. At the outset this was a radical plan. It was the economic component of what became known as 'Thatcherism'. Today it does not seem so revolutionary — mainly because the general approach has been followed by most of the other major industrial countries. Monetary targets were not invented in the UK. But the emphasis on the longer term perspective originated here. As did the emphasis on the striking the right balance between the contribution of monetary and fiscal policy

· How we operate policy

(2)

II. 1 In considering the operation of policy useful to divide between monetary and fiscal components.

Maybe something about fiscal policy.

Money GDP

2. The objective of the MTFS has and is to reduce inflation. The way you bring inflation down is by operating within a nominal framework ~~It is helpful to think in~~ and ~~terms of~~ reducing the growth of money GDP; that is GDP in current prices.

3 Money GDP is the amalgam of 2 things; the real rate of growth and the rate of inflation. Real growth depends on a whole lot of real things which the Government can influence to some extent by its micro-policies; supply side policies. In the short run it can also be affected by changes in ~~the growth of money GDP~~ monetary policy. But over the medium term this washes out and output tends to return to the level determined by the supply behaviour of the economy.

4 Inflation, on the other hand, can be influenced directly by monetary policy towards achieving an appropriate growth of money GDP. In the short run changes in money GDP show up to some extent in more or less output. Over the longer term they show up in the rate of inflation.

5 It follows that if you pursue a persistent policy to reduce the growth of money GDP to the trend growth of output inflation will be eliminated. On the other hand if money GDP stabilises at a higher rate ~~than~~ than the supply potential of the economy you will have persistent inflation. The extent of that inflation will depend on the extent to which money GDP growth exceeds the supply potential

6. Some critics argue that money GDP is unhelpful as a concept because it adds together 2 different things; output growth which is a good thing; and inflation which is a bad thing. This misses the point. The issue is not whether they are good or bad but whether they can be influenced by ~~macro economic~~ ~~fiscal~~ monetary policy. My argument is that money GDP can be influenced by monetary policy, including, of course, the exchange rate; but that over the medium term output can not be. The delivery of an appropriate path for money GDP is an essential element of in delivering lower inflation.

7. We can clearly see that mechanism working over the past 7 years; the growth of money GDP has been reduced from about [15 per cent] [over the last few years of the 1970s] to 8 per cent over the past 3 years. Inflation has been reduced from 13 per cent to 5 per cent.

And our aim is to make further progress. The MTFS sets out a path which will progressively reduce money GDP growth to 5½ per cent by the end of the decade. On the assumption of an underlying growth rate of 2½% this should deliver inflation at 3 per cent.

Monetary Targets

8. The way we deliver that path for money GDP is by the pursuit of an appropriate monetary policy. Some commentators have suggested a target for money GDP with policy instruments adjusted to meet that target in the light of the best available forecast. That is a useful check and an essential part of the analysis we perform. But it is not enough. It is essential to have in place a suitable monetary discipline that is visible and produces the correct responses. It is not enough to rely on forecasts. The record suggests that during inflationary periods they underestate the pressure on inflation. We need more of an anchor.

9. Since 1976 almost all of the major industrial countries have found that the most effective anchor has been monetary targets. But they have also found that they need to be applied with good sense and an eye for the changing technology of the financial world.

Broad Money

10. Initially the main focus of the MTFS was upon £M3, a broad measure of money which includes interest bearing deposits primarily held for savings rather than transactions purposes. There were a number of reasons for this emphasis. First it was already in residence. It had evolved naturally from the IMF's DCE targets and had its rapid growth in the early 1970's had preceded the rapid inflation of 1974-5. And it helped to focus attention upon fiscal policy and the extent of the Government's role in increasing money supply.

11. At the same time we warned that other measures of money would be monitored and £M3 would not inevitably receive exclusive attention. This was just as well as the relationship between £M3 and nominal GDP in the 1980's has been very different from that of the 1970's. Between 1970 and 1980 £M3 grew on average by [2]% less than money GDP. Since 1980 it has grown on average by 4% more than money GDP. It is not possible to be precise why we have seen this turnabout. The changes to the financial system have obviously played a part – deregulation and technological change. And persistently high real interest rates have made £M3 a useful savings medium. More and more financing has been channelled through the banks as they have been able to compete for business

(4)

12. Whatever the reason, changes to the growth of £M3 over the lifetime of the MTFS have not provided much information about subsequent movements in money GDP. This is not sufficient reason for ignoring them. We may have been going through a substantial period of adjustment. We must constantly guard against an excessive build-up of liquidity that would threaten our inflation objectives. But until the period of adjustment is over we must be realistic and accept that it has become very difficult to interpret the implications of particular growth of £M3.

Narrow Money

This is why we have given more weight to narrower measures of money. M1 proved to be troublesome because of the share of its money rose rapidly over the lifetime of the MTFS.

13 By contrast M0 the narrowest measure of money has proved a reliable indicator of movements of money GDP in the [illegible] years. If we examine annual data — adjusted for the miners strike and changes to bankers balance due to changed statutory requirements — we find that money GDP in the year in question has grown by between 2 and 5 per cent more than M0 in the previous year. ~~[illegible]~~ This is a narrow range. Furthermore the average velocity increase of 3 per cent is little different to the velocity trend over the early 1970's.

14 I am fully aware of the limitations of M0 as a target aggregate; in particular the narrow range of transactions it covers and the potential for sharper technological shifts. During the first half of the seventies the relationship was not so straightforward. ~~But in the meantime we should pay due heed to the message about~~ But following the experience of the past 10 years we will continue to give significant weight to its movement.

15 One argument often used by critics hostile to the target range for M0 is that it is not sensitive to interest rate changes. ~~[illegible]~~ They forget that excessive sensitivity to interest rate changes is in fact a disadvantage. It becomes too easy to bring about changes to monetary growth that are of marginal significance and the velocity trend is too sensitive to the underlying rate of inflation. That is one reason why we have rejected non-interest bearing M1 as a suitable target aggregate. In fact if we examine the movement of M0 and NIBM1 over the past x years we find that they both move in a similar fashion over a period of 2 or 3 years but in the short run NIBM1 is much more volatile — it spreads confusing noise. The degree of ~~interest~~ rate sensitivity of M0 to interest rate changes seems to be neither too great or too little.

16 Some critics ~~[illegible]~~ query the mechanism by which M0 can influence money GDP. This is to look for a black box mechanism that I have never claimed. Clearly my interpretation is that M0 is influenced by many of the factors that influence money GDP — particularly interest rates and disposable income changes. But they seem to influence M0 more immediately than they influence money GDP. In that sense it contains useful information. In essence it is an indicator variable that gives information about ... We do not need to rely upon it with blind faith when interest rate changes may be or maybe not necessary but those who have ignored it are throwing away useful information.

17 It is sometimes asked why interest rates are never changed in response to news about M0. This is largely because M0 growth only tends to change slowly and we would not expect sharp r changes to follow. But where it has not usually been the trigger for r action it has often persuaded us against changes that might otherwise have taken place. Let me be more precise. Most forecasts of inflation have been too pessimistic in recent years — particularly those generated outside the Treasury. The measures [illegible] pointing to a need for higher interest rates to secure our inflation objectives. Those who have given a high weight to £M3 have also tended to argue for higher interest rates than we actually [illegible] ... We have often resisted these blandishments because of the above reasoning — and in the

17. It is sometimes asked why interest rates are never changed in response to news about M0. This is largely because M0 growth only tends to change slowly and we would not expect sharp interest rate changes to follow. But whereas it has not usually been the trigger for interest rate action it has often [illegible] persuaded us against changes that might otherwise have taken place. Let me be more precise. Most forecasts of inflation have been too pessimistic in recent years – particularly those generated outside the Treasury. In general ~~we~~ they would have been pointing to a need for higher interest rates to deliver our inflation objective. And those who have given a high weight to £M3 have also tended to ~~agree~~ argue for higher interest rates than ~~we actually experienced~~ proved necessary. We have often resisted these blandishments because of the more reassuring – and in the event more accurate – signals coming from M0.

event more accurate signals coming from M0.

(5)

The Exchange Rate

1. [illegible] timing of short term interest rates changes have often been strongly influenced by exchange rate movements. As a result it is often, wrongly, concluded that we must be operating an exchange rate target. Let me try once again to set out our views about the role of the exchange rate in the operation of monetary policy.

2. ~~There have been times when~~ My remarks apply to the present environment. Under some circumstances a fixed exchange rate regime can be a very effective monetary discipline. It forces the authorities to recognise when policies being pursued are too expansionary or restrictive for inflation to continue running at the same rate as elsewhere. It leaves little room for vacillation and is a tough discipline.

3. But unless we are part of a formal ~~In the absence of~~ a fixed ~~[illegible]~~ exchange rate system, shared ~~operated~~ by other countries as well, it is very risky and dangerous to try to set up a unilateral exchange rate objective. There is no systematic expectation benefit and markets will continuously test resolve. Large rate changes will be necessary that can have profound implications for the real economy.

4. So we do not attempt to set a target exchange rate zone for ourselves and interest rates are not changed with such a target range in mind. But we are influenced by other considerations
   - a bias against sharp XR variation. Sharp changes whatever their cause can become self-fulfilling and lead to sharp changes to inflation. It is often necessary to act to limit the speed of change and enforce ~~[illegible]~~ some stability
   - a bias against XR's that provide an inflationary impulse. Where we are attempting to bring down inflation the XR should work to support that objective. That will mean a bracing - but not excessively tough - competitive environment.

   And if interest rates have had to be raised to prevent a falling exchange rate gaining momentum then the a reversal of these XR pressures can make room for a reversal of the interest rate change if the underlying monetary conditions are satisfactory

5. The XR can fulfill another role. That of being umpire when the various monetary aggregates are giving different messages. Unless it can be explained by developments ~~movements~~ in other countries and or special factors there must be a presumption that ~~sharp~~ persistent exchange rate movements reflect, to some degree, underlying monetary conditions. If there is a conflict between the messages coming from the monetary aggregates this can help to resolve the conflict.

6. This approach to the exchange rate is nothing new but it has been refined over time. The first occasion when the exchange rate played such a role was the Autumn of 1980. Following the abolition of the corset £M3 was growing rapidly whilst [broader] measures of money were growing [steadily] then slowing down. The exchange rate appreciated despite persistent expectations that this would not continue. Other asset prices, particularly for land and houses were rising slowly.

7. We had to choose between 2 interpretations of monetary conditions ~~, either that they signalled~~ In the event we chose to ~~attach~~ put more emphasis upon the interpretation that monetary conditions were tight. Interest rates were reduced by 2 per cent in November 1980 and a further 2 per cent in March 1981.

8. Some have argued that we ignored the messages about tight monetary conditions. That is clearly wrong. Others have argued that we responded too late and by too little. That has to be judged against the circumstances of the time — rising inflation, a very rapid growth of earnings, ~~pressure upon~~ growth than expected public borrowing and a very growth of liquidity and bank lending. And an MTFS that had recently been launched and had not had time to build up the credibility it now has.

9 The danger ~~[illegible]~~ costs of a sharp reversal of the exchange rate and with rapid earnings growth the build up of liquidity could not be ignored.

[signature]

~~Space~~

The Determination of Interest Rates

10. Our approach to interest rates is based upon an interpretation of monetary conditions. This ~~assessment~~ interpretation is based upon an assessment of the behaviour of the monetary aggregates together with other relevant evidence, especially the exchange rate.

11 The assessment of the behaviour of the monetary aggregates is done in relation to their targets. The targets in turn are determined ~~in relation~~ by reference to the desired medium term path for money GDP and an analysis of the underlying trend movement of velocity. In recent years M0 has tended to grow by 3%-4% less than money GDP whilst £M3 has grown by 4% or so more. This has been reflected in the targets set in this year's MTFS.

[Margin note, bracketing paragraphs 10–11: maybe these paragraphs should be integrated into ~~[illegible]~~ section on monetary targets and broad/narrow money]

(INSERT A) (next page)

12 There is no mechanical formula for taking the ~~exchange rate~~ various factors into account. This very often a case of weighing movements in one factor against movements in another. If the underlying growth of M0 or £M3 were to move significantly outside their target ranges there would be a presumption of action unless the other evidence available was overwhelming.

Short-term interest rates can be expected to have a relatively fast acting effect on the growth of narrow money

13 In the case of M0 this is straightforward. The rise in interest rates in response to an overrun of the target would be expected to bring M0 growth back within its target range, ~~but there It is also likely that the exchange rate would rise~~ And this would be likely to show up in the behaviour of the exchange rate.

14. In the case of £M3 the position is more complicated. Experience suggests that a change in short term rates is unlikely to alter the growth of £M3 significantly within the target period. But such action clearly affects the tightness of monetary conditions, which is what matters; and this would be likely to show up in the behaviour of M0 and the exchange rate.

15 It follows that the target for broad money does not have the same operational significance as that for narrow money.

16 INSERT A

* Short term interest rates are clearly the main instrument of monetary policy. In the final analysis they must be set by the monetary authorities, in the UK as elsewhere. There can be some misunderstanding about this. I have never suggested that the market could, entirely independently, set the level of interest rates. The ~~constellation~~ pattern of interest rates is pinned on the rate at which the Bank of England deals with the market. But this is not to say that the market does not exercise an influence on rates. There are times when the yield curve indicates very clearly the direction in which the market believes interest rates should move. At times we choose to validate the movement if we believe they are justified by monetary conditions. And on occasions even if we disagree with the underlying diagnosis it can be dangerous to resist a market-led move if it risks being misinterpreted.

But on other occasions it is right to resist. This was so earlier this year, when I decided on an early move in response to the falling oil price, but took the view that the pressure for a further rise beyond 12½ per cent was not required for reasons of monetary conditions and was founded on an exaggerated view of sterling's vulnerability to movements in the oil price].

This all sounds very complicated and on my occasions I am urged to provide a brief succinct summary of the operation of policy. Unfortunately the operation of monetary is difficult. That is an unhappy fact of life. It is sometimes suggested that this is a far cry from the original simple MTFS and that it was a mistake to begin with a relatively uncomplicated version. It is argued that both models can't be right. Either the 1980 model was too simple or the 1986 model is too obscure.

2. I recognise there have been changes, they fall into two categories; changes of presentation and changes of substance.

3. First the question of presentation. At the outset this Government had no track record. It was a new approach and there was a high degree of distrust about the motives of Government. Many people doubted if we would ever see single digit inflation again. At that point it was important to err on the side of rigidity and rules, rather than of flexibility and discretion. In the past discretion had generally been exercised in favour of financial relaxation; it erred on the side of priority to real growth at the expense of inflation. The first task was to convince markets, both at home and abroad, that we were serious about defeating inflation.

4. We have now built a track record. The inflation rate has been decisively reduced and it is much closer to the average of the other major industrial countries. We have demonstrated that inflation can be reduced by monetary control; and that we are not afraid to respond by tightening monetary policy if higher inflation is threatened.

5. At the same time we have seen the way that output recovery can be combined with low inflation. Steady output growth does not require persistent fiscal and monetary stimulus.

6. The task is now a different one. To make a further important dent in the inflation rate within a framework that leaves room for output to grow. We are now in a position to be more explicit about the complexities of policy without running the risk of creating worries that we are about to fall back into the bad old ways. Some countries – for example Germany and Switzerland – have not had to face this problem as their track record had existed for many years.

7. ~~The truth is that~~

Second, the problem of substance. I fear that without doubt the problem of operating monetary policy has become more complicated. In part this is because of deregulation and more competition. It is ~~one of the~~ a classic example of the sort of trade-off we have to face. In the long run there can be little doubt that deregulation and competition must be good for the financial sector and for the efficient operation of the economy. But in the immediate run they complicate the monetary signals and make the technical problems of monetary control that much greater.

8. These changes have been an important explanation for the changed relationship between £M3 and money GDP. And M1 has undergone considerable structural change as an increasing proportion of sight deposits became interest-bearing. It has become increasingly difficult to draw a line between money balances held for transactions and those held as savings.

9. And greater freedom of capital movements has changed the relationship between monetary policy, fiscal policy and the exchange rate. In the days of low capital mobility the current account probably had a ~~big~~ bigger influence on the exchange rate. There was a greater presumption that fiscal expansion would reduce the exchange rate. More recently capital flows have been a more dominant element. When combined with a regime of monetary targets it has created a strong presumption ~~The impact of fiscal policy changes upon the exchange rate have~~ fears that fiscal policy will lead to a higher exchange rate.

10. These changes inevitably change the balance between rules and discretion. Amidst these changes to ~~existing~~ important relationships is the necessity of monitoring information flows more carefully and coming to a judgement about the implications of the various indicators. In this process it is important that the best should not be the enemy of the good. It is no use ~~stopping~~ commentators urging me to ignore M0 because it only shows a relatively short lead over money GDP if there is nothing more robust.

Conclusions

As I said at the Mansion House, "at the end of the day the position is clear and unambiguous. The inflation rate is judge and jury." In looking back at our past record we have to examine the outturn for inflation. Some commentators suggested this meant we would be basing monetary policy on forecasts of inflation. That is not at all what I said. Today's inflation rate tells us something about monetary policy sometime earlier. The decline of inflation over the past 7 years tells me, that despite all the problems with the monetary aggregates, and the need to learn how to integrate exchange rate movements into that analysis, we have basically succeeded in delivering the appropriate monetary policy

CONFIDENTIAL

FROM: H J DAVIES
DATE: 24 MARCH 1986

SIR P MIDDLETON

cc Sir T Burns
Sir G Littler
Mr Cassell
Mr Peretz
Mr Fitchew
Mr Scholar
Mr Culpin
Mrs Lomax
Mr Cropper

LOMBARD ASSOCIATION SPEECH ON MONETARY POLICY: 16 APRIL

Following on from Friday evening's discussion of your outline I have put together a first draft.

2. Probably mistakenly I have tried, in drafting terms, to start more or less afresh, rather than doing a scissors and paste job on various MTFS paragraphs, Mansion House speeches, Budget statements etc. So the chances are that it is shot through with errors and hostages to fortune.

3. Could I draw attention to the following points, which I think need more thought:

i) Money GDP I think it all makes more sense if we can pull the strands together and relate them to the path for Money GDP. But in deference to your opposition to any mention of Money GDP I have left that section in note form, and in square brackets.

ii) Funding I was unclear after Friday whether we wanted to talk about funding or not. There is a section here, which draws on the Mansion House, again in square brackets. I think it would be odd not to say anything. But how little can we

get away with? There is a case, in the long form version, for talking about the components of funding too, and getting something about the National Savings target on the record.

iii) 1976 and all that. I have been less kind to the previous administration than you were. This is mainly a political question. I do not see why the Chancellor should be as positive as you were in your outline about 1976-79. But we might agree to differ on that.

iv) EMS This is not easy. The formulation we discussed on Friday does not seem to make sense to me, but I have put it in anyway because I couldn't think of anything better.

