PO-CH/NL/0239

PART C

Part. C.

Begins: 16/4/86.
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PO -CH /NL/0239
PART C

Chancellor's (Lawson) Papers:

SPEECH TO THE LOMBARD ASSOCIATION

DD's: 25 Years

20/12/95.

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PART C

LR1.74

pmp

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

16 April 1986

David Norgrove Esq
10 Downing Street
LONDON SW1

Dear David,

LOMBARD ASSOCIATION SPEECH

... I attach the final text of the speech on monetary policy which the Chancellor will be delivering to the Lombard Association tonight. It is embargoed for 8pm.

Copies go to Joan MacNaughton (Lord President's Office) and Andrew Lansley (Chancellor of the Duchy's Office).

Yours ever

Rachel

RACHEL LOMAX
Principal Private Secretary

Reference ....

MRS LOMAX

A few typos etc. plus are very small suggestion for clarity.

HF3 (Mr Hannah) are checking the money GDP, M0, £M3, inflation etc. figures, so you may like to check they have looked at all the points I've indicated.

MOM
16/4

CODE 18-78

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

Margaret

For final checking

ASAP.

R

16/4

9:25

Keith

Can you now give this priority? Not many figures to check, though you'll need a word with HF3.

MP

Annotated copy

(still one or 2 typos, which I'll clean up in the morning)

LOMBARD ASSOCIATION SPEECH

MONETARY POLICY

Clean copy below.

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 containing budget 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 the consensus among those throughout the world charged with responsibilities in these matters, was then radical, even revolutionary. Especially in Britain.

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

The policy we are pursuing today is identifiably the same as that which we embarked on 7 years ago. But it has clearly evolved - in terms both of presentation and of substance. This has led to some quite unnecessary confusion in the minds of a number of the commentators. So let me tonight 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, which we launched in March 1980.

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 short-term expediency that had dominated British economic policy 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, in a free society, the only levers at the Government's command are financial levers.

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

The fatal mistake that earlier Governments made was to confuse money demand with real demand. Expansionary policies can certainly boost money demand. But it is a dangerous delusion to suppose that this 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.

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 bring about higher real output and employment.

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

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

<u>Ultimate objectives</u>

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 rate at which the real economy is capable of growing over the longer term.

The validity of this approach has been amply borne out by the record since we first took office. The growth of total spending power, as measured by money GDP, has been halved, and inflation has come down from 13 per cent to 5 per cent. Yet we have seen a steady growth in output, at an average rate of almost 3 per cent a year since 1981.

The monetary and fiscal framework

~~Too [illegible] heads has unnecessary, unnecessary [illegible] questions about relationship between fiscal & monetary policy~~

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.

X

Some commentators have argued that monetary targets are otiose. That we should publish targets for money GDP - or Even simply inflation ~~or even wage costs~~ - and set policy in the light of the best available forecasts. That has not been our approach.

To adopt it would not provide us with any new instruments of policy. It would merely mean using the existing instruments with an even greater degree of discretion than we do ~~We simply do not have the detailed knowledge of the working of the economy - and the effect of individual policy instruments - needed to operate such policy. Inevitably, a very great deal would be left to the discretion of the authorities - far more than~~ at present, a point which usually escapes those who with one breath complain about the "monetary muddle" and with the next, suggest moving in this direction.

Moreover, ~~Relying on~~ ~~current~~ the latest available information about money GDP and inflation ~~[still more wage costs]~~ ~~would be no better:~~ ~~They~~ tells us ~~something~~ a great deal about the past stance of policy; but little about the action we should be taking now. ~~[Wage costs would be even worse. Part of our problem in this country is precisely that wages respond painfully slowly to changes in policy.]~~

Operational decisions have to be based on information available today which looks to the future. We cannot neglect those financial indicators that do give advance warning of future movements in money GDP and inflation.

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, since the boundaries are constantly shifting. So throughout my time as Chancellor I have chosen instead to set targets for 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 £M3, which has the advantage of familiarity.

But we must never forget that monetary 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.

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

This means that, in practice, the Budget deficit or PSBR should always be set low enough to ensure that it can absorb any likely shock and <u>still</u> be comfortably financed ~~in a non-inflationary way.~~

repetition

Thus the 1984-85 PSBR at some 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 any unexpected developments, for example in the oil market. NLM

It is worth recalling that little more than ten years ago public sector borrowing exceeded 9 per cent of GDP; and the last time the PSBR was below 2 per cent of GDP was some fifteen years ago.

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~~ Short term interest rates

Tax - same point as above

Start

To recapitulate. While fiscal policy has an important supporting role, and budget deficits need to be low, it is monetary policy that lies at the heart of the MTFS.

Next

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 the essential instrument of monetary policy. The Government has to ensure that they are at whatever level is necessary, in prevailing conditions, to ensure downward pressure on inflation. That is not to say that the market does not exercise an influence, which from time to time can be powerful. But we have never suggested that the market could, entirely independently, be left to set the level of interest rates.

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

X

"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 be indifferent to 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~~ A ~~best~~ good example of this sort of situation ~~is perhaps~~ was July 1984.

But there are certainly occasions when it is right to resist. This was the case earlier ~~in the~~ this year. Interest rates were raised promptly, ahead of any market pressure, 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 that had arisen for a further rise beyond $12\frac{1}{2}$ 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~~ So interest rates were not allowed to rise.

Assessing monetary conditions

I have said enough to show that the <u>timing</u> 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 making this 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 <u>presumption</u> 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 assessment 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.

Broad money

[For example,] it was clear ~~by last autumn that the target range~~ for £M3 had, not for ~~the~~ first time, been set too low,] given the cumulative evidence of a major change in the relationship between £M3 and money GDP in recent years.

Mr Hanna is checking all these but see X

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 than money GDP.

When (as it happens) £M3 div

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 per cent, ~~but~~ both money GDP ~~rose by 117 per cent,~~ and prices ~~increased by 96 per cent.~~ rose more than twice as fast

X Slightly ambiguous. I first read it as twice as fast as 77%

as later

This abrupt change of trend was initially interpreted as a one-off response to the ending of direct controls. But in fact it has persisted, although it is still not absolutely clear 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. Moreover, the persistent overfunding of recent years means that the underlying change of velocity trend has actually been understated.

~~What all this means in practice is that~~ The business of setting targets for £M3 ~~is~~ has become particularly hazardous.

The 11-15 per cent target range for £M3 in 1986-87 which I set in this year's Budget reflects both the recent trend of velocity and the effect of the abandonment of overfunding.

I believe it to be fully consistent with a further fall in inflation.

There is, incidentally, nothing unique about the complication I have been describing. The United States authorities have been going through just the same experience, for just the same sort of reasons, with their principal target aggregate, M1.

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 plain fact is that 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, including the abolition of exchange controls only six months after we took office.

Put later (breaks flow here, & makes quite indigestible chunk on £M3)

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 judgement: they included the behaviour of other narrower measures of money, and in particular the exchange rate.

Looking back, 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 the growth of £M3 in relation to its target ranges has proved a relatively poor guide to short term interest rate decisions ~~monetary conditions~~ for much of the 1980s. Indeed some would argue that the real question is why we have persisted with £M3 ~~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 an unlimited build up of liquidity. The risk in dropping £M3 was that markets might have taken it as a signal we were indeed prepared to do just that.

I am satisfied that the growth of £M3 in recent years reflects a genuine desire on the part of the private sector to increase its liquidity on a lasting basis. So it does not presage higher inflation. But that judgement 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.

Leave + shorten

Pure Mansion House — unnecessary to go into this in any detail

[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 - reflected in the rapidly growing bill mountain as well as £M3 itself - which were undesirable in themselves, and made policy harder to operate.

I reached the view that this excessive reliance on funding policy was neither necessary 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.]

Thus we can now say that funding policy prevents the public sector from contributing to inflation, while the active use of short term interest rates controls inflationing pressure from the private sector.]