4. I would be grateful for **comments by close on Tuesday**, please. If you or others think a further meeting is required, please note that I have to leave the office (to make a speech on the Budget!) by 5pm on Tuesday.

HJD

H J DAVIES

LOMBARD ASSOCIATION SPEECH: FIRST DRAFT 24 MARCH

1) INTRODUCTION

1986 marks the tenth anniversary of Britain's flight to the International Monetary Fund. The tenth anniversary of that embarrassing moment when Britain went bust.

It is also, I might recall, the twentieth anniversary of our victory in the World Cup.

Some knowledgeable commentators are forecasting a repeat of that triumph in Mexico this summer. But no-one, I think, has suggested that we might need to go back to the IMF.

2) THE LAST TEN YEARS

The 1976 debacle was the culmination of a long period of economic mismanagement.

Successive governments believed that it was possible, through the manipulation of fiscal and monetary policies, to accelerate or slow down the growth of real output and wealth. Budget deficits were set with an eye to their impact on real demand, and interest rates were adjusted in an attempt to control real variables. When it became clear that these policies did not produce the required response in an open economy, a range of controls were imposed on wages, prices and financial transactions, in an attempt to

buttress macroeconomic policy.

As Governments became more and more enmeshed in these wrongheaded attempts to foster growth, nominal variables were allowed to run wild. The constraints which Bretton Woods had imposed on exchange rate movements were increasingly ignored. Monetary growth was regarded as, at best, an irrelevance. The debt spiralled out of control.

We reaped the whirlwind in the form of rapid and accelerating inflation, and, just as important, inherited an economy so choked with controls that its own natural growth potential was almost destroyed. At the time, the IMF episode seemed to mark a decisive turning point. After many warning letters, all ignored, the bank manager turned up at the door. Something had to be done.

And something was done. Nominal targets were put in place. At the time, some of you may recall, they were expressed in terms of Domestic Credit Expansion - DCE. Not a useful concept since the abolition of exchange controls, but a reasonable target to choose in the circumstances of the time.

Public expenditure - principally capital spending - was cut back very sharply [number]. The PSBR was lowered significantly [numbers], though by present-day standards it was still very high. And, perhaps most importantly, the Labour government explicitly turned its back on the old demand-management philosophy. Mr Callaghan put it most succinctly when he said - in a phrase widely quoted at the time, and since - "the days when we could control growth by

public spending have gone for good" [or whatever the exact quote was].

But though Downing Street - numbers 10 and 11 - may have been converted to the joys of sound money, in the Labour Party more generally the conversion was skin-deep. And by 1979 it was clear that the IMF episode had been a false dawn. When the Conservative Government was elected in May of that year inflation was already rising fast once again. And, the overriding need was to assert, in the clearest possible terms, the Government's unshakeable commitment to reducing the rate of inflation, and its fundamental belief that Governments cannot hope to influence the long-term growth potential of the real economy through financial policy.

3) **THE FIRST MTFS**

That was the background against which the Medium Term Financial Strategy was constructed.

Six years after its first introduction in the Budget of 1980 it is easy to forget how revolutionary the MTFS was. It was the first attempt in the UK to establish a clear financial framework to which the Government was committed for a period of years. One which asserted the primacy of the control of inflation, explained clearly how it was to be achieved, and set a path for public sector borrowing consistent with declining inflation.

Looking back today at the first model of the MTFS we can see that there were faults in some elements of the specification. Just

as the first Morris mini in [1962], which revolutionised the small car market, had tiresome features. I recall that in driving rain the top speed was reduced to 35 miles an hour,because the distributor was just behind the radiator grille.

The mini has been improved since then. As has the MTFS.

But in both cases the basic design remains the same.

4) <u>**EVOLUTION 1979-1986**</u>

How has the MTFS changed since 1980?

At the outset there is no doubt that the construction was somewhat rigid. Though it was always acknowledged [?quote] that other aggregates and indicators would need to be taken into account, £M3 had pride of place. There were target ranges for broad money only, and ranges which were projected to fall over time, as inflation was reduced, reflecting the trend in velocity observed over the previous decade.

At the time it was certainly right to wish to err on the side of rigidity and rules, rather than of flexibility and discretion. The British government's credibility in financial management - though higher than it had been before 1976 - remained low. Whenever discretion had been exercised, it was always in the same direction, that of financial relaxation in an attempt to boost real growth. Our first task was to convince the markets, both at home and abroad, that we meant business. The early versions

of the MTFS achieved that essential first objective - and, after all, they worked as far as inflation was concerned.

It is not my intention today to explain every twist and turn of monetary policy since 1979. But it is important to be quite clear about what has changed between then and now, and what has remained the same.

There are those who argue that the monetarism of that glad confident morning is dead; there are others who maintain that the Government's rigour in controlling financial conditions has become more, not less severe. Both are far from the truth.

In a word, the objectives, the strategy of the MTFS remain unchanged. The precise specifications - the tactics if you like - have evolved as financial markets themselves have evolved.

The last seven years has been a period of dramatic and fundamental change in financial markets throughout the world. But the changes in London have perhaps been even more marked than those elsewhere. In part, this is a direct result of the removal of aritficial controls - a vital element in our policy from the start. The lifting of exchange controls in November 1979, and the removal of the corset on bank lending in July of the following year, were changes of fundamental importance.

Since then we have seen a radical process of liberalisation and innovation in financial markets which has inevitably altered the significance of different measures of money. The most important

consequence - from the perspective of the MTFS, at least - is that the relationship of broad money, and particularly of £M3, to money GDP has altered. The velocity of £M3 has declined, contrary to the experience of the seventies, as companies and individuals have held a greater proportion of their financial assets in the form of bank deposits. £M3 has become a savings medium to a far greater extent than hitherto. This has had two major consequences for monetary policy. First, a more rapid rate of growth of £M3 than forecast has been consistent with falling inflation. And, second, £M3 is now much less responsive to changes in short term interest rates.

At the same time as the behaviour of £M3 was becoming less predictable, and less susceptible to control, MO became more useful. Before the change in monetary control arrangements in the summer of 1981 there was little information in movements in MO, since the level of bankers' cash balances was constrained by the authorities. Since then MO has begun to exhibit a predictable relationship with the growth of money GDP and inflation, and its status as a target within the MTFS framework has been raised accordingly.

I will come in a moment to a detailed explanation of the way in which we operate policy from day to day.

But it is important to recognise that, significant though these changes have been, they are far outweighed by the elements of continuity. Of course in the popular prints they assume greater significance than they deserve because they are the major

preoccupation in life for the brokers pundits - after counting their own golden hellos and handshakes of course.

The plain fact is that the MTFS remains essentially unchanged. And for the best of reasons. Because it works. Inflation has come down, just as the Government said it would. Tight control of financial conditions has been maintained.

As I have observed before, in assessing the conduct of financial policy the inflation rate is judge and jury. In the case of my predecessor and myself the verdict is clear. We were charged with reducing inflation. And we are guilty as charged.

5) **THE POLICY NOW**

I fully accept, however, that it is not enough to point to our achievements and to argue that inflation is safe with us. This "black box" approach to monetary policy has obvious attractions to practitioners. It would make for an easy life if one gave up the attempt to specify policy in advance, and simply commented in retrospect on the signficant relationships between nominal variables that one had observed. Many of my economic advisers would prefer this manner of proceeding.

But it is not enough. Because financial markets, like any others, work better with a free flow of information. So it is right that the authorities should explain as clearly as possible what the medium and short term objectives of policy are. The authorities must retain a degree of discretion in the operation of policy,

but the extent of that discretion should be defined, as should the principles which govern its use. The prime objective of policy remains to exercise steady downward pressure on inflation through the control of money incomes. This control cannot be exercised directly. Instead, the Government must act on variables within its control. It must seek to maintain monetary conditions consistent with falling inflation, principally through manipulating short-term interest rates. And it must maintain tight control of its own spending in cash terms, and of its own borrowing requirement.

At the same time, microeconomic - supply side - policies should be used to improve the performance of the economy, to maximise its long term growth potential, and its ability to generate employment. That is not the principal subject of my speech this evening. But I should say that I attach great importance to that strand of policy, as each of my three budgets to date has amply demonstrated.

6) <u>THE CONDUCT OF POLICY</u>

The MTFS I published in the Budget Red Book last month - the seventh in the series - sets out the nominal framework within which policy will be conducted in the coming year.

There are target ranges for both MO and £M3, and illustrative ranges for MO for the following three years. The text explains the differing significance of these targets, and the way in which we interpret movements in the two aggregates in forming a view of the appropriate level of short-term interest rates.

Short-term interest rates are clearly the main instrument of monetary policy.

Funding

[I explained in my speech at the Mansion House in October last year that from now on funding policy would be directed at achieving a full fund of the PSBR over the yar as a whole, no more no less. The outcome for 1985-86 was consistent with that, and it remains our approach for the coming year. The purpose of funding the PSBR is to ensure that the Government's own deficit is financed in a non-inflationary way. We shall stick to that objctive, and, of course, with a borrowing requirement of the size seen in the last financial year, and forecast for this, there is no doubt whatsoever that it will be achieved.]

Interest Rates

In the final analysis short term interest rates must be set by the monetary authorities, in the United Kingdom as elsewhere. There has been a degree of misunderstanding of the Government's view on this point, some of it, I fear, wilful. We have never said that the market could, entirely independently, set the level of interest rates. Of course it cannot, since any constellation of rates is founded on the rate at which the Bank of England deals with the market. But this is not to say that the market does not exercise an influence on rates. There are times when the yield curve, or indeed the exchange rate, indicates very clearly the

direction in which the market believes interest rates should move. At times, the authorities are wise to validate the movement, if they share the view that monetary conditions are insufficiently tight to deliver the objective for inflation.

But there are other occasions on which it is right to resist. This was so earlier this year, when I decided on an early move in response to the falling oil price, but took the view that the pressure for a further rise beyond 12½ per cent was founded on inaccurate perceptions of sterling's vulnerability to movements in the oil price.

MO

The cornerstone of interest rate policy is the assessment of domestic financial conditions and in this assessment the two principal monetary aggregates, MO and £M3 play the leading role.

The City has not found it easy to understand the significance of MO. Wealthy young men with wallets full of plastic may only occasionally set eyes on a note or a coin. But my impression is that sentiment is changing, if slowly. As Gordon Pepper said in a recent bulletin, "MO, whether the City approves or not, is relevant because of the importance the Chancellor attaches to it". Quite so.

A more important reason for the change in sentiment is the realisation, for those who are prepared to look at the experience of other countries, that by international standards MO is by no

means impossibly narrow. Just over half the Germans principal target aggregate, known as Central Bank Money, is in fact notes and coin.

MO is ,and this is of course especially valuable, clearly related to spending patterns. Its velocity trend has been relatively stable over a number of years, which makes it appropriate to publish indicative ranges for the later years of the MTFS period.

If, therefore, MO moves outside its target range there will be a presumption in favour of action to bring it back within it. Though it will as usual be necessary to look carefully at the performance of other indicators; convincing evidence from them could make interest rates moves unnecessary.

£M3

In the case of £M3 different considerations apply. There has been some misunderstanding about the present status of £M3. I explained at the Mansion House last year that the range for 1985-86 had been set too low, and that action to bring the growth rate back within the range would not have been justified. But I said then, and I quote "I shall as usual be considering what target to set for 1986-87 at the time of the Budget".

As I have explained, £M3 does not respond rapidly or predictably to a change in interest rates. But movements outside the range set in the MTFS will nonetheless be important, and we shall need convincing evidence from other indicators that monetary conditions

are adequately tight if interest rates are not to be adjusted.

For the moment, given the uncertainty about the velocity trend of £M3, I think it right to publish a target range for the coming year only. I recognise that, at 11-15%, that range is a broad one. And with funding policy set to neutralise the impact of Government borrowing in monetary terms, it could imply a sizeable growth in bank credit extended to the private sector. The experience of the past few years suggests that this kind of growth can be perfectly consistent with confirmed progress on inflation. The structural factors encouraging the private sector to expand both sides of its balance sheet remain active. But if evidence that credit growth at this rate poses a threat to our inflation objective appears we shall take appropriate action. After narrow and broad money the most important of the other indicators is, of course, the exchange rate.

Exchange Rate

Since we are not participants in the exchange rate mechanism of the European Monetary System we do not have an announced exchange rate target, nor in those circumstances would it make sense to have one outside the EMS. And lest there be any misunderstanding on the point, let me say at once that there is no unannounced exchange rate target either.

But the exchange rate has come to play a more important role in the assessment of financial conditions. This is, in part, attributable to the enormous increase in the volatility of the

currency markets, with huge movements in nominal - and real - exchange rates over a very short period. But also, certainly, because the rate of change in domestic markets has clouded the significance of some domestic indicators.

We cannot be indifferent to the level of the exchange rate. And major movements in the rate, whatever their cause, can have an impact on domestic conditions and on inflation.

But nor can we unilaterally choose the exchange rate we want to have with the rest of the world.

Again the events of 1976 are instructive, when a unilateral contest with the rest of the world led to predictable results. In recent years we have intervened in the market from time to time, to repay debt, and occasionally to borrow. And where appropriate, in concert with others, we have intervened to smooth fluctuations in the rate. In the case of the Plaza agreement last year, when G5 ministers all accepted the case for a downward adjustment in the dollar, particularly against the deutschemark and the yen, our ambitions were higher, but once again modest, realistic and fully in line with those of our partners.

[Money GDP

Control of public spending. Borrowing sterilised by funding. Close monitoring of narrow and broad money. Taking exchange rate into account. Administering interest rates accordingly.

All allow Government to achieve the indicated path for nominal incomes.

Money GDP the route from intermediate targets to final objective of inflation. Figures slow to appear, retrospective adjustments etc, but an essential backward-looking check on success.

Over last five years Money GDP has been steadily reduced. And division betwen inflation and real growth become steadily more favourable. So that this year close to 3% each way. But performance for a generation.]

7) <u>CONCLUSION</u>

The conduct of monetary policy is necessarily a matter of some complexity. Those who seek refuge in comfortable certainties are inevitably disappointed in the end.

In the last 10 years the United Kingdom has gradually rejoined the rest of the world. In the conduct of macroeconomic policy generally - in other words the primacy given to sound monetary conditions. And, in consequence, in the performance of our real economy, which has returned to a path of steady, non-inflationary growth.

This is just as true of the detailed conduct of monetary policy.

"Monetary policy is implemented day by day and week by week...in the light of monetary growth, judged in the context of the flow

of information about the economy, the outlook for prices, and domestic and international financial markets including the value of [sterling] in the foreign exchange markets."

Had I not inserted "sterling" for "dollar" you would no doubt have known at once that the last sentence was a recent quotation from Paul Volcker. It conveniently summarises the approach I have been describing here today.

We, like the Federal Reserve, like the Bundesbank, like the Swiss, must tread a difficult path, and strike a delicate balance between rules and discretion. The positions we have respectively chosen are very similar in character. That fact, and the dramatic improvement in our inflation record, serves to convince me that we are on the right track.

Standard Chartered

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Telephone 01-623 8711 Telex 884689 Cables Stacharmer London EC3

MM/cm

Rt. Hon. Nigel Lawson, PC, MP,
Chancellor of The Exchequer,
Treasury Chambers,
Parliament Street,
London, SW1P 3AG.

26th March 1986

Dear Chancellor,

LOMBARD ASSOCIATION

I refer to my letters of the 5th and 24th June, 1985, concerning the Association's invitation and your acceptance to be the Guest of Honour and Speaker at the Association's dinner on the 16th April, 1986.

As promised in my letter of 24th June, 1985, I am now reverting to you to finalise details in the above respect.

Firstly, please note that the Association meets for dinner in the Great Hall at the Institute of Chartered Accountants, Moorgate Place, EC2. Moorgate Place is accessed from Moorgate and the arched entrance to Moorgate Place is opposite 49 Moorgate (Goldfields Building) and on one side of the entrance is Texas Commerce Bank and on the other is Marine Midland Bank. A map is enclosed for ease of reference and I trust that you will not have difficulty in finding the venue for the dinner.

Secondly, please note that dinner commences at 6.15 pm, but that we meet for drinks beforehand, which will give you the opportunity of meeting the Association's Committee members. I shall meet you at the entrance to the Institute of Chartered Accountants at 5.50pm on the 16th April and will escort you to the Chairman's pre-dinner reception.

Thirdly, you will undoubtedly be interested to know that the order of speakers to the chosen theme, "The UK -An Economy On The Right Track?", has proceeded as planned, and Professor Richard Layard (Charter for Jobs), Sir Peter Tapsell (Conservative Centre Forward Movement), John Caff (Director of Economics, CBI), Norman Willis (General Secretary, TUC) and Professor Sir James Ball (Prof. of Economics, London Business School) have all given their talks.

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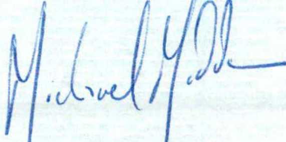
Please do not hesitate to let me know through your office if there is any further information which you require.

Yours sincerely,



M. Madden
Managing Director.

N² P²

SCALE 0 ¼ ½ MILE

FROM: H J DAVIES
DATE: 27 MARCH 1986

CHANCELLOR

cc EST
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Peretz
Mr Fitchew
Mr Scholar
Mr Culpin
Mr Cropper
Mr Ross-Goobey

LOMBARD ASSOCIATION SPEECH ON MONETARY POLICY: 16 APRIL

I attach a draft speech, which takes account of comments from Sir Peter Middleton, Mr Cassell, Mr Peretz and Mr Sedgwick on my first draft.

2. It is slightly messy, with rather more square bracketed passages than is ideal at this stage. But in part this comes from the need to think about two versions, a short and a long one. You will see that many of the square bracketed pieces are, I think, more suitable for the long exposition than for use at the dinner itself.

3. The principal point at issue amongst those who have commented on the draft is the status we should give to money GDP. The existing structure is something of a compromise between those who would prefer an extended discussion of the role of money GDP early on, and those who would rather sweep it up at the end of the section on the operation of policy and emphasise its role as a retrospective check on progress.

4. There is some duplication built in at the moment, because at Mr Cassell's request I have added a section headed Setting Interest Rates from Mr Peretz's first version. This pulls together the implications of what has been said in the earlier sections about the roles of the two monetary aggregates and the exchange rate. I think that in the short form of the speech you might be

able to exclude that altogether since the implications of what you say earlier on are fairly clear. But you will want to make up your own mind about how explicit we should be about our internal processes.

5. I am afraid I shall now have to hand over the co-ordination of the drafting to someone else. I do not know how I shall be able to wait until 16 April to learn the outcome.

HJD

H J DAVIES

1253/10

LOMBARD ASSOCIATION SPEECH: SECOND DRAFT 27 MARCH

1) INTRODUCTION

1986 marks the tenth anniversary of Britain's flight to the International Monetary Fund.

It is also, I might recall, the twentieth anniversary of our victory in the soccer World Cup.

Some knowledgeable commentators are forecasting a repeat of that triumph in Mexico this summer. But no-one, I think, has suggested that we might need to go back to the IMF.

Terrible opening.

2) THE LAST TEN YEARS

The 1976 debacle was the culmination of a long period of economic mismanagement. Ironically this stemmed from an exaggerated view of the powers of ~~monetary policy~~ money by people who usually professed to play down the importance of ~~money~~ monetary policy.

Successive governments believed that it was possible, through the manipulation of fiscal and monetary policies, to accelerate or slow down the growth of real output and wealth. Public spending was controlled - or, more usually, not controlled - in volume terms. Fiscal policy and interest rates were adjusted primarily

to achieve effects on real variables - except during periodic balance of payments crises. Partly becsause these policies did not produce the required response in an open economy, and partly because they produced other damaging side effects, a range of controls were imposed at various times on wages, prices and financial transactions, in an attempt to buttress macroeconomic policy.

In the early 1970s Governments became more and more enmeshed in these wrongheaded attempts to foster growth, and nominal variables were allowed to run wild. Until that time, for countries other than the US, the constraints which Bretton Woods had imposed on exchange rate movements provided a framework to keep prices in check. Indeed it was the failure of successive Administrations in the US to observe any nominal framework which blew the Bretton Woods system away.

Both in the UK and the US we reaped the whirlwind in the form of rapid and accelerating inflation from 1973 to 1975. But in the UK - an additional and equally important point - we inherited an economy so choked with controls that its own natural growth potential was almost destroyed. At the time, the IMF episode seemed to mark a decisive turning point. After many warning letters, all ignored, the bank manager turned up at the door. Something had to be done.

And something was done. Nominal targets were put in place. At the time, some of you may recall, they were expressed in terms of Domestic Credit Expansion - DCE. Not a useful concept since

the abolition of exchange controls, but a reasonable target to choose in the circumstances of the time.

Public expenditure - principally capital spending - was cut back very sharply [number]. The PSBR was lowered significantly [numbers], though by present-day standards it was still very high. And, perhaps most importantly, the Labour government explicitly turned its back on the old demand-management philosophy. Mr Callaghan when Prime Minister put it most succinctly when he said - in words widely quoted at the time, and since - "We used to think that you could just spend your way out of recession, and increase employment, by cutting taxes and boosting government spending. I tell you in all candour that this option no longer exists, and that insofar as it ever did exist, it worked by injecting inflation into the economy."

But though Downing Street - numbers 10 and 11 - may have been converted to the joys of sound money, in the Labour Party more generally the conversion was skin-deep. And by 1979 it was clear that the IMF episode had been a false dawn. When the Conservative Government was elected in May of that year inflation was already rising fast once again. And the overriding need was to assert, in the clearest possible terms, the Government's unshakeable commitment to reducing the rate of inflation, and its fundamental belief that Governments cannot hope to influence the long-term growth potential of the real economy through financial policy.

3) <u>**THE FIRST MTFS**</u>

That was the background against which the Medium Term Financial

Strategy was constructed.

Six years after its first introduction in the Budget of 1980 it is easy to forget how revolutionary the MTFS was. It was the first attempt in the UK to establish a clear financial framework to which the Government was committed for a period of years. One which asserted the primacy of the control of inflation, explained clearly how it was to be achieved, and set a path for public sector borrowing consistent with declining inflation.

Looking back today at the first model of the MTFS we can see that there were faults in some elements of the specification. Just as the first Morris mini in [1962], which revolutionised the small car market, had tiresome features. I recall that in driving rain the top speed was reduced to 35 miles an hour,because the distributor was just behind the radiator grille.

The mini has been improved since then. As has the MTFS.

But in both cases the basic design remains the same.

[Mr Peretz satirically suggests you could instead use Land Rover - early models gave a bumpy ride, now the high powered Range Rover, a more flexible vehicle which goes faster too]

[Mr Cassell sees a case for more breast-beating about the problems. I would not bother in the short version, but the long version could include an extended discussion.]

4) **EVOLUTION 1979-1986**

How has the MTFS changed since 1980?

At the outset there is no doubt that the construction was somewhat rigid. Though it was acknowledged from the start that the way in which the money supply was defined for target purposes would need to be adjusted from time to time as circumstances changed £M3 had pride of place. [Quote from 1980 Green Paper in long version]. There were target ranges for broad money only, and ranges which were projected to fall over time, as inflation was reduced, reflecting the trend in velocity observed over the previous decade.

At the time it was certainly right to wish to err on the side of rigidity and rules, rather than of flexibility and discretion. The British government's credibility in financial management - though higher than it had been before 1976 - remained low. Whenever discretion had been exercised, it was always in the same direction, that of financial relaxation in an attempt to boost real growth. Our first task was to convince the markets, both at home and abroad, that we meant business. The early versions of the MTFS achieved that essential first objective - and, after all, they worked as far as inflation was concerned.

It is not my intention today to explain every twist and turn of monetary policy since 1979. But it is important to be quite clear about what has changed between then and now, and what has remained the same.

There are those who argue that the monetarism of that glad confident morning is dead; there are others who maintain that the Government's rigour in controlling financial conditions has become more, not less severe. Both are far from the truth.

In a word, the objectives, the strategy of the MTFS remain unchanged. The precise specifications - the tactics if you like - have evolved as financial markets themselves have evolved.

More changes in last 6 years than previous 60.

The last seven years has been a period of dramatic and fundamental change in financial markets throughout the world. But the changes in London have perhaps been even more marked than those elsewhere. In part, this is a direct result of the removal of aritficial controls - a vital element in our policy from the start. The lifting of exchange controls in November 1979, and the removal of the corset on bank lending in ~~July~~ June of the following year were changes of fundamental importance.

Since then we have seen a radical process of liberalisation and innovation in financial markets which has inevitably altered the significance of different measures of money. The most important consequence - from the perspective of the MTFS, at least - is that the relationship of broad money, and particularly of £M3, to money GDP has altered. The velocity of £M3 has declined, contrary to the experience of the seventies, as companies and individuals have held a greater proportion of their financial assets in the form of bank deposits. £M3 has become a savings medium to a far greater extent than hitherto. This has had two major consequences for monetary policy. First, a more rapid rate of growth of £M3

than forecast has been consistent with falling inflation. And, second, since £M3 contains a larger interest-bearing element ~~and~~ it is now less responsive to changes in short term interest rates.

The difficulties of interpreting movements in £M3 at a time of rapid structural change and innovation in financial markets led to the introduction in 1982 of a target for narrow money as well as for broad. It was hoped that this would provide a closer measure of movements in money balances held for transactions. However, it soon became apparent that the measure chosen for narrow money, M1, was undergoing considerable structural change as an increasing proportion of sight deposits became interest-bearing.

The obvious alternative, non-interest-bearing M1, was itself subject to structural change, and in any case was not a very good aggregate for targeting since it was highly sensitive to changes in interest rates, Structural changes, including this time those in building societies, also ruled out M2.

It became increasingly difficult to draw a line between money balances held for transactions and those held as savings. The one aggregate that was unequivocally a transactions balance was MO. Although this had been affected by financial innovation such as the growing use of cash dispensers and credit cards, it exhibited over a run of years a predictable relationship with the growth of money GDP and inflation. It also had the merit of having an unambiguous response to changes in interest rates.

So for all these reasons in 1984 MO was adopted as the best

indicator of changes in narrow money and was targeted in place of M1. [Some of this discussion of narrow money could be omitted in the shorter version.]

I will come in a moment to a detailed explanation of the way in which we operate policy from day to day.

But it is important to recognise that, significant though these changes have been, they are far outweighed by the elements of continuity. Of course in the popular prints they assume greater significance than they deserve because they are the major preoccupation in life for the brokers pundits - after counting their own golden hellos and handshakes of course.

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I fully accept, however, that it is not enough to point to our achievements and to argue that inflation is safe with us. This ~~"black box"~~ approach to monetary policy has obvious attractions

to practitioners. It would make for an easy life if one gave up the attempt to specify policy in advance, and simply commented in retrospect on the signficant relationships between nominal variables that one had observed. Many of my economic advisers would prefer this manner of proceeding.

But it is not enough. Because financial markets, like any others, work better with a free flow of information. So it is right that the authorities should explain as clearly as possible what the medium and short term objectives of policy are. The authorities must retain a degree of discretion in the operation of policy, but the extent of that discretion should be defined, as should the principles which govern its use. The prime objective of policy remains to exercise steady downward pressure on inflation through a gradual reduction in the growth of money GDP over the medium term. This control of money GDP cannot be exercised directly. Instead, the Government must act on intermediate financial variables. It must seek to maintain monetary conditions consistent with falling inflation, principally through manipulating short-term interest rates. And it must maintain tight control of its own spending in cash terms, and of its own borrowing requirement.

At the same time, microeconomic - supply side - policies should be used to improve the performance of the economy, to maximise its long term growth potential, and its ability to generate employment. That is not the principal subject of my speech this evening. But I should say that I attach great importance to that strand of policy, as each of my three budgets to date has amply demonstrated.

6) THE CONDUCT OF POLICY

The MTFS I published in the Budget Red Book last month - the seventh in the series - sets out the nominal framework within which policy will be conducted in the coming year.

The objectives for money GDP over the whole period are shown, together with target ranges for both MO and £M3, in the coming year and illustrative ranges for MO for the following three years. The text explains the differing significance of these targets, and the way in which we interpret movements in the two aggregates in forming a view of the appropriate level of short-term interest rates.

Funding

[long version - Over the last year MO has grown by around 3½ per cent, towards the bottom of its target range. Whereas £M3 rose by 14¾ per cent, well above the target range in last year's FSBR - though that range was suspended in the autumn as the reasons for a large expansion of broad money became clear.

This rapid growth of £M3 has been powered mainly by the strong demand for credit by the private sector. Until last autumn the authorities had sought to offset the monetary effects of some of this growth in credit by selling more long-term debt than necessary to fund the PSBR. Thus the Government was performing an intermediatory role which was not being undertaken by the private

sector, converting short term credit into long term liabilities. But systematic overfunding in this way is bound to produce distortions in financial markets, the principal manifestation of which was a large and rising stock of commercial bills held in the Issue Department of the Bank of England.]

I explained in my speech at the Mansion House in October last year that from now on funding policy would be directed at achieving a full fund of the PSBR over the year as a whole, no more no less. The outcome for 1985-86 was consistent with that, and it remains our approach for the coming year. The purpose of funding the PSBR is to ensure that the Government's own deficit is financed in a non-inflationary way. We shall stick to that objective, and, of course, with a borrowing requirement of the size seen in the last financial year, and forecast for this, there is no doubt whatsoever that it will be achieved.

[long form - Discussion of character and operation of the funding programme. Overall aim of funding deficit cheaply by matching the preferences of investors. Role of National Savings in the programme. How funding will change after the Big Bang.]

Interest Rates

[The following section is an important pt, but exposition is wholly wrong]

Short term interest rates are clearly the main instrument of monetary policy. In the final analysis they must be set by the monetary authorities, in the United Kingdom as elsewhere. There has been a degree of misunderstanding of the Government's view on this point, some of it, I fear, wilful. We have never said

that the market could, entirely independently, set the level of interest rates. Of course it cannot, since any constellation of rates is founded on the rate at which the Bank of England deals with the market. But this is not to say that the market does not exercise an influence on rates. There are times when the yield curve, or indeed the exchange rate, indicates very clearly the direction in which the market believes interest rates should move. At times, the authorities are wise to validate the movement, if they share the view that monetary conditions are insufficiently tight to deliver the objective for inflation.[Also, on occasion, it can be wrong to resist market originated moves in interest rates, even if the balance of evidence suggested that such a move might not be needed. To resist a market-led move in some circumstances can risk being misinterpreted as a weakening of policy.]

But there are other occasions on which it is right to resist. This was so earlier this year, when I decided on an early move in response to the falling oil price, but took the view that the pressure for a further rise beyond 12½ per cent was founded on inaccurate perceptions of sterling's vulnerability to movements in the oil price.

MO

The cornerstone of interest rate policy is the assessment of domestic financial conditions and in this assessment the two principal monetary aggregates, MO and £M3 play the leading role.

The City has not found it easy to understand the significance of MO. Wealthy young men with wallets full of plastic may only occasionally set eyes on a note or a coin. But my impression is that sentiment is changing, if slowly.

One important reason for the change in sentiment is the realisation, for those who are prepared to look at the experience of other countries, that by international standards MO is by no means impossibly narrow. Just over half the Germans principal target aggregate, known as Central Bank Money, is in fact notes and coin.

MO is, and this is of course especially valuable, clearly related to spending patterns. Its velocity trend has been relatively stable over a number of years, (in sharp contrast to the experience with all measures of broad money) which makes it appropriate to publish indicative ranges for the later years of the MTFS period.

If, therefore, MO moves outside its target range there will be a presumption in favour of action to bring it back within it. Though it will as usual be necessary to look carefully at the performance of other indicators; convincing evidence from them could make interest rates moves unnecessary.

£M3

In the case of £M3 different considerations apply. There has been some misunderstanding about the present status of £M3. I explained at the Mansion House last year that the range for 1985-86 had been set too low, and that action to bring the growth rate back

within the range would not have been justified. But I said then, and I quote "I shall as usual be considering what target to set for 1986-87 at the time of the Budget".

As I have explained, £M3 does not respond rapidly or predictably to a change in interest rates. But movements outside the range set in the MTFS will nonetheless be important, and we shall need convincing evidence from other indicators that monetary conditions are adequately tight if interest rates are not to be adjusted.

For the moment, given the uncertainty about the velocity trend of £M3, I think it right to publish a target range for the coming year only. I recognise that, at 11-15%, that range may at first sight appear to be a high one. And with funding policy set to neutralise the impact of Government borrowing in monetary terms, it could imply a continuation of the sizeable growth in bank credit extended to the private sector. But it does not in any way represent a loosening of policy. The experience of the past few years suggests that this kind of growth can be perfectly consistent with confirmed progress on inflation. The structural factors encouraging the private sector to expand both sides of its balance sheet remain active. But if evidence that credit growth at this rate poses a threat to our inflation objective appears we shall take appropriate action. We shall continue to monitor conditions by looking at the whole range of financial indicators, including of course, the exchange rate.

Exchange Rate

Since we are not participants in the exchange rate mechanism of

the European Monetary System we do not have an announced exchange rate target, nor in those circumstances would it make sense to have one outside the EMS. And lest there be any misunderstanding on the point, let me say at once that there is no unannounced exchange rate target either.

But the exchange rate has come to play a more important role in the assessment of financial conditions because the pace of innovation in domestic markets has clouded the significance of some domestic indicators.

We cannot be indifferent to the level of the exchange rate. And major movements in the rate, whatever their cause, can have an impact on domestic conditions and on inflation.

But nor can we unilaterally choose the exchange rate we want to have with the rest of the world.

Again the events of 1976 are instructive, when a unilateral contest with the rest of the world led to predictable results. In recent years we have intervened in the market from time to time, to repay debt, and occasionally to borrow. And where appropriate, in concert with others, we have intervened to smooth fluctuations in the rate. In the case of the Plaza agreement last year, when G5 ministers all accepted the case for a downward adjustment in the

See 1981 notes for reason for retaining Z 3 (para 9)

See 1982 notes para 2.5 (MHD) – & 2.12
& 2.8 (AR)
& 2.14 (probs. with bond areas)

dollar, particularly against the deutschemark and the yen, our ambitions were higher, but once again modest, realistic and fully in line with those of our partners.

[Optional use of quote from 1810 Select Committee report on gold bullion - as you requested.

"The committee beg leave to report to the House their most clear opinion that... the price of gold bullion and the general course of exchange with foreign countries, taken for any considerable period of time, form the best general criterion from which any inference can be drawn regarding the sufficiency or excess of paper currency in circulation; and the Bank of England cannot safely regulate the amount of its issues without having reference to the criterion presented by these two circumstances."].

Setting Interest rates

The way we operate policy can therefore be described as follows. There is a presumption that if either Mo or £M3 were to move outside its target range, then we would take action on short-term interest rates. But that presumption has to be tested against the other evidence, including the exchange rate. Since different indicators do not always point in the same direction, it is very often a question of weighing movements in one against movements in another. There is no simple mechanical rule for this, nor can there be.

There is also an important operational difference between the target for MO and the target for broad money. For a while movements

in short-term interest rates can be expected to have a relatively fast acting and unambiguous effect on the growth of narrow money, and on the exchange rate, their effect on £M3 is less certain and slower acting. Thus a rise in interest rates triggered by a rise in the growth of £M3 outside its range would certainly tighten monetary conditions; but it would be unlikely to cause £M3 to return to its range within the target period.

Operation of policy involves a continuous process of weighing all the evidence of monetary conditions: growth of target aggregates,movement of the exchange rate, and movement of other aggregates and indicators.

[<u>Money GDP</u>

I have set out today in some detail the theory and practice of financial policy. It begins with firm control of public spending and the funding of the deficit in a non-inflationary way.

Then we monitor narrow and broad money closely, taking the exchange rate into account, and interest rates accordingly.

Together, these fiscal and monetary policies will allow the Government to achieve the path for money GDP set out in the MTFS.

Money GDP is the route from intermediate targets to the final objective of inflation. It is a medium term objective, though, rather than a target itself, because information is lagged, and subject to revision. Furthermore, the impact on it of use of the

instruments at our disposal is also lagged.

Over last five years the growth of Money GDP has been steadily reduced. And the division betwen inflation and real growth has become steadily more favourable. So that this year close to 3% each way. The best performance for a generation. [Insert NEDC pledge?]

7) <u>CONCLUSION</u>

The conduct of monetary policy is necessarily a matter of some complexity. Those who seek refuge in comfortable certainties are inevitably disappointed in the end.