~~It is worth recalling, in the context, that~~ it used to be the case in this country that governments shield away from what needed to be done out of fear of the political repercussions of higher mortgage rates. And I will understand that: no one enjoys the prospect of higher mortgage rates - least of all a government committed to wider home ownership. But it meant that an essential instrument in the fight against inflation was blunted and compromised.

This is optional* — I would drop it in present situation, rates, [illegible] [illegible] you are [illegible] [illegible] optional

By contrast, we have not hesitated - and will not hesitate - to raise interest rates as and when necessary; ~~and we have moved to a position where credit is rationed by price rather than bureaucracy.~~

late.

~~This, of course, is all part of our wider move to let markets work more freely, and to restore the role of the price mechanism.~~

optional - depending on whether the return to heading needed? X

~~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 since the MTFS of 1984.

Narrow money

The position with MO is more straightforward than is the case with £M3. Its relationship with money GDP appears to be relatively well established and predictable. Over the past 8 years, adjusted for the changes and ~~rates~~ ratio arrangements in 1981, money GDP ~~seems to~~ has grown between 2 and 5 per cent faster than MO in the previous year - very much the same sort of velocity trend as in the 1970s.

Mr Hammond checking

In contrast to £M3, 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~~ within a relatively short space of time. ~~Hence my observation in the Budget speech that the £M3 target does not have the same operational significance on the MO target.~~

It is sometimes suggested that MO cannot be taken seriously because it covers only a narrow range of transaction balances - though I note that few cavil with the German target aggregate, Central Bank Money, half of which consists of notes and coins. I accept that MO is not ideal: but it is important that the best should not be the enemy of the good. The fact is that MO is the most satisfactory 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.

But messages coming from both 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. And here the exchange rate is of particular importance.

The exchange rate

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.

X I accept that in the right circumstances membership of a formal fixed exchange rate system can itself provide a very effective framework for monetary policy. Indeed, 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~~ obliging the authorities to take timely action when domestic policies are out of line with other ~~[illegible]~~ low-inflation countries.

Of course the exchange rate will not signal the right policy action every time, any more than the monetary aggregates. But, over the medium term, maintaining a fixed exchange rate against countries who share our 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 seek to limit wild swings in the exchange rate, particularly against our European competitors. And a firm exchange rate is an important 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 of domestic monetary growth and the exchange rate that will deliver the conditions necessary to keep downward pressure on inflation.

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

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 is coming 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 of 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 at 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.

It would have been surprising indeed if there had not been some changes. There have been profound changes in the UK economy in the past 7 years; and nowhere ~~has~~ have those

And the plain fact is that 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, including the abolition of exchange controls only six months after we took office.

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.

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

X of narrow money and the exchange rate have become correspondingly more prominent.

The reduced role of broad money has also been reflected in funding policy. I have made it clear that the objective of funding policy ~~was~~ is to fund the PSBR over the

X year as a whole: no more, no less.

Thus we can now say that funding policy prevents the public sector from contributing to inflation, while the active use of short term interest rates controls inflationary pressure from the private sector.

We have not hesitated - and will not hesitate - to raise interest rates as and when necessary; and we have moved to a position where credit is ~~rationed~~ determined by price rather than bureaucratic controls.

This, of course, is all part of our wider move to let markets work more freely, and to restore the role of the price mechanism.

But the most important change is perhaps this.

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 ~~the 1980~~ 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.

Above all, at that time 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, ~~[illegible]~~ ~~was~~ were? what created confidence both within the country and outside it about the conduct of policy.

unless in opposition!

We had, regrettably, a very different track record in this country. We had a record of constantly shifting and chopping and changing, ~~possessing short-term horizons,~~ 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~~ are 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.

pmp

FROM: S P HANNAH

DATE: 16 April 1986

MR CULPIN

cc PPS
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Peretz
Mr Sedgwick
Mr Walsh
Mr Vernon
Ms Coyle
Mr Heath

LOMBARD ASSOCIATION SPEECH

In the sections of the speech dealing with broad and narrow money there are a number of factual statements concerning monetary growth, money GDP growth and inflation since the 1970's. This note provides the background arithmetic which underlies these statements.