In the last 10 years the United Kingdom has gradually rejoined the rest of the world. In the conduct of macroeconomic policy generally - in other words the primacy given to sound monetary conditions. And, in consequence, in the performance of our real economy, which has returned to a path of steady, non-inflationary growth.

This is just as true of the detailed conduct of monetary policy.

"Monetary policy is implemented day by day and week by week...in the light of monetary growth, judged in the context of the flow of information about the economy, the outlook for prices, and domestic and international financial markets including the value of [sterling] in the foreign exchange markets."

Had I not inserted "sterling" for "dollar" you would no doubt

have known at once that the last sentence was a recent quotation from Paul Volcker. It conveniently summarises the approach I have been describing here today.

We, like the Federal Reserve, like the Bundesbank, like the Swiss, must tread a difficult path, and strike a delicate balance between rules and discretion. The positions we have respectively chosen are very similar in character. That fact, and the dramatic improvement in our inflation record, serves to convince me that we are on the right track.

pp8

FROM: A ROSS GOOBEY
DATE: 9 APRIL 1986

cc Mrs Lomax
Sir T Burns.

1. SIR P MIDDLETON

2. SIR T BURNS

LOMBARD ASSOCIATION SPEECH

It has been suggested that I might list some questions which I believe the young scribblers would like answered in the speech next week.

i) How is velocity and the trend in velocity being monitored for £M3 (and MO)?

ii) Is there likely to be a more timely estimate of money GDP?

iii) What importance is being given to the trend in prices of physical assets (houses, stock prices) in the assessment of monetary condtions?

iv) What evidence is there that the fall in £M3 velocity is likely to accelerate from its recent trend?

v) The "antis" in the press, Bill Keegan et al, will continue to deride the inability of the chosen broad money aggregates to "predict" future inflation.

ARG

A ROSS GOOBEY

DRAFT 2 Date: 9 April 1986

LOMBARD

The publication of the Medium Term Financial Strategy set the framework for macro-economic policy making in this country. It was also a major influence on economic thinking throughout the world. Indeed, the best tribute to the MTFS is that its approach and language have become the common currency of economic management.

2. The ethos of the MTFS was realism. To direct economic policy towards objectives which could be achieved and to eschew those which could not. And to design policies which would improve the economy in the medium term. And discard those which sacrificed long term objectives for transitory short term considerations. Thus it was that macro-economic policies focussed on the defeat of inflation and micro-economic policies on improving the output performances of the economy - the supply side.

3. This may seem commonsense - even commonplace, today, but in 1979 it was far from that. Remember, we still had not got rid of the belief that Government spending would produce output, that more spending would produce more output. All you needed to do was decide on the output required and spend to achieve it. If only the Chancellor's job was that easy.

4. The MTFS not only brought monetary and fiscal policy together within a single framework, it also did this far more explicitly than had been attempted before. There were good reasons for this. No one, either at home or abroad, really believed that British Governments would resist the fool's option - to spend excessively, to get into financial difficulties, try to get out of the difficulties by inflation, that most evil of taxes. We had no track record of the sort that the Japanese, the Germans, the Americans - indeed practically anyone among our main competitors - had. If we were to live in the same world as them such a record had to be established.

5. Simply writing down a set of numbers in the MTFS was not enough. It had to be seen to succeed in its objectives. But it was a radical new start. The Government's role was set out clearly and simply - even starkly - so that the private sector would be in no doubt and could base its own decisions against a clear statement by a committed government accordingly. Government policy henceforth would provide direction and sound financial discipline - it would not simply react to try to compensate for inefficiencies and rigidities in the private sector. There were now some rules for the public sector, rules which could not possibly be mistaken or misunderstood.

6. Other countries have not of course gone about things in exactly the same way. But they all have a counter-inflationary framework in which downward pressure is exerted on monetary variables, and structural defects are being reduced over the medium term. On an international level these policies have been outstandingly successful. The inflation rate has come down decisively; output is going steadily, and the same policies will consolidate and improve on this performance.

7. But my main objective today is to explain how the MTFS has succeeded in this country, the way it has evolved as we have gained experience and how we operate policy at present.

8. An essential first stage was to get our accounting on to a cash basis. Getting rid of all the astonishing number of dodges which went under the name of "funny money" was a major undertaking. But we were able to commence the MTFS with three essential cash concepts: public expenditure which is now planned and controlled in cash terms, the public sector borrowing requirement and, of course, the supply of money in the economy.

9. These could all be related to each other by considering their effect on national output in current price or money terms - commonly known as money GDP. This is the only framework which makes any sense if the object is to reduce inflation.

10. Money GDP is an amalgam of two things. The real rate of growth and the rate of inflation. Real growth is primarily the

responsibility of the private sector. The Government can do a lot to help. But not with its macro-economic policies. This is where micro-economic policies count. They enable markets to work better, remove restrictions, improve incentives and generally develop a dynamic and enterprising economy. These policies are an essential part of the Government's economic programme. The fact that I am not dwelling on them tonight does not diminish their essential part in the Government's medium term strategy. Real output can of course be affected in the short term by changes in financial policy. But there is no lasting effect. In the medium term these effects are ironed out and output returns to the level determined by the supply performance of the economy.

11. Inflation is quite different. Though changes in output resulting from financial policy are transitory, changes in the rate of price increases are long lasting and cumulative. Governments can easily get inflation into the system. But because of these long term dynamics, it is desperately difficult to get out.

12. The only way to do it is to accept the medium term nature of inflation, and pursue policies to bring down the growth of money GDP over the medium term. Once money GDP has been reduced to the trend growth of output, inflation will be eliminated. If you follow the alternative of allowing money GDP to grow in excess of the supply potential of the economy, all you can get in the medium term is more inflation. The bigger the gap, the greater the inflation. Output remains unaffected in the medium term.

13. Some still argue that money GDP is an unhelpful concept - because it combines two different things: real output which is a good thing and inflation which is bad. But this misses the point. Inflation is eliminated if money GDP can be brought down to the appropriate level. The question is can it? The answer is that it can by appropriate monetary and fiscal policies. And it follows that the movement in money GDP is the best possible indicator of the success of these policies. And the path of money GDP is therefore an essential element underlying the MTFS.

14. Look at the record over the last 7 years. The growth of money GDP has been halved from over 15% to under 8 %. Inflation has been reduced from 13% to 5%. Further progress in reducing money GDP will bring further progress in lower price increases. The MTFS path I set in the Budget sees money GDP coming down to 5½% by the end of the decade. Growth can confidently be assumed at an underlying 2½%. So inflation of 3% is within our grasp.

15. The way we deliver that path of money GDP is by the pursuit of an appropriate monetary policy. Some commentators have suggested a target for money GDP with policy instruments adjusted to meet that target in the light of the best available forecast. That is a useful check and an essential part of the analysis we perform. But it is not enough. It is essential to have in place a suitable monetary discipline that is visible and produces the correct responses. It is not enough to rely on forecasts. The record suggests that during inflationary periods they understate the pressure on inflation. We need more of an anchor.

[16. It is the role of monetary policy to deliver that path for money GDP. Fiscal policy and public borrowing, can make this easier. The more that structural budget deficits are reduced the less the risk they will be monetised and the less the strain on monetary policy and interest rates.]

17. The classical framework for financial discipline - the gold standard and the balanced budget - had both a monetary and fiscal component. So does the MTFS. From the start we recognised that a firm monetary policy has to be buttressed by setting public sector borrowing at a level that can be comfortably financed in a non-inflationary way. In theory, of course, there is no precise relationship between the PSBR and any given rate of monetary growth. But in practice the only way to be sure of financing the public sector soundly is to plan for a low PSBR. Experience has shown the wisdom of leaving a margin of safety. The 1984-85 PSBR, at 3% of GDP, was still the lowest for over a decade, even though the £3 billion cost of the coal strike was met entirely by higher borrowing. In fact, the PSBR has been less than 3½% of GDP in every year since 1981-82; and the latest estimates suggest that it was below 2% of GDP last year. It is planned to be below 2%

again in the current financial year. It is worth recalling that little more than 10 years ago - in 1975-76 - borrowing reached 9¼% of GDP; and the last time the PSBR was below 2% of GDP was 1971-72.

18. This approach to fiscal policy has become part of the accepted wisdom in other major countries. It is now a long time since the OECD Ministers have not referred to the need to reduce structural deficits over the medium term as an agreed tenet of financial policy.

19. But it is monetary policy which at the end of the day delivers the money GDP path.

20. What do I mean by monetary policy? Let me give you the answer and then elaborate. I mean the combination of indicators that we use to assess the monetary health of the economy and which guide decisions on interest rates. They are the measures of money supply which experience shows are related to money GDP. The exchange rate which tells us both about money conditions in this country compared with our competitors overseas, and serves as a valuable check on domestic conditions at times of uncertainty. And a variety of other indicators - house prices are one - which give an early indication that monetary conditions may be becoming lax.

21. Since 1976 almost all the major countries have found monetary targets to be an effective element in the control of monetary conditions. They have to be applied with good sense and judgement. And above all they have to be read with an eye to the effect of other policies and the development of technology. It would be difficult to find any country which is not keenly aware of the need to continually update its monetary strategy to keep its essential objectives intact.

22. We are no exception to this general rule. Initially the main focus of the MTFS was on £M3. This was a broad measure of money which came into being in its present form as a result of the IMF discussions in 1976. But it had been around in different manifestations much earlier, and the rapid growth of M3 in the early 1970s had preceded the rapid inflation of 1974-75.

23. It had one other great advantage in those early days. The counterparts to M3 were the PSBR, bank lending and the balance of payments. It thus provided the first, early constraint on the PSBR. It did what the MTFS itself now does. It gave some assurance that public borrowing would not be expanded to such an extent as to make the control of £M3, by funding and interest rates, impossible. In other words the Government could not dodge its own role in increasing the supply of money.

24. Not surprisingly therefore, having a definition of money which was accepted in the markets, with an IMF pedigree and with a good track record, the first version of the MTFS was explained predominently in terms of £M3.

25. At the same time, the possibility was recognised that £M3 would not remain a reliable guide as controls - especially those on the banking system and foreign exchange - were removed. We did not quite realise then the coming impact of technology, but deregulation was Government policy and very much in our minds. So from the outset we developed and monitored other measures of money. We discussed them and the attendant methods of control widely. Remember the 1981 Green Paper on Monetary Control and the public debate which it provoked.

26. This was just as well as the relationship between £M3 and money GDP in the 1980s has been very different from that in the 1970s. Between 1970 and 1980, M3 grew on average by 2% less than money GDP. Since 1980 it has grown on average by about 4% more.

27. It is not absolutely clear why this has happened. A combination of a freer banking system, greater international competition and new technology is certainly part of the story. So is the level of interest rates - high in real terms after allowing for inflation. This means that people can use interest bearing bank accounts as a savings medium and earn a healthy rate of interest. The banks have been very successful financial institutions over this period. Their deposits have grown. And these deposits are £M3.

28. Whatever the reason, £M3 has given progressively less information about money GDP. So it has also played a progressively smaller part in monetary policy decisions. We have not felt compelled to meet £M3 targets because other indicators have convinced us, rightly, that £M3 was giving the wrong signals. It no longer has a role in funding decisions, and it has a relatively small weight in our thinking about short term interest rates.

29. I did consider very carefully before the Budget whether the time had come to drop £M3 as a target altogether. We would then have monitored it and nurtured it against the day when the factors causing its present unreliable behaviour ceased. But in the end I decided to try a target for 1986-87 with a range which reflects its recent trend velocity, but not to hazard any figures for later years. The reason was that an excessive build up of liquidity could threaten our inflation objectives. And to drop £M3 would make it appear that we were completely unconcerned. So I retained the target, recognising that the role of £M3 in interest rate decisions would be rather atmospheric. Other indications would be giving more certain information.

30. There are of course different measures of broad money. We have tried several of these over the years and rejected them. Some have performed a bit better than £M3 for a while. But all exhibit the same sort of characteristics. So it would have been completely misleading to put one of these in the place of £M3 as a target aggregate, because it would have implied a degree of confidence in the new figure which we simply did not feel. Outside Germany, which is exceptional in the relatively slow pace of financial innovation, there is not a country in the world which is not experiencing these sort of difficulties in interpreting the wide aggregates.

31. That is why, over the years, we have also paid attention to the narrower definitions of money. M1 the traditional narrow aggregate has however been affected by the same forces which have affected £M3. As current accounts have increased their interest bearing elements, the nature of M1 has changed. And it is now no more reliable than £M3.

32. M0 on the other hand has proved a reliable indicator of movements in money GDP in the year ahead. We can expect money

GDP to grow between 2 and 5% more than M0 in the previous year. This is a narrow range. And our confidence is increased by the fact that its average velocity is very much what it was in the 1970s.

33. It has been suggested that M0 cannot be taken seriously because of the narrow range of transactions which it covers. And that it, too, has potential for distortion as a result of technological change. The fact is however that there are no signs of it giving misleading signals, and its lack of any interest bearing component is a source of comfort. So we shall continue to give significant weight to its movement in our assessment of monetary conditions.

34. M0 has therefore been given target status for the last two years. It has the right characteristics for a target aggregate. I have explained its relevance. It moves unambiguously in the opposite direction to changes in interest rates. And it has an appropriate sensitivity to these changes - not so great that the change is meaningless and not so little that it is of no significance.

35. Other critics have looked for a black box mechanism relating M0 to money GDP of a sort which I have never claimed. My judgement is that M0 is influenced by many of the factors that influence money GDP - especially changes in interest rates and disposable incomes. But that influence shows up in M0 more immediately than it does in money GDP. So it is a useful indicator of when interest rate changes may be necessary. We do not, of course, rely on it exclusively. But it is undoubtedly an important factor in decision-making. It provides stability in our assessment of monetary conditionsfrom month to month. It may not trigger many changed, but it is an essential guide post as to where we are going.

36. It is sometimes asked why interest rates are never changed in response to news about M0. This is largely because M0 growth only tends to change slowly and we would not expect sharp interest rate changes to follow. But whereas it has not usually been the trigger for interest rate action it has often persuaded us against changes that might otherwise have taken place. Let me be more

LR1.56 CONFIDENTIAL BURNS MIDDLETON VERSION + COMMENTS

FROM: MRS R LOMAX
DATE: 10 April 1986

MR CASSELL

cc Economic Secretary
Sir P Middleton (or)
Sir T Burns (or)
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr C Kelly
Miss O'Mara
Mr Walsh
Mr Ross Goobey

Ch/ This had some useful material, but I didn't think much of it as a speech. The first few pages, drafted by PEM personally, are very odd. The second half is entirely Terry, much of which I have retained, in slightly different form. RL. 11/4

LOMBARD ASSOCIATION SPEECH

I attach a redraft of the Lombard Association Speech, by Sir Peter Middleton and Sir Terence Burns, which reflects the Chancellor's reactions to Howard Davies' earlier draft.

2. Could I please have comments as soon as possible, and no later than lunchtime tomorrow? I would be grateful if Miss O' Mara and Mr Walsh would check it through carefully for factual accuracy.

RL.

RACHEL LOMAX

Mr Culpin

I enclose - for your personal edification - the original B-M draft, which you were spared. The trip to Washington had some advantages.

RL.
16/4

DRAFT 2 Date: 9 April 1986

LOMBARD

The publication of the Medium Term Financial Strategy set the framework for macro-economic policy making in this country. It was also a major influence on economic thinking throughout the world. Indeed, the best tribute to the MTFS is that its approach and language have become the common currency of economic management.

2. The ethos of the MTFS was realism. To direct economic policy towards objectives which could be achieved and to eschew those which could not. And to design policies which would improve the economy in the medium term. And discard those which sacrificed long term objectives for transitory short term considerations. Thus it was that macro-economic policies focussed on the defeat of inflation and micro-economic policies on improving the output performances of the economy - the supply side.

3. This may seem commonsense - even commonplace, today, but in 1979 it was far from that. Remember, we still had not got rid of the belief that Government spending would produce output, that more spending would produce more output. All you needed to do was decide on the output required and spend to achieve it. If only the Chancellor's job was that easy.

4. The MTFS not only brought monetary and fiscal policy together within a single framework, it also did this far more explicitly than had been attempted before. There were good reasons for this. No one, either at home or abroad, really believed that British Governments would resist the fool's option - to spend excessively, to get into financial difficulties, try to get out of the difficulties by inflation, that most evil of taxes. We had no track record of the sort that the Japanese, the Germans, the Americans - indeed practically anyone among our main competitors - had. If we were to live in the same world as them such a record had to be established.

5. Simply writing down a set of numbers in the MTFS was not enough. It had to be seen to succeed in its objectives. But it was a radical new start. The Government's role was set out clearly and simply - even starkly - so that the private sector would be in no doubt and could base its own decisions against a clear statement by a committed government accordingly. Government policy henceforth would provide direction and sound financial discipline - it would not simply react to try to compensate for inefficiencies and rigidities in the private sector. There were now some rules for the public sector, rules which could not possibly be mistaken or misunderstood.

6. Other countries have not of course gone about things in exactly the same way. But they all have a counter-inflationary framework in which downward pressure is exerted on monetary variables, and structural defects are being reduced over the medium term. On an international level these policies have been outstandingly successful. The inflation rate has come down decisively; output is going steadily, and the same policies will consolidate and improve on this performance.

7. But my main objective today is to explain how the MTFS has succeeded in this country, the way it has evolved as we have gained experience and how we operate policy at present.

8. An essential first stage was to get our accounting on to a cash basis. Getting rid of all the astonishing number of dodges which went under the name of "funny money" was a major undertaking. But we were able to commence the MTFS with three essential cash concepts: public expenditure which is now planned and controlled in cash terms, the public sector borrowing requirement and, of course, the supply of money in the economy.

9. These could all be related to each other by considering their effect on national output in current price or money terms - commonly known as money GDP. This is the only framework which makes any sense if the object is to reduce inflation.

10. Money GDP is an amalgam of two things. The real rate of growth and the rate of inflation. Real growth is primarily the

responsibility of the private sector. The Government can do a lot to help. But not with its macro-economic policies. This is where micro-economic policies count. They enable markets to work better, remove restrictions, improve incentives and generally develop a dynamic and enterprising economy. These policies are an essential part of the Government's economic programme. The fact that I am not dwelling on them tonight does not diminish their essential part in the Government's medium term strategy. Real output can of course be affected in the short term by changes in financial policy. But there is no lasting effect. In the medium term these effects are ironed out and output returns to the level determined by the supply performance of the economy.