2. The factual statements are as follows:-

(a) Between 1970 and 1980, £M3 grew on average by about 1½ per cent less than money GDP

The attached table 1, prepared by Mr Heath, shows annual growth rates in money GDP and £M3 in each year 1970 to 1980. Both money GDP and £M3 are measured as annual averages. The average difference between the annual growth rates comes out at 1.8 per cent.

An alternative method would be to compare the level of money GDP in 1970 (annual average) and that in 1980 and see how the average annual compound growth rate compares with that of £M3 (again using an annual average since levels in any particular month, or even quarter, can be subject to significant temporary distortions). On this basis the figures show a difference of 1.6 per cent.

On yet another method - using 1970H2 and 1980H2 with the half years representing a compromise between using end-period stocks and flows and avoiding distortions in particular quarters - the difference between the average annual compound growth rates comes out at 1.4 per cent.

On balance it was decided that "about 1½ per cent" was the appropriate form of words in the light of the range of estimates derived.

(b) Since 1980 it [£M3] has grown between 2 and 6 per cent more than GDP

Table 1 contains the relevant figures. An adjustment has been made to the £M3 figures to correct for the 1981 break.

(c) Put another way, while £M3 has grown by around 75 per cent over the past five years, money GDP has grown by only about 50 per cent, and prices by about 40 per cent. Over the previous five years, when (as it happens) £M3 grew by a similar amount, both money GDP and prices rose by more than twice as fast as over the latest five years.

Table 2 contains the relevant figures and uses the averages in the second half of the years concerned (largely to avoid the distortions to money GDP caused by the miners' strike which affected the 1985H1 level but not that in 1985H2).

(d) Over the past 10 years, adjusted for the coal strike and change in the cash ratio arrangements in 1981, money GDP has generally grown between 2 and 5 per cent faster than MO in the previous year.

Table 3 contains the relevant figures. The figures are based on annual averages and are not adjusted for breaks. Over the past ten years the main exceptions to the 2-5 per cent range were 1983 (lagged MO growth being artificially depressed by a change in definition) and 1984 (money GDP depressed by the miners' strike). Otherwise the difference in growth rates generally remains within thc 2-5 per cent band (in 1979 and 1981 the difference goes slightly below 2 per cent).

S P HANNAH

TABLE 1 :

	Money GDP growth*	£M3 growth+	Difference (money GDP - £M3)
		Annual % changes	
1970	9.68	6.28	3.40
1971	12.30	12.29	0.01
1972	10.74	24.15	-13.41
1973	15.54	25.54	-10.00
1974	13.65	16.92	-3.27
1975	26.36	7.33	19.03
1976	19.32	8.04	11.28
1977	15.03	7.73	7.30
1978	15.16	15.46	-0.30
1979	16.93	13.06	3.87
1980	17.21	16.67	0.54
1981	10.20	15.44	-5.24
1982	8.91	10.86	-1.95
1983	8.72	11.78	-3.06
1984	5.99	8.88	-2.89
1985	9.58	12.84	-3.26

N.B average difference 1970 to 1980 = +1.8 per cent

* GDP(E) at current market prices; not corrected for miners' strike
\+ corrected for 1981 break

TABLE 2 :

Half year averages

	RPI (Index 1975=100,nsa)	MONEY GDP* (£m,sa)	£M3+ (£m,sa)
1975H2	105.2	27811.0	39650.5
1980H2	201.3	59609.5	72384.2
1985H2	279.8	89196.0	125665.0
% changes			
'75H2 - '80H2	+91%	+114%	+83%
'80H2 - '85H2	+39%	+50%	+74%

* GDP(E) at current market prices; it is estimated that the effects of the miners strike had unwound by 1985H2

\+ corrected for 1981 break

TABLE 3 :

Annual % changes

	MONEY GDP GROWTH*	MO GROWTH LAGGED 1 YEAR	DIFFERENCE (Money GDP - Lagged MO)
1976	19.32	14.31	5.01
1977	15.03	10.98	4.05
1978	15.16	10.57	4.59
1979	16.93	15.09	1.84
1980	17.21	13.05	4.16
1981	10.20	8.50	1.70
1982	8.91	4.63	4.28
1983	8.72	0.89(a)	7.83(a)
1984	5.99(b)	5.72	0.27(b)
1985	9.58(b)	5.58	4.00(b)

* GDP(E) at market prices

(a) affected by change in MO definition

(b) affected by miners' strike

16/4

CHANCELLOR OF THE EXCHEQUER

LOMBARD ASSOCIATION

6.00 pm Informal drinks
6.15 pm Dinner
8.00 pm Chancellor's Speech
(30 minutes)
8.30 ish Q + A session
9.00 pm Session finishes

Having dealt with that, I thought I might ~~[illegible]~~ spend the rest of my time to-night explaining, in some detail, what are the key stations of that track is: I refer, of course, to the Govt's monetary policy. If some of it is heavy going, I hope you will forgive me.

Forgive me, too, for the fact that can't stay for questions: have to get back to House — debate on [illegible]

~~[illegible]~~

Delighted to have the opportunity to address this high-powered and influential Club.

The [illegible] heading of the session to which you have kindly invited me to take part is

"The UK - An economy on the Right Track?"

- In the form of a question; to which my answer is 'Yes'

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

Done

Madden of the Lombard Assn:

would not send a copy of my speech.

Please do so forthwith, with my compliments.

L

CHANCELLOR OF THE EXCHEQUER

Is this what you wanted? N.

~~Ch.~~ ~~Debbie~~ Below

Could you please send back the "housekeeping" string on the hourband speech - it is in the speech material folder (blue) - at no rush.

RL. 14/4.

1. Rachel
2. Chancellor

Returned with thanks

DL 15/4

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16TH APRIL, 1986

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pmp.

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Robert Fleming & Co. Ltd.

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16/4/86.

pwp.

LOMBARD ASSOCIATION SPEECH
MONETARY POLICY

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 CONTAINING BUDGET 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 the consensus among those throughout the world charged with responsibilities in these matters, was then radical, even revolutionary.
Especially in Britain.

A few months 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 that proposition into practice has been one of this Government's major achievements.

THAT IS AN IMPORTANT REASON WHY OVERSEAS OPINION IS IN NO DOUBT THAT BRITAIN IS INDEED ON THE RIGHT TRACK.

THE POLICY WE ARE PURSUING TODAY IS IDENTIFIABLY THE SAME AS THAT WHICH WE EMBARKED ON 7 YEARS AGO.
BUT IT HAS CLEARLY EVOLVED - IN TERMS BOTH OF PRESENTATION AND OF SUBSTANCE.
THIS HAS LED TO SOME QUITE UNNECESSARY CONFUSION IN THE MINDS OF A NUMBER OF THE COMMENTATORS.
SO LET ME TONIGHT 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, WHICH WE LAUNCHED IN MARCH 1980.

IT HAD TWO FEATURES, BOTH NOVEL AT THE TIME.

FIRST IT PROVIDED A <u>MEDIUM TERM</u> FRAMEWORK FOR MONETARY AND FISCAL POLICY.

IT SYMBOLISED THE GOVERNMENT'S BREAK WITH POLICIES OF FINE TUNING AND SHORT-TERM EXPEDIENCY THAT HAD DOMINATED BRITISH ECONOMIC POLICY FOR MOST OF THE POST WAR PERIOD.

SECOND, IT WAS A STRATEGY ABOUT <u>FINANCE</u>.

PARTLY BECAUSE INFLATION IS A FINANCIAL PROBLEM, AND HAS TO BE CONTROLLED BY FINANCIAL MEANS.

AND PARTLY BECAUSE, IN A FREE SOCIETY, THE ONLY LEVERS AT THE GOVERNMENT'S COMMAND ARE FINANCIAL LEVERS.

THIS APPROACH TO REDUCING INFLATION AMOUNTED TO SCALING DOWN THE GROWTH OF NOMINAL DEMAND IN THE ECONOMY - THAT IS, THE GROWTH OF MONEY GDP.

THIS IN TURN IS AN AMALGAM OF TWO THINGS: THE REAL RATE OF GROWTH AND THE RATE OF INFLATION.