11. Inflation is quite different. Though changes in output resulting from financial policy are transitory, changes in the rate of price increases are long lasting and cumulative. Governments can easily get inflation into the system. But because of these long term dynamics, it is desperately difficult to get out.

12. The only way to do it is to accept the medium term nature of inflation, and pursue policies to bring down the growth of money GDP over the medium term. Once money GDP has been reduced to the trend growth of output, inflation will be eliminated. If you follow the alternative of allowing money GDP to grow in excess of the supply potential of the economy, all you can get in the medium term is more inflation. The bigger the gap, the greater the inflation. Output remains unaffected in the medium term.

13. Some still argue that money GDP is an unhelpful concept - because it combines two different things: real output which is a good thing and inflation which is bad. But this misses the point. Inflation is eliminated if money GDP can be brought down to the appropriate level. The question is can it? The answer is that it can by appropriate monetary and fiscal policies. And it follows that the movement in money GDP is the best possible indicator of the success of these policies. And the path of money GDP is therefore an essential element underlying the MTFS.

14. Look at the record over the last 7 years. The growth of money GDP has been halved from over 15% to under 8 %. Inflation has been reduced from 13% to 5%. Further progress in reducing money GDP will bring further progress in lower price increases. The MTFS path I set in the Budget sees money GDP coming down to 5½% by the end of the decade. Growth can confidently be assumed at an underlying 2½%. So inflation of 3% is within our grasp.

15. The way we deliver that path of money GDP is by the pursuit of an appropriate monetary policy. Some commentators have suggested a target for money GDP with policy instruments adjusted to meet that target in the light of the best available forecast. That is a useful check and an essential part of the analysis we perform. But it is not enough. It is essential to have in place a suitable monetary discipline that is visible and produces the correct responses. It is not enough to rely on forecasts. The record suggests that during inflationary periods they understate the pressure on inflation. We need more of an anchor.

[16. It is the role of monetary policy to deliver that path for money GDP. Fiscal policy and public borrowing, can make this easier. The more that structural budget deficits are reduced the less the risk they will be monetised and the less the strain on monetary policy and interest rates.]

17. The classical framework for financial discipline - the gold standard and the balanced budget - had both a monetary and fiscal component. So does the MTFS. From the start we recognised that a firm monetary policy has to be buttressed by setting public sector borrowing at a level that can be comfortably financed in a non-inflationary way. In theory, of course, there is no precise relationship between the PSBR and any given rate of monetary growth. But in practice the only way to be sure of financing the public sector soundly is to plan for a low PSBR. Experience has shown the wisdom of leaving a margin of safety. The 1984-85 PSBR, at 3% of GDP, was still the lowest for over a decade, even though the £3 billion cost of the coal strike was met entirely by higher borrowing. In fact, the PSBR has been less than 3½% of GDP in every year since 1981-82; and the latest estimates suggest that it was below 2% of GDP last year. It is planned to be below 2%

again in the current financial year. It is worth recalling that little more than 10 years ago - in 1975-76 - borrowing reached 9¼% of GDP; and the last time the PSBR was below 2% of GDP was 1971-72.

18. This approach to fiscal policy has become part of the accepted wisdom in other major countries. It is now a long time since the OECD Ministers have not referred to the need to reduce structural deficits over the medium term as an agreed tenet of financial policy.

19. But it is monetary policy which at the end of the day delivers the money GDP path.

20. What do I mean by monetary policy? Let me give you the answer and then elaborate. I mean the combination of indicators that we use to assess the monetary health of the economy and which guide decisions on interest rates. They are the measures of money supply which experience shows are related to money GDP. The exchange rate which tells us both about money conditions in this country compared with our competitors overseas, and serves as a valuable check on domestic conditions at times of uncertainty. And a variety of other indicators - house prices are one - which give an early indication that monetary conditions may be becoming lax.

21. Since 1976 almost all the major countries have found monetary targets to be an effective element in the control of monetary conditions. They have to be applied with good sense and judgement. And above all they have to be read with an eye to the effect of other policies and the development of technology. It would be difficult to find any country which is not keenly aware of the need to continually update its monetary strategy to keep its essential objectives intact.

22. We are no exception to this general rule. Initially the main focus of the MTFS was on £M3. This was a broad measure of money which came into being in its present form as a result of the IMF discussions in 1976. But it had been around in different manifestations much earlier, and the rapid growth of M3 in the early 1970s had preceded the rapid inflation of 1974-75.

23. It had one other great advantage in those early days. The counterparts to M3 were the PSBR, bank lending and the balance of payments. It thus provided the first, early constraint on the PSBR. It did what the MTFS itself now does. It gave some assurance that public borrowing would not be expanded to such an extent as to make the control of £M3, by funding and interest rates, impossible. In other words the Government could not dodge its own role in increasing the supply of money.

24. Not surprisingly therefore, having a definition of money which was accepted in the markets, with an IMF pedigree and with a good track record, the first version of the MTFS was explained predominently in terms of £M3.

25. At the same time, the possibility was recognised that £M3 would not remain a reliable guide as controls - especially those on the banking system and foreign exchange - were removed. We did not quite realise then the coming impact of technology, but deregulation was Government policy and very much in our minds. So from the outset we developed and monitored other measures of money. We discussed them and the attendant methods of control widely. Remember the 1980 Green Paper on Monetary Control and the public debate which it provoked.

26. This was just as well as the relationship between £M3 and money GDP in the 1980s has been very different from that in the 1970s. Between 1970 and 1980, M3 grew on average by 2% less than money GDP. Since 1980 it has grown on average by about 4% more.

27. It is not absolutely clear why this has happened. A combination of a freer banking system, greater international competition and new technology is certainly part of the story. So is the level of interest rates - high in real terms after allowing for inflation. This means that people can use interest bearing bank accounts as a savings medium and earn a healthy rate of interest. The banks have been very successful financial institutions over this period. Their deposits have grown. And these deposits are £M3.

28. Whatever the reason, £M3 has given progressively less information about money GDP. So it has also played a progressively smaller part in monetary policy decisions. We have not felt compelled to meet £M3 targets because other indicators have convinced us, rightly, that £M3 was giving the wrong signals. It no longer has a role in funding decisions, and it has a relatively small weight in our thinking about short term interest rates.

29. I did consider very carefully before the Budget whether the time had come to drop £M3 as a target altogether. We would then have monitored it and nurtured it against the day when the factors causing its present unreliable behaviour ceased. But in the end I decided to try a target for 1986-87 with a range which reflects its recent trend velocity, but not to hazard any figures for later years. The reason was that an excessive build up of liquidity could threaten our inflation objectives. And to drop £M3 would make it appear that we were completely unconcerned. So I retained the target, recognising that the role of £M3 in interest rate decisions would be rather atmospheric. Other indications would be giving more certain information.

30. There are of course different measures of broad money. We have tried several of these over the years and rejected them. Some have performed a bit better than £M3 for a while. But all exhibit the same sort of characteristics. So it would have been completely misleading to put one of these in the place of £M3 as a target aggregate, because it would have implied a degree of confidence in the new figure which we simply did not feel. Outside Germany, which is exceptional in the relatively slow pace of financial innovation, there is not a country in the world which is not experiencing these sort of difficulties in interpreting the wide aggregates.

31. That is why, over the years, we have also paid attention to the narrower definitions of money. M1 the traditional narrow aggregate has however been affected by the same forces which have affected £M3. As current accounts have increased their interest bearing elements, the nature of M1 has changed. And it is now no more reliable than £M3.

32. M0 on the other hand has proved a reliable indicator of movements in money GDP in the year ahead. We can expect money

GDP to grow between 2 and 5% more than M0 in the previous year. This is a narrow range. And our confidence is increased by the fact that its average velocity is very much what it was in the 1970s.

33. It has been suggested that M0 cannot be taken seriously because of the narrow range of transactions which it covers. And that it, too, has potential for distortion as a result of technological change. The fact is however that there are no signs of it giving misleading signals, and its lack of any interest bearing component is a source of comfort. So we shall continue to give significant weight to its movement in our assessment of monetary conditions.

34. M0 has therefore been given target status for the last two years. It has the right characteristics for a target aggregate. I have explained its relevance. It moves unambiguously in the opposite direction to changes in interest rates. And it has an appropriate sensitivity to these changes - not so great that the change is meaningless and not so little that it is of no significance.

35. Other critics have looked for a black box mechanism relating M0 to money GDP of a sort which I have never claimed. My judgement is that M0 is influenced by many of the factors that influence money GDP - especially changes in interest rates and disposable incomes. But that influence shows up in M0 more immediately than it does in money GDP. So it is a useful indicator of when interest rate changes may be necessary. We do not, of course, rely on it exclusively. But it is undoubtedly an important factor in decision-making. It provides stability in our assessment of monetary conditionsfrom month to month. It may not trigger many changed, but it is an essential guide post as to where we are going.

36. It is sometimes asked why interest rates are never changed in response to news about M0. This is largely because M0 growth only tends to change slowly and we would not expect sharp interest rate changes to follow. But whereas it has not usually been the trigger for interest rate action it has often persuaded us against changes that might otherwise have taken place. Let me be more

precise. Most forecasts of inflation have been too pessimistic in recent years - particularly those generated outside the Treasury. In general they have been pointing to a need for higher interest rates to deliver our inflation objection. And those who have given a high weight to £M3 have also tended to argue for higher interest rates than proved necessary. We have often resisted these blandishments because of the more reassuring - and in the event more accurate - signals coming from MO.

The Exchange Rate

By contrast the timing of short term interest rate changes has often been strongly influenced by exchange rate movements. As a result it is often wrongly concluded that we must be operating an exchange rate target. Let me try once again to set out our views about the role of the exchange rate in the operation of monetary policy.

My remarks apply to the present environment. In some circumstances, a fixed exchange rate regime can be a very effective monetary discipline. It forces the authorities to recognise when policies are too expansionary or too restrictive for inflation to continue coming down at the same rate as in other countries. It leaves little room for variation and it is indeed a tough discipline.

Unless we are part of a formal fixed exchange rate system, shared by other countries as well, it is both risky and dangerous to try and set up a unilateral exchange rate objective. There is no systematic expectational benefit and markets are continuously tempted to test the authorities' resolve. Large changes in interest rates may be needed which can have profound effects on the real economy.

So we do not attempt to set a target exchange rate zone for ourselves. Interest rates are not changed with such a target range in mind. But we are influenced by other considerations:-

- a bias against sharp exchange rate changes. Whatever their cause they can be self-fulfilling and lead to sharp changes in inflation. So it is often necessary to act to limit the speed of change and enforce some stability.

- a bias towards a firm exchange rate. Exchange rates should support the Government's general objective to bring down inflation. That will mean a bracing - but not excessively - competitive environment.

The exchange rate can fulfil another role. That of being umpire when the various monetary aggregates are giving different messages. There must be a presumption that persistent exchange rate movements reflect, to some degree, underlying monetary conditions - unless they can obviously be explained by developments in other countries or by special factors. So if there is a conflict in the messages coming from the monetary aggregates, the exchange rate can help to resolve it.

There is nothing new in this approach to the exchange rate, though it has devolved over time. The first occasion when the exchange rate played such a role was in the autumn of 1980. Following the abolition of the corset £M3 was growing rapidly whilst most of the narrow measures of money were slowing down. Somewhat unexpectedly, the exchange rate appreciated steadily. Other asset prices, particularly for land and houses, were rising slowly.

We had to choose between two interpretations of monetary conditions. We reached the conclusion that monetary conditions were tight - rightly as it turned out. Interest rates were reduced by 2 per cent in November 1980 and a further 2 per cent in March 1981.

Some have argued that we failed to appreciate fully the tightness of monetary conditions. That is clearly wrong. Others have argued that we responded too late and by too little. That has to be judged against the circumstances of the time - rising inflation, a very rapid growth in earnings, greater than expected public borrowing and a very rapid growth in liquidity and bank lending. An MTFS that had recently been launched and had not yet had time to build up the credibility it now has. Given the rapid build up of liquidity, a risk of a very sharp reversal in the exchange rate would give added impetus to the inflationary spiral which could not be ignored.

The determination of interest rates

Our approach to interest rates is based on an interpretation of monetary conditions which in turn reflects an overall assessment of the behaviour of the monetary aggregates together with other relevant evidence, especially the exchange rate.

Let me be quite clear. Short term interest rates are above all an instrument of monetary policy. In the final analysis they must be set by the monetary authorities in the UK as elsewhere. This is not to say that the market does not exercise an influence on rates. But we have never suggested the market could, entirely independently, set the level of interest rates. Of course there are times when the yield curve indicates very clearly the direction in which the market believes that interest rates should move. And there are times when we choose to validate a movement if we believe it is justified by monetary conditions. There can also be -

rarer - occasions when it is right to move, even when we are not convinced that a move is justified. It can be dangerous to resist a market led move, where to do so would cast doubt on the authorities' resolve to control inflation.

But there are other occasions where it is right to resist. This was so earlier this year. I decided on an early move in response to the falling oil price, but took the view that the pressure for a further rise beyond 12½ per cent was not justified on monetary grounds and was based on the exaggerated view of sterling's vulnerability to movements in the oil price.

So the timing of interest rate changes can often involve a delicate assessment of market tactics. It also involves an assessment of monetary conditions which itself is rarely straightforward. There is no mechanical formula for taking the various factors into account. It is very often the case of weighing movements in one indicator against movements in another. That is not to deny the special status of the monetary targets. If the underlying growth of MO or £M3 were to move significantly outside their target ranges, there is always a presumption of action, unless the evidence of other indicators is conclusive.

In the case of MO this is relatively straightforward. Short term interest rates tend to have a fairly fast acting effect on the growth of narrow money. So a rise in interest rates can be expected to bring MO growth back within its target range within the target period. It is also be likely to show up fairly promptly in the behaviour of the exchange rate.

In the case of £M3 the position is more complicated. Experience suggest that a change in short term rates is unlikely to alter the growth of £M3 significantly within the target period. But such action clearly affects the tightness of monetary conditions, which is what matters.

This is why I said in my Budget Speech that the target for broad money does not have the same operational significance as that for narrow money.

The development of the MTFS

I am often urged to provide a brief succinct summary of the operation of monetary policy, and I am aware that what I have just said is a far cry from that. Unfortunately the operation of monetary policy is difficult: that is an unhappy fact of life. It is sometimes suggested that quite different from the original MTFS and that it was a mistake to begin with a relatively uncomplicated version. It is argued that both models cannot be right. Either the 1980 model was too simple or the 1986 modelis too obscure.

I recognise of course that there have been changes. They fall into two categories: changes of presentation and changes of substance.

First the question of presentation. At the outset the Government had no track record. The MTFS represented a new approach. Many people doubted if we would ever see a single digit inflation again. At that point it was important to err on the side of rigidity and rules, rather than flexibility and discretion. In the past discretion had generally been exercised in favour of financial relaxation; it erred on the side of giving priority to real growth at the expense of inflation.

Our first task was to convince markets both at home and abroad, that we were serious about defeating inflation.

We have now built a track record. The inflation rate has been decisively reduced and it is much closer to the average of other major industrial countries. We have demonstrated that inflation can be reduced by monetary control; and that we are not afraid to respond by tightening monetary policy if that success is threatened.

At the same time we have seen clearly that output recovery can be combined with low inflation. Steady output growth does not require persistent fiscal and monetary stimulus.

The task is now a different one. To make a further important dent in the inflation rate within a framework that leaves room for output to grow. We are now in a position to be more explicit about the complexities of policy without running the risk of creating worries that we are about to fall back into the bad old ways. Some countries - for example Germany and Switzerland - have not had to face this problem, thanks to the track record built up over many years.

Second, the problem of substance. Without doubt the problem of operating monetary policy has become more complicated. In part this is because of deregulation and more competition in financial markets. It is a classic example of the sort of trade off we have had to face. In the long run there can be little doubt that deregulation and competition must be good for the financial sector and for the efficient operation of the economy. But in the shorter term they undoubtedly complicate the monetary signals and make the technical problems of monetary control that much greater.

These changes have been an important explanation for the changed relationship between £M3 and money GDP. And for the structural changes that have affected M1 as an increasing proportion of sight deposits have become interest bearing. It has become increasingly difficult to draw a line between money balances held for transactions and those held as savings.

And greater freedom of capital movements has changed the relationship between monetary policy, fiscal policy and the exchange rate. In the days of low capital mobility the current account probably had a bigger influence on

the exchange rate. There was a greater presumption that fiscal expansion would reduce the exchange rate. More recently capital flows have been a more dominant element. Combined with the regime of monetary targets this has created a stronger presumption that easier fiscal policy will lead to a higher exchange rate.

These changes inevitably change the balance between rules and discretion. There is a greater need to monitor information more carefully before coming to a judgement about the implications of the various indicators. In the process, it is important that the best should not be the enemy of the good. It is no use commentators urging me to ignore MO because it only shows a relatively short lead over money GDP if there is nothing more robust.

Conclusions

As I said at the Mansion House, "At the end of the day the position is clear and unambiguous. The inflation rate is judge and jury". In looking back at our past record we have to examine the outturn for inflation. Some commentators suggested this meant we would be basing monetary policy on forecasts of inflation. That is not at all what I said. Today's inflation rate tells us something about monetary policy in the past. The decline of inflation over the past 7 years tells me, that despite all the problems with the monetary aggregates, and the need to learn how to integrate exchange rate movements into that analysis, we have basically succeeded in delivery the appropriate monetary policy.

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LOMBARD ASSOCIATION SPEECH

April is the season of international meetings. My appearance here tonight is sandwiched between the Spring meetings of the IMF in Washington and the OECD in Paris.

Meeting other Finance Ministers, I am always struck by the extent to which we share a common approach to economic management.

The need for firm financial discipline: the importance of reducing fiscal deficits: improving the working of markets and promoting greater competition. These priorities are taken for granted by all major countries today.

It is easy to forget how much has changed since we first took office 7 years ago.

An approach to economic policy that is now commonplace was then radical, even revolutionary. Especially in the UK.

Shortly before the 1979 Election I wrote "The time has come for a wholly new approach to economic policy in Britain. The overriding need is for a long term stabilisation programme to defeat inflation, recreate business confidence, and provide a favourable climate for economic growth".

Putting those brave words into practice has been one of this Government's major achievements. That is an important reason why foreign opinion is in no doubt that Britain is indeed on the right track.

It would be idle to pretent that everything turned out as we expected. I want to spend my time tonight talking

about one particular area where practice is considerably more complicated than theory - monetary policy.