THE FATAL MISTAKE THAT EARLIER GOVERNMENTS MADE WAS TO CONFUSE MONEY DEMAND WITH REAL DEMAND.
EXPANSIONARY POLICIES CAN CERTAINLY BOOST MONEY DEMAND. BUT IT IS A DANGEROUS DELUSION TO SUPPOSE THAT THIS IMPLIES 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 BRING ABOUT HIGHER REAL OUTPUT AND EMPLOYMENT.

BUT IMPORTANT THOUGH MONEY IS, IT 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.

THAT IS WHY THE MTFS HAS BEEN ACCOMPANIED, FROM THE VERY BEGINNING, BY A CONSTELLATION OF 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 RATE AT WHICH THE REAL ECONOMY IS CAPABLE OF GROWING OVER THE LONGER TERM.

THE VALIDITY OF THIS APPROACH HAS BEEN AMPLY BORNE OUT BY THE RECORD SINCE WE FIRST TOOK OFFICE.

THE GROWTH OF TOTAL SPENDING POWER, AS MEASURED BY MONEY GDP, HAS BEEN HALVED, AND INFLATION HAS COME DOWN FROM 13 PER CENT TO 5 PER CENT.

YET WE HAVE SEEN A STEADY GROWTH IN OUTPUT, AT AN AVERAGE RATE OF ALMOST 3 PER CENT A YEAR SINCE 1981.

<u>**THE MONETARY AND FISCAL FRAMEWORK**</u>

REDUCING THE GROWTH OF MONEY GDP REQUIRES 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 PUBLISH TARGETS FOR MONEY GDP - OR EVEN SIMPLY INFLATION - AND SET POLICY IN THE LIGHT OF THE BEST AVAILABLE FORECASTS.

THAT HAS NOT BEEN OUR APPROACH.

TO ADOPT IT WOULD NOT PROVIDE US WITH ANY NEW INSTRUMENTS OF POLICY.

IT WOULD MERELY IMPLY USING THE EXISTING INSTRUMENTS WITH AN EVEN GREATER DEGREE OF DISCRETION THAN WE DO AT PRESENT.

MOREOVER, THE LATEST AVAILABLE INFORMATION ABOUT MONEY GDP AND INFLATION TELLS US A GREAT DEAL ABOUT THE PAST STANCE OF POLICY; BUT LITTLE ABOUT THE ACTION WE SHOULD BE TAKING NOW.

OPERATIONAL DECISIONS HAVE TO BE BASED ON INFORMATION AVAILABLE TODAY WHICH LOOKS TO THE FUTURE.

WE CANNOT NEGLECT THOSE FINANCIAL INDICATORS THAT DO GIVE ADVANCE WARNING OF FUTURE MOVEMENTS IN MONEY GDP AND INFLATION.

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, SINCE THE BOUNDARIES ARE CONSTANTLY SHIFTING.

SO THROUGHOUT MY TIME AS CHANCELLOR I HAVE CHOSEN INSTEAD TO SET TARGETS FOR NARROW MONEY, IN THE SHAPE OF M0, WHICH HAS SHOWN A PREDICTABLE RELATIONSHIP WITH MONEY GDP

OVER A CONSIDERABLE NUMBER OF YEARS, AND BROAD MONEY, IN THE SHAPE OF £M3, WHICH HAS THE ADVANTAGE OF FAMILIARITY.

BUT WE MUST NEVER FORGET THAT MONETARY 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.

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 THIS 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 EITHER PUBLIC EXPENDITURE OR TAXATION, WHERE THE ECONOMY BENEFITS MOST FROM A STABLE LONG-TERM TREND.

THIS MEANS THAT, IN PRACTICE, THE BUDGET DEFICIT OR PSBR SHOULD ALWAYS BE SET LOW ENOUGH TO ENSURE THAT IT CAN

ABSORB ANY LIKELY SHOCK AND STILL BE COMFORTABLY FINANCED IN A NON-INFLATIONARY WAY.

THUS THE 1984-85 PSBR AT SOME 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 WELL 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 ANY UNEXPECTED DEVELOPMENTS, FOR EXAMPLE IN THE OIL MARKET.

IT IS WORTH RECALLING THAT LITTLE MORE THAN TEN YEARS AGO PUBLIC SECTOR BORROWING EXCEEDED 9 PER CENT OF GDP; AND THE LAST TIME THE PSBR WAS BELOW 2 PER CENT OF GDP WAS SOME FIFTEEN YEARS AGO.

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.

SHORT TERM INTEREST RATES

TO RECAPITULATE.
WHILE FISCAL POLICY HAS AN IMPORTANT SUPPORTING ROLE, AND BUDGET DEFICITS NEED TO BE LOW, IT IS MONETARY POLICY THAT 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.

SHORT TERM INTEREST RATES ARE THE ESSENTIAL INSTRUMENT OF MONETARY POLICY.

THE GOVERNMENT HAS TO ENSURE THAT THEY ARE AT WHATEVER LEVEL IS NECESSARY, IN PREVAILING CONDITIONS, TO ENSURE DOWNWARD PRESSURE ON INFLATION.

THAT IS NOT TO SAY THAT THE MARKET DOES NOT EXERCISE AN INFLUENCE, WHICH FROM TIME TO TIME CAN BE POWERFUL.

BUT WE HAVE NEVER SUGGESTED THAT THE MARKET COULD, ENTIRELY INDEPENDENTLY, BE LEFT TO SET THE LEVEL OF INTEREST RATES.

THE RELATIONSHIP BETWEEN OFFICIAL INFLUENCE AND MARKET FACTORS WAS CLEARLY SET OUT IN THE MARCH 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 BE INDIFFERENT TO 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.
A GOOD EXAMPLE OF THIS SORT OF SITUATION WAS JULY 1984.

BUT THERE ARE CERTAINLY OCCASIONS WHEN IT IS RIGHT TO TAKE A LEAD.
THIS WAS THE CASE EARLIER THIS YEAR.
EARLY IN JANUARY INTEREST RATES WERE RAISED PROMPTLY, AHEAD OF ANY MARKET PRESSURE, TO PREVENT A DOWNWARD MOVEMENT IN THE EXCHANGE RATE ACQUIRING AN UNHEALTHY MOMENTUM.

SUBSEQUENTLY, HOWEVER, I TOOK THE VIEW THAT THE PRESSURE THAT HAD ARISEN 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.

SO 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 MAKING THIS 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 <u>PRESUMPTION</u> 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 ASSESSMENT 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.

Broad money

The business of setting targets for £M3 has become particularly hazardous, given the cumulative evidence of a major change in the relationship between £M3 and money GDP in recent years.

Between 1970 and 1980, £M3 grew on average by about 1½ per cent LESS than money GDP.
Since 1980 it has grown between 2 and 6 per cent MORE than money GDP.

PUT ANOTHER WAY, WHILE £M3 HAS GROWN BY AROUND 75 PER CENT OVER THE PAST FIVE YEARS, MONEY GDP HAS GROWN BY ONLY ABOUT 50 PER CENT, AND PRICES BY ABOUT 40 PER CENT. OVER THE PREVIOUS FIVE YEARS, WHEN (AS IT HAPPENS) £M3 GREW BY A SIMILAR AMOUNT, BOTH MONEY GDP AND PRICES ROSE BY MORE THAN TWICE AS FAST AS OVER THE LATEST FIVE YEARS.

THIS ABRUPT CHANGE OF TREND WAS INITIALLY INTERPRETED AS A ONE-OFF RESPONSE TO THE ENDING OF DIRECT CONTROLS.
BUT IN FACT IT HAS PERSISTED, ALTHOUGH IT IS STILL NOT ABSOLUTELY CLEAR 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.
MOREOVER, THE PERSISTENT OVERFUNDING OF RECENT YEARS MEANS THAT THE UNDERLYING CHANGE OF VELOCITY TREND HAS ACTUALLY BEEN <u>UNDER</u>STATED.

THE 11-15 PER CENT TARGET RANGE FOR £M3 IN 1986-87 WHICH I SET IN THIS YEAR'S BUDGET REFLECTS BOTH THE RECENT TREND OF VELOCITY AND THE EFFECT OF THE ABANDONMENT OF OVERFUNDING.