The policy we are pursuing today is identifiably the same as the one we embarked on 7 years ago. But it has clearly evolved - both in terms of presentation and substance. I shall try to explain what has not changed - as well as what has, and why.

The Medium Term Financial Strategy

Our main priority in 1979 was to achieve a lasting reduction in the rate of inflation. So our first task was to replace the shifts and strategems of the 1960s and 1970s by a clear and unequivocal commitment to financial discipline. That was the role of the Medium Term Financial Strategy,

It had two features, both novel at the time. First it provided a medium term framework for monetary and fiscal policy. It symbolised the Government's break with policies of fine tuning and crisis management that had dominated British life for most of the post War period.

Second, it was a strategy about finance. Partly because inflation is a financial problem, and has to be controlled by financial means. And partly because the only levers at the Government's command are financial levers.

This approach to reducing inflation depended in the first instance on scaling down the growth of nominal demand in the economy - that is, the growth of money GDP. This is an amalgam of two things: the real rate of growth and the rate of inflation.

The crucial mistake that earlier Governments made was to equate money demand and real demand. Expansionary policies boost money demand. But it was a dangerous

~~illusion~~ delusion to suppose that this ~~was automatically translated into~~ implies a higher rate of growth of <u>real</u> output.

Experience shows just the opposite. During the 1970s GDP in money terms more than quadrupled: but of that increase only 1/20th represented an increase in real output, the other 19/20ths was reflected in sharply higher prices.

Alas there is no magic short cut to boosting the rate of growth of real output; in anything other than the very short term, the growth of output depends on the supply performance of the economy. And that can only be raised by a determined effort to remove restrictions, improve incentives and generally develop a dynamic and enterprising economy.

By contrast it is all too easy to raise the rate of inflation by allowing money GDP to grow in excess of the supply potential of the economy. The bigger the gap the greater the inflation.

But conversely the way to squeeze inflation <u>out</u> of the system is to reduce the rate of growth of money GDP. Which is exactly what the MTFS was - and is - designed to do.

The validity of this approach has been amply borne out by the record of the last 7 years. The growth of money GDP has been halved from over 15 per cent to under 8 per cent. Inflation has been reduced from 13 per cent to 5 per cent. And after an initial setback, we have seen a steady growth in output, of an average rate of 3 per cent a year since 1981.

<u>The monetary and fiscal framework</u>

Reducing the growth of money GDP requires above all an appropriately restrictive monetary policy. And as in most other countries with a serious commitment to

financial discipline, this aim has been encapsulated in published targets for monetary growth.

Some commentators have argued that monetary targets are otiose. That we should simply publish targets for money GDP - or even inflation - and set policy in the light of the best available forecasts. That has not been our approach. For one thing we simply do not have a sufficiently detailed knowledge of the working of the economy to operate such a policy. And secondly, monetary policy is above all about markets, and one function of monetary targets is to provide an anchor for the market's expectations.

But we must never forget that targets are a means to an end. Their use depends on the robustness of a relationship between a particular measure of money on the one hand, and money GDP and inflation on the other. In the real world, no economic relationship is perfect. So monetary targetry was not and never can be a substitute for making an intelligent assessment of monetary conditions, based on all the evidence.

That is why the MTFS has always been more than a row of numbers. What it has been - and remains - is a commitment to maintain monetary conditions that will keep steady downward pressure on money GDP, and so on inflation.

I shall have more to say later about what this means in practice. But a discussion of the Medium Term Financial Strategy cannot be complete without a word on fiscal policy.

The classical framework for financial discipline - the gold standard and the balanced budget - had both a monetary and a fiscal component. So does the MTFS. From the start we recognised that a firm monetary policy has to be buttressed by setting public sector borrowing at a

level that can be comfortably financed in a non-inflationary way. In theory of course there is no precise relationship between the PSBR and any given rate of monetary growth. But in practice the only way to be sure of financing the public sector soundly is to plan for a low PSBR.

Experience has shown the wisdom of leaving a margin of safety. The 1984-85 PSBR at 3 per cent of GDP was still the lowest for over a decade even though the £3 billion cost of the coal strike was met entirely by higher borrowing. The latest figures suggest that the PSBR was below 2 per cent of GDP last year. And it is planned to be below 2 per cent again in the current financial year - a level that will put us in a strong position to cope with unexpected developments, for example in the oil market.

It is worth recalling that little more than ten years ago - in 1975-76 - borrowing reached 9¼ per cent of GDP; and the last time the PSBR was below 2 per cent of GDP was in 1971-72.

This emphasis on low public sector borrowing has become part of the accepted wisdom in other major countries. It is a long time since OECD Ministers failed to refer to the need to reduce structural deficits over the medium term as an agreed tenet of fiscal policy.

Monetary policy

To recapitulate. While fiscal policy has an important supporting role, monetary policy lies at the heart of the MTFS. The central task of monetary policy is to create monetary conditions that will bring steady downward pressure on the rate of growth of money GDP, and hence on inflation.

In practice this involves a combination of economic analysis and market judgement. Policy must be continuously informed by a careful assessment of what monetary conditions are - and need to be - to meet the Government's objective. But implementing interest rate decisions in today's fast moving financial markets also requires a degree of tactical skill.

Let me be quite clear. Short term interest rates are above all an instrument of monetary policy. That is not to say that the market does not exercise an influence, certainly on the structure and also, at times, on the level of short term interest rates. But we have never suggested that the market could, entirely independently, set the level of interest rates.

The relationship between official influence and market factors was clearly set out in the 1980 Green Paper on Monetary Control.

> "The level of short term interest rates at any time is determined by the interaction of the markets and the authorities. The short term interest rates generated by the market are not necessarily those needed to achieve the monetary targets".

Put bluntly, even though the authorities are not the only players in the field, no Government that is interested in controlling the quantity of money can afford to ignore its price.

Let me give some examples. There are times when the structure of money market rates indicates very clearly the direction in which the market believes that interest rates should move. It is obviously right to validate a movement, if we believe it is justified by monetary conditions. Last week was such a time.

Less frequently, there can be times when it is dangerous for the authorities to resist a market led move in interest rates, if to do so would cast doubt on the Government's resolve to control inflation. So, for tactical reasons, it may sometimes be right to acquiesce in a change in interest rates, even when we are not convinced that it is justified by the fundamentals. The best example of this sort of situation is perhaps July 1984.

But there are certainly occasions when it is right to resist. This was the case earlier in the year. Interest rates were raised promptly early in January to prevent a downward movement in the exchange rate acquiring an unhealthy momentum. Subsequently, however, I took the view that the pressure for a further rise beyond 12½ per cent was not justified on monetary grounds, and was based on an exaggerated view of sterling's vulnerability to movements in the oil price. And interest rates were not allowed to rise.

Assessing monetary conditions

I have said enough to show that the timing of interest rate changes can often involve a delicate assessment of market tactics. Looking beyond day to day market management, however, the guiding principle is to maintain, on average, a level of short term interest rates that will deliver the monetary conditions needed to reduce inflation.

There is no mechanical formula for taking this crucial judgement. Assessing monetary conditions very often involves weighing movements in one indicator against movements in another.

That is not to deny the special status of the monetary targets. Movements in the aggregates outside their target ranges always establish a presumption in favour of changing short term interest rates.

But that presumption is not overriding. For two reasons:-

- First, we can never be completely confident that the target ranges have been set correctly: that is, that they have been based on a correct understanding of the relationship between the aggregate in question and money GDP.

- Second, in differing degrees all the monetary aggregates respond to changes in short term interest rates with a lag: so it takes time for policy action to bring them back within their target range.

For example, it was clear by last autumn that the target range for £M3 had been set too low. Indeed, with the benefit of hindsight, it is clear that there has been a change in the relationship between £M3 and money GDP in recent years.

Between 1970 and 1980, £M3 grew on average by 2 per cent less than money GDP. Since 1980 it has grown between 2 and 6 per cent more.

Put another way, while £M3 has grown by [77] per cent over the past five years, money GDP has grown by only [52] per cent, and prices by [42] per cent. Over the previous five years, £M3 grew by [77], but money GDP rose by [117] per cent, and prices increased by [96] per cent.

It is still not absolutely clear why this has happened, or how well established the new trend is. A combination of a freer banking system, greater international competition and new technology is certainly part of the story. So is the level of real interest rates. But what it means in practice is that the business of setting targets for £M3 is particularly hazardous.

In view of all the uncertainties, I set a target range for £M3 in 1986-87 that reflects the most recent trend in velocity.

The new range also allows for the possibility that heavy overfunding in some recent years had the effect of artificially depressing £M3 growth relative to the growth in money GDP.

These judgements will need to be assessed in the light of experience. That was why I decided not to publish illustrative ranges for later years.

Faced with difficulties with their main target aggregate, Ml, the United States authorities have from time to time adopted a similarly cautious approach, relating it to what they call "monitoring status", during periods when there have been particular uncertainties about its velocity trend.

Indeed, other major countries rarely if ever publish monetary targets for more than the year immediately ahead.

There are also considerable uncertainties about the relationship between £M3 and short term interest rates. Experience suggests that a change in short term rates is unlikely to alter the growth of £M3 significantly within the target period: and the very short term response to £M3 to a rise in interest rates is unpredictable, and may even be perverse.

The position with MO is more straightforward. Its relationship with money GDP appears to be relatively well established and stable. Money GDP seems to grow between 2 and 5 per cent more than MO in the previous year - very much the same sort of relationship as in the 1970s.

The growth of MO responds fairly rapidly and predictably to changes in the short term interest rates. So a rise in interest rates can be expected to bring MO growth back within its target range over the target period.

The messages coming from the different monetary aggregates need to be continuously tested against the evidence of other indicators, especially when, as sometimes happens, the various measures of money give conflicting signals. At such times, the exchange rate has often played an important role as umpire.

In an economy as open as the UK's there is a presumption that persistent exchange rate movements reflect, to some degree, underlying monetary conditions. And as I have frequently observed, significant movements in the exchange rate, whatever their cause, can have a short term impact on the general price level and on inflationary expectations which make sound internal policies harder to implement.

The timing of short term interest rate changes has often been strongly influenced by exchange rate movements. This has led some commentators to argue that the exchange rate is in practice the dominant influence on monetary policy, and even that we are operating some kind of informal exchange rate target.

Neither is true.

It is not entirely surprising that the exchange rate sometimes acts as a trigger for interest rate changes. The exchange rate is a sensitive barometer, responding rapidly to changes in short term interest rates and changes in market expectations. But it is patently untrue that every fluctuation in the exchange rate - or even every persistent movement - has produced an interest rate response.

Equally the fact that MO has rarely been the trigger for interest rate action is not evidence that it carries little weight in interest rate decisions. Its role has been less visible, but nonetheless important.

Arguments for higher interest rates - based on the behaviour of broad money, or over-pessimistic forecasts of inflation - have often been resisted, because of the more reassuring - and in the event more accurate - signals coming from MO.

But to return to the role of the exchange rate. I accept of course that membership of a fixed exchange rate regime can in principle be a substitute for monetary targets. The exchange rate can be a tough discipline: forcing the authorities to recognise when domestic policies are out of line with other countries.

But it is both risky and dangerous to try and operate a unilateral exchange rate objective, outside a formal fixed exchange rate system, shared by other countries, and supported by a co-ordinated approach to economic management and intervention.

We have not attempted to set a target exchange rate zone for ourselves.

Our interpretation of exchange rate movements does reflect a bias against sharp exchange rate changes; and a bias towards a firm rate, that will support the Government's general objectives on inflation.

But, in essence, the exchange rate is one input - and only one - to an overall assessment of financial conditions. Our aim is to strike a balance between domestic monetary growth and the exchange rate that will deliver conditions that keep downward pressure on inflation.

Evolution of the medium term financial strategy

Almost all my fellow Finance Ministers - and the Governors of their respective Central Banks - would recognise this description of how monetary policy is conducted in practice. Most well conducted countries operate policy in a very similar way. Those who are members of a fixed exchange rate system typically have domestic monetary targets; and those outside such systems still recognise the need to take account of the exchange rate.

But how different is it from the original conception of the MTFS?

It would have been surprising if there had not been some changes. There have been profound changes in the UK economy in the past 7 years; and nowhere has those changes been more pronounced than financial markets.

And, quite rightly, both the presentation and the substance of the MTFS have evolved in response to them.

To start with presentation.

At the time of the first MTFS almost everything remained to be done. Inflation, monetary growth and the public sector deficit were all high. The long process of containing public expenditure and dismantling the controls that were stifling the economy's natural growth potential had only just begun. I have explained how we had embarked on a policy very far from the accepted wisdom of the 1960s and the 1970s. Those who understood what we were about - and not everyone did - doubted our resolve.

In the circumstances of the time, the overriding need was for simplicity and clarity in getting across the central message. This Government - unlike its predecessors - was

determined to pursue a sustained programme of scaling down the growth in money GDP and squeezing inflation out of the system.

In a word, financial discipline was to be restored.

So we kept it simple. Monetary policy was expressed in terms of a target for a single aggregate: and that aggregate was one with which UK markets were already familiar - £M3.

Policy making in the real world is never that simple. But in presenting policy there is always a balance to be struck between clarity and openness.

Even in 1980, we made it clear that no one aggregate could be a sufficient measure of monetary conditions; and that the definition and choice of target aggregates might have to change in response to circumstances. But the commitment to a target for £M3 was a useful shorthand for our resolve to reduce inflation and pursue prudent fiscal and monetary policies.

£M3 had been blessed by the IMF; it was well understood in the markets; and it was thought to indicate links with other policies - including most notably fiscal policy. So, in the words of the 1980 Green Paper, targeting of £M3 was widely understood to give "a general assurance that macroeconomic policies available to the Government will be used in a way which mutually support each other in the reduction of inflation".

This was an oversimplification. But in the early days of the MTFS, I am sure we were right to err on the side of clarity. Unlike Germany, the UK had no proven track record of prudent consistent and credible financial management. History was on the side of the sceptics.

Happily times have changed. Over the past 7 years the UK has had a Government that has pursued a consistent and responsible financial strategy. We are providing a model for others and not a cautionary tale.

It will take time before we build up a reputation equal to Germany's. But we are acquiring the right sort of track record. The evidence is there to show that we mean what we say.

We have not hesitated to raise interest rates as and when necessary; we have halved the rate of growth of money GDP; and the result over the past three years has been the best combination of output growth and low inflation for a generation.

As far as the presentation of policy goes, the delicate balance between clarity and openness has shifted. Because the basic framework of our policies are not in doubt, we can now afford to be franker about the difficulties and complexities of putting them into effect.

There have been changes of substance too. In recent years we have moved further and faster than most of our competitors in freeing up financial markets. A range of outdated controls have been abolished, starting with the abolition of exchange controls only six months after we took office.

In the longer term, I have no doubt that these changes are in the interest of the British economy. But their immediate effect has been to blur long standing distinctions between different financial assets, and between the activities of various financial institutions.

This has inevitably affected the significance of the various measures of money. Policy has had to respond,

and in the process, it has certainly become more complicated.

Broad money, including £M3 has been most profoundly affected. As a result it has come to pay a progressively smaller part in monetary policy decisions.

Problems started to emerge at a fairly early stage. As far back as the autumn of 1980, interest rates were reduced by 2 per cent, even though £M3 was way outside its target range, on the view that it was giving a misleading impression of the tightness of the monetary conditions.

The 1981 MTFS listed the factors that had underpinned this judgement: they included the behaviour of other narrower measures of money, and the exchange rate.

With the benefit of hindsight, this was clearly the right decision, as was the subsequent decision to raise the £M3 target substantially in the 1982 MTFS. Few would now dispute that £M3 has proved a relatively poor guide to monetary conditions for much of the 1980s. Indeed some would argue that the real question is why we have persisted with it for so long, and in particular why I did not drop it altogether at the time of the last Budget.

Difficulties of interpretation there have certainly been. But it would be quite wrong to conclude from recent experience that we can safely tolerate any build up of liquidity.

The risk in dropping £M3 is that markets would do just that. The £M3 target is evidence of our continuing concern with liquidity.

We have taken the view that the growth of £M3 in recent years reflects a genuine desire on the part of the

private sector to build up its liquidity on a lasting basis. I believe that judgement to be correct. But it must be continuously tested against other evidence. A similar judgement proved disastrously wrong in the early 1970s.

One reason why we have come to put increasing weight on the exchange rate and narrow measures of money is because we would expect these indicators to give early warning were the rapid growth of broad money to start to make its way into higher spending. What went wrong in the early 1970s was that the clear signals from these indicators were ignored.

The reduced emphasis on broad money has also been reflected in funding policy. For many years the principal aim of funding policy was to control the growth of broad money and liquidity. From time to time this involved overfunding - that is, selling more debt than needed to fund the PSBR.

In recent years, the attempt to contain a strong growth in liquidity, the reasons for which were only partially understood, came to make overfunding almost a way of life.

This led to distortions - not least the rapidly growing bill mountain - which were undesirable in themselves, and made policy harder to opeate.

I reached the view that this excessive reliance on funding policy was neither sensible nor desirable. Accordingly, I made it clear in my Mansion House Speech last year that the objective of funding policy was to fund the PSBR over the year as a whole: no more no less.

I have already explained why the problems of £M3 gave more prominence to the role of narrow money and the exchange rate. In particular, MO has been given target status for the last two years.

It is sometimes suggested that MO cannot be taken seriously because it covers only a narrow range of transaction balances. I accept that it is not ideal: but it has demonstrated a relatively stable velocity trend over a long period, and it shows a reliable and unambiguous relationship with short term interest rates.

It is important that the best should not be the enemy of the good. The fact is that MO is the best narrow aggregate we have. As in the United States, the more familiar narrow aggregate, M1, has been seriously distorted by a rapid growth of interest bearing sight deposits, some of which were previously held in the form of term deposits. And the same developments have distorted its non-interest bearing component.

The truth is that it has become increasingly difficult to draw a line between money balances held for transactions and those held for savings. MO is only a proxy for transactions balances: but for as long as it continues to bear a reliable relationship with money GDP, we shall continue to give it a significant weight in our assessment of monetary conditions.

Conclusions

These are significant technical changes and much ink has been spilt in describing and explaining them. Rightly so. Neither the authorities nor the markets have anything to gain from deliberate obfuscation.

But it is important not to miss the wood for the trees. The essence of the policy is the commitment to reduce inflation.

That has not, and will not, change.

And after 7 years, we have the track record to prove it.

DRAFT

LOMBARD ASSOCIATION SPEECH

11/4/86.

April is the season of international meetings. My appearance here tonight is sandwiched between the Spring meetings of the IMF in Washington and the OECD in Paris.

Meeting other Finance Ministers, I am always struck by the extent to which we share a common approach to economic management.

The need for firm financial discipline: the importance of reducing fiscal deficits: improving the working of markets and promoting greater competition. These priorities are taken for granted by all major countries today.

It is easy to forget how much has changed since we first took office 7 years ago.

An approach to economic policy that is now commonplace was then radical, even revolutionary. Especially in the UK.

Shortly before the 1979 Election I wrote "The time has come for a wholly new approach to economic policy in Britain. The overriding need is for a long term stabilisation programme to defeat inflation, recreate business confidence, and provide a favourable climate for economic growth".

Putting those brave words into practice has been one of this Government's major achievements. That is an important reason why foreign opinion is in no doubt that Britain is indeed on the right track.

It would be idle to pretend that everything turned out as we expected. I want to spend my time tonight talking

about one particular area where practice is considerably more complicated than theory - monetary policy.

The policy we are pursuing today is identifiably the same as the one we embarked on 7 years ago. But it has clearly evolved - both in terms of presentation and substance. I shall try to explain what has not changed - as well as what has, and why.

The Medium Term Financial Strategy

Our main priority in 1979 was to achieve a lasting reduction in the rate of inflation. So our first task was to replace the shifts and strategems of the 1960s and 1970s by a clear and unequivocal commitment to financial discipline. That was the role of the Medium Term Financial Strategy.

It had two features, both novel at the time. First it provided a medium term framework for monetary and fiscal policy. It symbolised the Government's break with policies of fine tuning and crisis management that had dominated British life for most of the post War period.

Second, it was a strategy about finance. Partly because inflation is a financial problem, and has to be controlled by financial means. And partly because the only levers at the Government's command are financial levers.

This approach to reducing inflation depended in the first instance on scaling down the growth of nominal demand in the economy - that is, the growth of money GDP. This is an amalgam of two things: the real rate of growth and the rate of inflation.

The crucial mistake that earlier Governments made was to equate money demand and real demand. Expansionary policies boost money demand. But it was a dangerous

illusion to suppose that this was automatically translated into a higher rate of growth of real output.

Experience shows just the opposite. During the 1970s GDP in money terms more than quadrupled: but of that increase only 1/20th represented an increase in real output, the other 19/20ths was reflected in sharply higher prices.

Alas there is no magic short cut to boosting the rate of growth of real output; in anything other than the very short term, the growth of output depends on the supply performance of the economy. And that can only be raised by a determined effort to remove restrictions, improve incentives and generally develop a dynamic and enterprising economy.

By contrast it is all too easy to raise the rate of inflation by allowing money GDP to grow in excess of the supply potential of the economy. The bigger the gap the greater the inflation.

But conversely the way to squeeze inflation out of the system is to reduce the rate of growth of money GDP. Which is exactly what the MTFS was - and is - designed to do.

The validity of this approach has been amply borne out by the record of the last 7 years. The growth of money GDP has been halved from over 15 per cent to under 8 per cent. Inflation has been reduced from 13 per cent to 5 per cent. And after an initial setback, we have seen a steady growth in output, of an average rate of 3 per cent a year since 1981.

The monetary and fiscal framework

Reducing the growth of money GDP requires above all an appropriately restrictive monetary policy. And as in most other countries with a serious commitment to

financial discipline, this aim has been encapsulated in published targets for monetary growth.

Some commentators have argued that monetary targets are otiose. That we should simply publish targets for money GDP - or even inflation - and set policy in the light of the best available forecasts. That has not been our approach. For one thing we simply do not have a sufficiently detailed knowledge of the working of the economy to operate such a policy. And secondly, monetary policy is above all about markets, and one function of monetary targets is to provide an anchor for the market's expectations.

But we must never forget that targets are a means to an end. Their use depends on the robustness of a relationship between a particular measure of money on the one hand, and money GDP and inflation on the other. In the real world, no economic relationship is perfect. So monetary targetry was not and never can be a substitute for making an intelligent assessment of monetary conditions, based on all the evidence.

That is why the MTFS has always been more than a row of numbers. What it has been - and remains - is a commitment to maintain monetary conditions that will keep steady downward pressure on money GDP, and so on inflation.

I shall have more to say later about what this means in practice. But a discussion of the Medium Term Financial Strategy cannot be complete without a word on fiscal policy.

The classical framework for financial discipline - the gold standard and the balanced budget - had both a monetary and a fiscal component. So does the MTFS. From the start we recognised that a firm monetary policy has to be buttressed by setting public sector borrowing at a

level that can be comfortably financed in a non-inflationary way. In theory of course there is no precise relationship between the PSBR and any given rate of monetary growth. But in practice the only way to be sure of financing the public sector soundly is to plan for a low PSBR.

Experience has shown the wisdom of leaving a margin of safety. The 1984-85 PSBR at 3 per cent of GDP was still the lowest for over a decade even though the £3 billion cost of the coal strike was met entirely by higher borrowing. The latest figures suggest that the PSBR was below 2 per cent of GDP last year. And it is planned to be below 2 per cent again in the current financial year - a level that will put us in a strong position to cope with unexpected developments, for example in the oil market.

It is worth recalling that little more than ten years ago - in 1975-76 - borrowing reached 9¼ per cent of GDP; and the last time the PSBR was below 2 per cent of GDP was in 1971-72.

This emphasis on low public sector borrowing has become part of the accepted wisdom in other major countries. It is a long time since OECD Ministers failed to refer to the need to reduce structural deficits over the medium term as an agreed tenet of fiscal policy.

Monetary policy

To recapitulate. While fiscal policy has an important supporting role, monetary policy lies at the heart of the MTFS. The central task of monetary policy is to create monetary conditions that will bring steady downward pressure on the rate of growth of money GDP, and hence on inflation.

In practice this involves a combination of economic analysis and market judgement. Policy must be continuously informed by a careful assessment of what monetary conditions are - and need to be - to meet the Government's objective. But implementing interest rate decisions in today's fast moving financial markets also requires a degree of tactical skill.

Let me be quite clear. Short term interest rates are above all an instrument of monetary policy. That is not to say that the market does not exercise an influence, certainly on the structure and also, at times, on the level of short term interest rates. But we have never suggested that the market could, entirely independently, set the level of interest rates.

The relationship between official influence and market factors was clearly set out in the 1980 Green Paper on Monetary Control.

> "The level of short term interest rates at any time is determined by the interaction of the markets and the authorities. The short term interest rates generated by the market are not necessarily those needed to achieve the monetary targets".

Put bluntly, even though the authorities are not the only players in the field, no Government that is interested in controlling the quantity of money can afford to ignore its price.

Let me give some examples. There are times when the structure of money market rates indicates very clearly the direction in which the market believes that interest rates should move. It is obviously right to validate a movement, if we believe it is justified by monetary conditions. Last week was such a time.

Less frequently, there can be times when it is dangerous for the authorities to resist a market led move in interest rates, if to do so would cast doubt on the Government's resolve to control inflation. So, for tactical reasons, it may sometimes be right to acquiesce in a change in interest rates, even when we are not convinced that it is justified by the fundamentals. The best example of this sort of situation is perhaps July 1984.

But there are certainly occasions when it is right to resist. This was the case earlier in the year. Interest rates were raised promptly early in January to prevent a downward movement in the exchange rate acquiring an unhealthy momentum. Subsequently, however, I took the view that the pressure for a further rise beyond 12½ per cent was not justified on monetary grounds, and was based on an exaggerated view of sterling's vulnerability to movements in the oil price. And interest rates were not allowed to rise.

Assessing monetary conditions

I have said enough to show that the timing of interest rate changes can often involve a delicate assessment of market tactics. Looking beyond day to day market management, however, the guiding principle is to maintain, on average, a level of short term interest rates that will deliver the monetary conditions needed to reduce inflation.

There is no mechanical formula for taking this crucial judgement. Assessing monetary conditions very often involves weighing movements in one indicator against movements in another.

That is not to deny the special status of the monetary targets. Movements in the aggregates outside their target ranges always establish a presumption in favour of changing short term interest rates.

But that presumption is not overriding. For two reasons:-

- First, we can never be completely confident that the target ranges have been set correctly: that is, that they have been based on a correct understanding of the relationship between the aggregate in question and money GDP.

- Second, in differing degrees all the monetary aggregates respond to changes in short term interest rates with a lag: so it takes time for policy action to bring them back within their target range.

For example, it was clear by last autumn that the target range for £M3 had been set too low. Indeed, with the benefit of hindsight, it is clear that there has been a change in the relationship between £M3 and money GDP in recent years.

Between 1970 and 1980, £M3 grew on average by 2 per cent <u>less</u> than money GDP. Since 1980 it has grown between 2 and 6 per cent <u>more</u>.

Put another way, while £M3 has grown by [77] per cent over the past five years, money GDP has grown by only [52] per cent, and prices by [42] per cent. Over the previous five years, £M3 grew by [77], but money GDP rose by [117] per cent, and prices increased by [96] per cent.

It is still not absolutely clear why this has happened, or how well established the new trend is. A combination of a freer banking system, greater international competition and new technology is certainly part of the story. So is the level of real interest rates. But what it means in practice is that the business of setting targets for £M3 is particularly hazardous.

In view of all the uncertainties, I set a target range for £M3 in 1986-87 that reflects the most recent trend in velocity.

The new range also allows for the possibility that heavy overfunding in some recent years had the effect of artificially depressing £M3 growth relative to the growth in money GDP.

These judgements will need to be assessed in the light of experience. That was why I decided not to publish illustrative ranges for later years.

Faced with difficulties with their main target aggregate, M1, the United States authorities have from time to time adopted a similarly cautious approach, relating it to what they call "monitoring status", during periods when there have been particular uncertainties about its velocity trend.

Indeed, other major countries rarely if ever publish monetary targets for more than the year immediately ahead.

There are also considerable uncertainties about the relationship between £M3 and short term interest rates. Experience suggests that a change in short term rates is unlikely to alter the growth of £M3 significantly within the target period: and the very short term response to £M3 to a rise in interest rates is unpredictable, and may even be perverse.

The position with MO is more straightforward. Its relationship with money GDP appears to be relatively well established and stable. Money GDP seems to grow between 2 and 5 per cent more than MO in the previous year - very much the same sort of relationship as in the 1970s.

The growth of MO responds fairly rapidly and predictably to changes in the short term interest rates. So a rise in interest rates can be expected to bring MO growth back within its target range over the target period.

The messages coming from the different monetary aggregates need to be continuously tested against the evidence of other indicators, especially when, as sometimes happens, the various measures of money give conflicting signals. At such times, the exchange rate has often played an important role as umpire.

In an economy as open as the UK's there is a presumption that persistent exchange rate movements reflect, to some degree, underlying monetary conditions. And as I have frequently observed, significant movements in the exchange rate, whatever their cause, can have a short term impact on the general price level and on inflationary expectations which make sound internal policies harder to implement.

The timing of short term interest rate changes has often been strongly influenced by exchange rate movements. This has led some commentators to argue that the exchange rate is in practice the dominant influence on monetary policy, and even that we are operating some kind of informal exchange rate target.

Neither is true.

It is not entirely surprising that the exchange rate sometimes acts as a trigger for interest rate changes. The exchange rate is a sensitive barometer, responding rapidly to changes in short term interest rates and changes in market expectations. But it is patently untrue that every fluctuation in the exchange rate - or even every persistent movement - has produced an interest rate response.

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Very much a scissors & paste job

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11/4/86.

LOMBARD ASSOCIATION SPEECH

MONETARY POLICY

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It is easy to forget how much has changed since we first took office 7 years ago.

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Shortly before the 1979 Election I wrote "The time has come for a wholly new approach to economic policy in Britain. The overriding need is for a long term stabilisation programme to defeat inflation, recreate business confidence, and provide a favourable climate for economic growth".

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~~It would be idle to pretend that everything turned out as we expected. I want to spend my time tonight talking~~

about one particular area where practice is considerably more complicated than theory - monetary policy.

The policy we are pursuing today is identifiably the same as the one we embarked on 7 years ago. But it has clearly evolved - both in terms of presentation and substance. I shall try to explain what has not changed, as well as what has, and why.

The Medium Term Financial Strategy

Our main priority in 1979 was to achieve a lasting reduction in the rate of inflation. So our first task was to replace the shifts and strategems of the 1960s and 1970s by a clear and unequivocal commitment to financial discipline. That was the role of the Medium Term Financial Strategy.

It had two features, both novel at the time. First it provided a medium term framework for monetary and fiscal policy. It symbolised the Government's break with policies of fine tuning and crisis management that had dominated British life for most of the post War period.

Second, it was a strategy about finance. Partly because inflation is a financial problem, and has to be controlled by financial means. And partly because the only levers at the Government's command are financial levers.

This approach to reducing inflation depended in the first instance on scaling down the growth of nominal demand in the economy - that is, the growth of money GDP. This is an amalgam of two things: the real rate of growth and the rate of inflation.

The crucial mistake that earlier Governments made was to equate money demand and real demand. Expansionary policies boost money demand. But it was a dangerous

illusion to suppose that this was automatically translated into a higher rate of growth of real output.

Experience shows just the opposite. During the 1970s GDP in money terms more than quadrupled: but of that increase only 1/20th represented an increase in real output, the other 19/20ths was reflected in sharply higher prices.

In essence, the mistakes of the past were based on ascribing magical properties to money: the belief that manipulating money, whether through printing or borrowing, could ~~[illegible]~~ bring about higher real output and employment.

But important though money is, it ~~But money~~ isn't magic.

The only sustainable way to boost the rate of growth of real output is to improve the supply performance of the economy. That means removing restrictions, improving incentives and generally developing a more dynamic and enterprising economy. ~~And~~ That is why the MTFS has been accompanied, from the very beginning, by a ~~set~~ constellation of ~~liberalising~~ policies designed to let free markets work better.

Ultimate objectives

In terms of ultimate objectives, therefore:

- the purpose of the MTFS is to reduce the growth of total money demand - total spending power - in the economy, which can conveniently be measured by money GDP, at a rate which will gradually squeeze inflation out of the system while allowing the economy to expand in real terms;

- the purpose of our supply side policies is to increase the ~~long run~~ rate at which the real economy is capable of growing ~~can expand in real terms without generating inflation.~~ over the longer term.

The validity of this approach has been amply borne out by the record of the last 7 years. The growth of money GDP has been halved, from over 15 per cent to under 8 per cent. Inflation has been reduced from 13 per cent to 5 per cent. And after an initial setback, we have seen a steady growth in output, of an average rate of 3 per cent a year since 1981.

The monetary and fiscal framework

Reducing the growth of money GDP requires above all an appropriately restrictive monetary policy. And as in most other countries with a serious commitment to

In principle, there is a strong case for setting targets in terms of non-interest-bearing money on the one hand and interest-bearing money on the other. But in practice this is not realistic. The boundary is shifting fast. So I have chosen instead to set targets for MO, which at least is relatively stable, and £M3, which has the advantages of familiarity.

Throughout my time as Chancellor

narrow money in the shape of MO, which has shown a predictable relationship with money GDP over a considerable number of years, and broad money in the shape of

financial discipline, this aim has been encapsulated in published targets for monetary growth.

Some commentators have argued that monetary targets are otiose. That we should simply publish targets for money GDP - or even inflation - and set policy in the light of the best available forecasts. That has not been our approach. For one thing we simply do not have a sufficiently detailed knowledge of the working of the economy to operate such a policy. And secondly, monetary policy is above all about markets, and one function of monetary targets is to provide an anchor for the market's expectations.

But we must never forget that targets are a means to an end. Their use depends on the robustness of a relationship between a particular measure of money on the one hand, and money GDP and inflation on the other. In the real world, no economic relationship is perfect. So monetary targetry was not and never can be a substitute for making an intelligent assessment of monetary conditions, based on all the evidence.

That is why the MTFS has always been more than a row of numbers. What it has been - and remains - is a commitment to maintain monetary conditions that will keep steady downward pressure on money GDP, and so on inflation.

I shall have more to say later about what this means in practice. But a discussion of the Medium Term Financial Strategy cannot be complete without a word on fiscal policy.

The classical framework for financial discipline - the gold standard and the balanced budget - had both a monetary and a fiscal component. So does the MTFS. From the start we recognised that a firm monetary policy has to be buttressed by setting public sector borrowing at a

There is, of course, no scientific formula for determining the 'right' size of the PSBR. Nor is there any precise relationship between the PSBR and any given rate of monetary growth. But in practice there are very real constraints on how much it is prudent to borrow. In the first place, over the medium (and longer) term, it is clearly important that the amount of public debt, and the burden that imposes, should not rise as a proportion of the economy as a whole. But, second, within this overall framework, it is important to set the budget deficit at a level that can be comfortably financed in a non-inflationary way. And by that I do not just mean the budget deficit if all goes well. From time to time there will be shocks to the system, such as (for example) the coal strike of 1984-85. It cannot be sensible to budget so close to the limits of prudence that any such shocks would need to be met by disruptive changes in the level of

Experience has shown the wisdom of leaving a margin of safety. The 1984-85 PSBR at 3 per cent of GDP was still the lowest for over a decade even though the £3 billion cost of the coal strike was met entirely by higher borrowing. The latest figures suggest that the PSBR was below 2 per cent of GDP last year. And it is planned to be below 2 per cent again in the current financial year - a level that will put us in a strong position to cope with unexpected developments, for example in the oil market.

It is worth recalling that little more than ten years ago - in 1975-76 - borrowing reached 9¼ per cent of GDP; and the last time the PSBR was below 2 per cent of GDP was in 1971-72.

This emphasis on low public sector borrowing has become part of the accepted wisdom in other major countries. It is a long time since OECD Ministers failed to refer to the need to reduce structural deficits over the medium term as an agreed tenet of fiscal policy.

Monetary policy

To recapitulate. While fiscal policy has an important supporting role, monetary policy lies at the heart of the MTFS. The central task of monetary policy is to create monetary conditions that will bring steady downward pressure on the rate of growth of money GDP, and hence on inflation.

either public expenditure or taxation, where the economy benefits more from a stable long-term trend.

This means that, in practice, the Budget deficit or PSBR should always be set [illegible] low enough to ensure that it can absorb any likely shocks and still be comfortably financed in a non-inflationary way.

In practice this involves a combination of economic analysis and market judgement. Policy must be continuously informed by a careful assessment of what monetary conditions are - and need to be - to meet the Government's objective. But implementing interest rate decisions in today's fast moving financial markets also requires a degree of tactical skill.

Let me be quite clear. Short term interest rates are above all an instrument of monetary policy. That is not to say that the market does not exercise an influence, certainly on the structure and also, at times, on the level of short term interest rates. But we have never suggested that the market could, entirely independently, set the level of interest rates.

The relationship between official influence and market factors was clearly set out in the 1980 Green Paper on Monetary Control.

> "The level of short term interest rates at any time is determined by the interaction of the markets and the authorities. The short term interest rates generated by the market are not necessarily those needed to achieve the monetary targets".

Put bluntly, even though the authorities are not the only players in the field, no Government that is interested in controlling the quantity of money can afford to ignore its price.

Let me give some examples. There are times when the structure of money market rates indicates very clearly the direction in which the market believes that interest rates should move. It is obviously right to validate a movement, if we believe it is justified by monetary conditions. Last week was such a time.

Less frequently, there can be times when it is dangerous for the authorities to resist a market led move in interest rates, if to do so would cast doubt on the Government's resolve to control inflation. So, for tactical reasons, it may sometimes be right to acquiesce in a change in interest rates, even when we are not convinced that it is justified by the fundamentals. The best example of this sort of situation is perhaps July 1984.

But there are certainly occasions when it is right to resist. This was the case earlier in the year. Interest rates were raised promptly early in January to prevent a downward movement in the exchange rate acquiring an unhealthy momentum. Subsequently, however, I took the view that the pressure for a further rise beyond 12½ per cent was not justified on monetary grounds, and was based on an exaggerated view of sterling's vulnerability to movements in the oil price. And interest rates were not allowed to rise.

Assessing monetary conditions

I have said enough to show that the *timing* of interest rate changes can often involve a delicate assessment of market tactics. Looking beyond day to day market management, however, the guiding principle is to maintain, on average, a level of short term interest rates that will deliver the monetary conditions needed to reduce inflation.

There is no mechanical formula for ~~taking~~ making this ~~crucial~~ key judgement. Assessing monetary conditions very often involves weighing movements in one indicator against movements in another.

That is not to deny the special status of the monetary targets. Movements in the aggregates outside their target ranges always establish a *presumption* in favour of changing short term interest rates.

But that presumption is not overriding. For two reasons:-

- First, we can never be completely confident that the target ranges have been set correctly: that is, that they have been based on a correct understanding of the relationship between the aggregate in question and money GDP.

- Second, in differing degrees all the monetary aggregates respond to changes in short term interest rates with a lag: so it takes time for policy action to bring them back within their target range.

For example, it was clear by last autumn that the target range for £M3 had been set too low. Indeed, with the benefit of hindsight, it is clear that there has been a change in the relationship between £M3 and money GDP in recent years.

Between 1970 and 1980, £M3 grew on average by 2 per cent <u>less</u> than money GDP. Since 1980 it has grown between 2 and 6 per cent <u>more</u>.

Put another way, while £M3 has grown by [77] per cent over the past five years, money GDP has grown by only [52] per cent, and prices by [42] per cent. Over the previous five years, £M3 grew by [77], but money GDP rose by [117] per cent, and prices increased by [96] per cent.

It is still not absolutely clear why this has happened, or how well established the new trend is. A combination of a freer banking system, greater international competition and new technology is certainly part of the story. So is the level of real interest rates. But what it means in practice is that the business of setting targets for £M3 is particularly hazardous.

In view of all the uncertainties, I set a target range for £M3 in 1986-87 that reflects the most recent trend in velocity.

The new range also allows for the possibility that heavy overfunding in some recent years had the effect of artificially depressing £M3 growth relative to the growth in money GDP.

These judgements will need to be assessed in the light of experience. That was why I decided not to publish illustrative ranges for later years.

Faced with difficulties with their main target aggregate, M1, the United States authorities have from time to time adopted a similarly cautious approach, relating it to what they call "monitoring status", during periods when there have been particular uncertainties about its velocity trend.

Indeed, other major countries rarely if ever publish monetary targets for more than the year immediately ahead.

There are also considerable uncertainties about the relationship between £M3 and short term interest rates. Experience suggests that a change in short term rates is unlikely to alter the growth of £M3 significantly within the target period: and the very short term response to £M3 to a rise in interest rates is unpredictable, and may even be perverse.

In recent years we have moved further and faster than most of our competitors in freeing up financial markets. A range of outdated controls have been abolished, starting with the abolition of exchange controls only six months after we took office.

In the longer term, I have no doubt that these changes are in the interest of the British economy. But their immediate effect has been to blur long standing distinctions between different financial assets, and between the activities of various financial institutions.

This has inevitably affected the significance of the various measures of money. Policy has had to respond, and in the process, it has certainly become more complicated.

Broad money, including £M3, has been most profoundly affected. As a result it has come to pay a progressively smaller part in monetary policy decisions.

Problems started to emerge at a fairly early stage. As far back as the autumn of 1980, interest rates were reduced by 2 per cent, even though £M3 was way outside its target range, on the view that it was giving a misleading impression of the tightness of monetary conditions.

The 1981 MTFS listed the factors that had underpinned this judgment: they included the behaviour of other narrower measures of money, and the exchange rate.

With the benefit of hindsight, this was clearly the right decision, as was the subsequent decision to raise the £M3 target substantially in the 1982 MTFS. Few would now dispute that £M3 has proved a relatively poor guide to monetary conditions for much of the 1980s. Indeed some would argue that the real question is why we have persisted with it for so long, and in particular why I did not drop it altogether at the time of the last Budget.

But I believe it would be quite wrong to conclude from recent experience that we can safely tolerate any build up of liquidity. The risk in dropping £M3 is that markets would do just that.

We have taken the view that the growth of £M3 in recent years reflectes a genuine desire on the part of the

private sector to build up its liquidity on a lasting basis. I believe that judgement to be correct. But it must be continuously tested against other evidence. A similar judgement proved disastrously wrong in the early 1970s.

One reason why we have come to put increasing weight on the exchange rate and narrow measures of money is because we would expect these indicators to give early warning were the rapid growth of broad money to start to make its way into higher spending. What went wrong in the early 1970s was that the clear signals from these indicators were ignored.

The reduced emphasis on broad money has also been reflected in funding policy. For many years the principal aim of funding policy was to control the growth of broad money and liquidity. From time to time this involved overfunding - that is, selling more debt than needed to fund the PSBR.

In recent years, the attempt to contain a strong growth in liquidity, the reasons for which were only partially understood, came to make overfunding almost a way of life.

This led to distortions - not least the rapidly growing bill mountain - which were undesirable in themselves, and made policy harder to opeate.

I reached the view that this excessive reliance on funding policy was neither sensible nor desirable. Accordingly, I made it clear in my Mansion House Speech last year that the objective of funding policy was to fund the PSBR over the year as a whole: no more no less.

I have already explained why the problems of £M3 gave more prominence to the role of narrow money and the exchange rate. In particular, MO has been given target status for the last two years.

The position with MO is more straightforward. Its relationship with money GDP appears to be relatively well established and stable. Money GDP seems to grow between 2 and 5 per cent more than MO in the previous year - very much the same sort of relationship as in the 1970s.

The growth of MO responds fairly rapidly and predictably to changes in the short term interest rates. So a rise in interest rates can be expected to bring MO growth back within its target range over the target period.

It is sometimes suggested that MO cannot be taken seriously because it covers only a narrow range of transaction balances. I accept that MO is not ideal: but it has demonstrated a relatively stable velocity trend over a long period, and it shows a reliable and unambiguous relationship with short term interest rates.

It is important that the best should not be the enemy of the good. The fact is that MO is the best narrow aggregate we have. As in the United States, the more familiar narrow aggregate, M1, has been seriously distorted by a rapid growth of interest bearing sight deposits, some of which were previously held in the form of term deposits. And the same developments have distorted its non-interest bearing component.

The truth is that it has become increasingly difficult to draw a line between money balances held for transactions and those held for savings. MO is only a proxy for transactions balances: but for as long as it continues to bear a reliable relationship with money GDP, we shall continue to give it a significant weight in our assessment of monetary conditions.

The messages coming from the different monetary aggregates need to be continuously tested against the evidence of other indicators, especially when, as sometimes happens, the various measures of money give conflicting signals. At such times, the exchange rate has often played an important role as umpire.

In an economy as open as the UK's there is a presumption that persistent exchange rate movements reflect, to some degree, underlying monetary conditions. And as I have frequently observed, significant movements in the exchange rate, whatever their cause, can have a short term impact on the general price level and on inflationary expectations which make sound internal policies harder to implement.

The timing of short term interest rate changes has often been strongly influenced by exchange rate movements. This has led some commentators to argue that the exchange rate is in practice the dominant influence on monetary policy, and even that we are operating some kind of informal exchange rate target.

Neither is true.

It is not entirely surprising that the exchange rate sometimes acts as a trigger for interest rate changes. The exchange rate is a sensitive barometer, responding rapidly to changes in short term interest rates and changes in market expectations. But it is patently untrue that every fluctuation in the exchange rate - or even every persistent movement - has produced an interest rate response.

there have been particular uncertainties about its velocity trend.

Indeed, other major countries rarely if ever publish monetary targets for more than the year immediately ahead.

There are also considerable uncertainties about the relationship between £M3 and short term interest rates. Experience suggests that a change in short term rates is unlikely to alter the growth of £M3 significantly within the target period: and the very short term response to £M3 to a rise in interest rates is unpredictable, and may even be perverse.

The messages coming from the different monetary aggregates need to be continuously tested against the evidence of other indicators, especially when, as sometimes happens, the various measures of money give conflicting signals. At such times, the exchange rate has often played an important role as umpire.

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In interpreting exchange rate movements, I confess to a bias against sharp exchange rate changes; and, more particularly, a bias towards a firm rate, (MK) that will support the Government's general objectives on inflation. I believe that a commitment to a non-accommodating exchange rate - that is, a rate which will not be devalued to accommodate excessive pressures from wages or other costs - can usefully complement a commitment to a non-accommodating domestic monetary policy. Both are part and parcel of sound money.

The exchange rate

I accept of course that in the right circumstances membership of a formal fixed exchange rate system can provide a very effective framework for monetary policy. The gold standard was the earliest and most durable form of financial discipline. Modern fixed exchange rate systems are more flexible. But the exchange rate can still provide a very clear and tough discipline, forcing the authorities to take timely action when domestic policies are out of line with other countries.

Of course the exchange rate will not signal the right policy action every time any more than the monetary aggregates. But over medium term, maintaining fixed exchange rates between countries who share a common resolve to reduce inflation is a pretty robust way of keeping domestic monetary policy on the rails.

But I see no role for an exchange rate target outside a formal exchange rate system, shared by other countries, and supported by a co-ordinated approach to economic management and intervention. And that, for the UK, means outside the exchange rate mechanism of the EMS.

In market terms, an explicit target is an open invitation to speculators to test the authorities' resolve. And an informal, unannounced target does nothing to improve the clarity and credibility of policy.

Let me repeat. The Government does not believe the time is yet right for us to join the ERM. And we have no informal exchange rate target or zone.

But it clearly makes sense to limit wild swings in the exchange rate, particularly against our European competitors. And a firm exchange rate is a discipline on industrial costs: as I have repeatedly made clear,

companies who fail to contain their own costs cannot look to a depreciating exchange rate to bail them out.

In essence, however, the exchange rate is one input - albeit an important one - to an overall assessment of financial conditions.

Our aim is to strike a balance ~~between~~ of domestic monetary growth and the exchange rate that ~~would~~ will deliver the conditions ~~that~~ necessary to keep downward pressure on inflation.

Those who recall the economic history of Britain in the 'fifties may recall some resemblance to the thinking behind the abortive 'Robot' plan - the idea that the key of the conduct of sound economic policy lay in the interplay of interest rates and the exchange rate.

But I do not believe one can run a private and unannounced regime for fixed or even target exchange rates.

Membership of a fixed exchange rate regime would be one thing. But it is both risky and dangerous to try to operate a unilateral exchange rate objective, outside a formal system shared by other countries, and supported by a co-ordinated approach to economic management and intervention.

We have not attempted to set a target exchange rate zone for ourselves.

And it is of course patently untrue that every fluctuation in the exchange rate - or even every persistent movement - has produced an interest rate response.

Evolution of the medium term financial strategy

Almost all my fellow Finance Ministers - and the Governors of their respective Central Banks - would recognise this description of how monetary policy is conducted in practice. Most well conducted countries operate policy in a very similar way. Those who are members of a fixed exchange rate system typically have domestic monetary targets; and those outside such systems still recognise the need to take account of the exchange rate.

And as a result, inflation has come down worldwide.

Those who attribute this to the worldwide fall in commodity prices, of which the recent collapse in the oil price is merely the most spectacular example, put the cart before the horse.

Just as the excessive global monetary expansion of the early 1970s was responsible for the explosion of commodity prices that occurred at that time, so the return to prudent monetary policy in the 1980s — a return in which this Government was in the vanguard — has been directly responsible for the subsequent fall in commodity prices.

It is not all the fortuitous gift of some global fairy godmother.

Conclusion

I have described how, over the years, the MTFS has evolved, and where policy stands now.

~~But how different is it from the original conception of the MTFS?~~

It would have been surprising if there had not been some changes. There have been profound changes in the UK economy in the past 7 years; and nowhere has those changes been more pronounced than financial markets.

But the most important change is ~~that~~ perhaps this.

At the time of the first MTFS, almost everything remained to be done. Inflation, monetary growth and ~~the~~ public

sector deficit were all high. The long process of containing public expenditure and dismantling the controls that were stifling the economy's natural growth potential was only just beginning. We had embarked on a policy far from the accepted wisdom of the 1960s and the 1970s. Those who understood what we were about - and not everyone did - doubted our resolve.

So we kept it simple. Monetary policy was expressed in terms of a target for a single aggregate: and that aggregate was one with which UK markets were already familiar - £M3.

It had been blessed by the IMF; it was well understood in the markets; and it was thought to indicate links with other policies - including most notably fiscal policy. So, in the words of the 1980 Green Paper, targeting of £M3 was widely understood to give "a general assurance that macroeconomic policies available to the Government will be used in a way which mutually support each other in the reduction of inflation".

But even in 1980, we made it clear that no one aggregate could be a sufficient measure of monetary conditions; and that the definition and choice of target aggregates might have to change in response to circumstances.

At that time, the UK had no consistent track record of prudent financial management. And the task of disinflation was massive.

economies soundly for a long period, such as Germany, have acquired a track record, acquired a reputation, both for consistency of economic policy and for a general anti-inflationary bias in their policy, and that track record, that reputation, was what created confidence both within the country and outside it about the conduct of policy. We had, regrettably, a very different track record in this country. We had a track record of constantly shifting and changing, chopping and changing, having short-term horizons, not carrying out any policy for any length of time and all the time a tendency to yield to inflationary processes. That is what we faced when we came in, a very bad track record, and we have to try and change expectations and condition people's thinking, both in this country and overseas, and the medium-term financial strategy play a critically important part in securing that by showing that the Government was firmly committed to carrying out this particular policy and continuing with it right through the medium term and giving people this medium-term horizon. Since then we have been pursuing this policy for the best part of seven years and we now are accumulating and acquiring a track record and reputation which is helpful rather than harmful to the economy, but it will take a further period of time before it can be as beneficial as is the case in a country like Germany, which has had this good track record for very much longer. That is a fundamental difference, but we have never said for a moment that £M3 was the keystone of the medium-term financial strategy.

164. If I may bring you back from seven or eight long years ago to the present situation, when you said in your Budget speech that you had set the range for £M3 at 11 to 15 per cent. I waited fully expecting that, in line with your previous speeches, you would then say: "This range will lead to, provide for or even ensure that inflation will continue on its downward path," but you did not use any of those words. You simply said - and this is a big change - this range of 11 to 15 per cent

Now, in 7 years, we have built up a track record, and reduced the problems to scale.

It will take time before we earn a reputation equal to Germany's. But we are on the way, and the evidence is there to show that we mean what we say.

Take interest rates, for example. It used to be the

(Y)

Moreover, in the pursuit of monetary policy there is always a difficult tactical balance to be struck, which we may not always have got right, between conforming to the current preoccupations of the financial markets and seeking to shape the market's perception of what really matters.

Over time, we have gradually somewhat shifted the emphasis from the former to the latter, but the need of striking a balance is still there.

At the time of the first MTFS, almost everything remained to be done. Inflation, monetary growth and public sector borrowing were all high. Financial discipline had to be restored. The long process of containing public expenditure and dismantling the controls that were stifling the economy's natural growth potential was only just beginning. We had embarked on a policy far from the accepted wisdom of the 1960s and the 1970s. Those who understood what we were about - and not everyone did - doubted our resolve.

So it was essential to keep it simple. Monetary policy was expressed in terms of a target for a single aggregate: and that aggregate was one with which UK markets were already familiar - £M3.

It had been blessed by the IMF; it had been targeted by the previous Government; and it had a clear link with fiscal policy. So, in the words of the March 1980 Green Paper, targeting of £M3 was widely understood to give "a general assurance that macroeconomic policies available to the Government will be used in a way which mutually support each other in the reduction of inflation".

But even as far back as that Green Paper, we also made it clear that no one aggregate could be a sufficient measure of monetary conditions; and that the definition and choice of target aggregates might have to change in response to circumstances.

Insert (Y) →

Above all, ~~at that time~~ when we first took office, the UK had no consistent track record of prudent financial management - quite the reverse. The task ahead of us was massive.

Those countries that have been conducting their economies soundly for a long period, such as Germany, had acquired a track record, acquired a reputation, both for consistency of economic policy and for a general anti-inflationary bias in their policy. That track

record, that reputation, was what created confidence both within the country and outside it about the conduct of policy.

We had, regrettably, a very different track record in this country. We had a record of constantly shifting, and chopping and changing, not carrying out any policy for any length of time - and all the time a tendency to yield to inflationary pressures.

That is what we faced when we entered office in 1979, and we had to try and change expectations and condition people's thinking, both in this country and overseas.

The medium-term financial strategy played a critically important part in securing that, by showing that the Government was firmly committed to carrying out an anti-inflationary monetary and fiscal policy and persisting with it over a period of years.

Since then we have been pursuing this policy for the best part of seven years, and at last we are accumulating and acquiring a track record and a reputation which is helpful rather than harmful to the economy.

No doubt it will take a further period of time before it can be as beneficial as is the case in a country like Germany, which has had a good track record for very much longer.

But we are on the way, and the evidence is there to show that we mean what we say.