I BELIEVE IT TO BE FULLY CONSISTENT WITH A FURTHER FALL IN INFLATION.

THERE IS, INCIDENTALLY, NOTHING UNIQUE ABOUT THE COMPLICATION I HAVE BEEN DESCRIBING.
THE UNITED STATES AUTHORITIES HAVE BEEN GOING THROUGH JUST THE SAME EXPERIENCE, FOR JUST THE SAME SORT OF REASONS, WITH THEIR PRINCIPAL TARGET AGGREGATE, M1.

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.

FEW WOULD NOW DISPUTE THAT THE GROWTH OF £M3 IN RELATION TO ITS TARGET RANGES HAS PROVED A RELATIVELY POOR GUIDE TO SHORT TERM INTEREST RATE DECISIONS FOR MUCH OF THE 1980s.

INDEED SOME WOULD ARGUE THAT THE REAL QUESTION IS WHY WE HAVE PERSISTED WITH £M3 FOR SO LONG, AND IN PARTICULAR WHY I DID NOT DROP IT ALTOGETHER AT THE TIME OF THE LAST BUDGET.

I BELIEVE IT WOULD BE QUITE WRONG TO CONCLUDE FROM RECENT EXPERIENCE THAT WE CAN SAFELY TOLERATE AN UNLIMITED BUILD UP OF LIQUIDITY.

THE RISK IN DROPPING £M3 WAS THAT MARKETS MIGHT HAVE TAKEN IT AS A SIGNAL WE WERE INDEED PREPARED TO DO JUST THAT.

I AM SATISFIED THAT THE GROWTH OF £M3 IN RECENT YEARS REFLECTS A GENUINE DESIRE ON THE PART OF THE PRIVATE SECTOR TO INCREASE ITS LIQUIDITY ON A LASTING BASIS.

SO IT DOES NOT PRESAGE HIGHER INFLATION.

BUT THAT JUDGEMENT 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.

Narrow money

MO has been given target status since the MTFS of 1984.

The position with MO is more straightforward than is the case with £M3.

Its relationship with money GDP appears to be relatively well established and predictable, WITH

~~Over the past 10 years, adjusted for the coal strike and the change in the cash ratio arrangements in 1981, money GDP has generally grown between 2 and 5 per cent faster than MO in the previous year~~ - very much the same sort of velocity trend as in the 1970s.

The main point about this relationship ~~between MO and money GDP~~ is that MO is a useful <u>advance</u> indicator: it is influenced by many of the factors that influence money GDP, especially changes in interest rates and disposable incomes, but these influences show up in MO more immediately than they do in money GDP.

And, in contrast to £M3, the growth of M0 responds fairly rapidly and predictably to changes in short term interest rates.

So a rise in interest rates can be expected to bring M0 growth back within its target range within a relatively short span of time.

It is sometimes suggested that M0 cannot be taken seriously because it covers only a narrow range of transaction balances - though I note that few cavil with the German target aggregate, Central Bank Money, half of which consists of notes and coins.

I accept that M0 is not ideal: but it is important that the best should not be the enemy of the good.

The fact is that M0 is the most satisfactory 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.

BUT MESSAGES COMING FROM BOTH 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.
AND HERE THE EXCHANGE RATE IS OF PARTICULAR IMPORTANCE.

THE EXCHANGE RATE

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.

I ACCEPT THAT IN THE RIGHT CIRCUMSTANCES MEMBERSHIP OF A FORMAL FIXED EXCHANGE RATE SYSTEM CAN ITSELF PROVIDE A VERY EFFECTIVE FRAMEWORK FOR MONETARY POLICY.

INDEED, 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, OBLIGING THE AUTHORITIES TO TAKE TIMELY

ACTION WHEN DOMESTIC POLICIES ARE OUT OF LINE WITH OTHER LOW-INFLATION COUNTRIES.

OF COURSE THE EXCHANGE RATE WILL NOT SIGNAL THE RIGHT POLICY ACTION EVERY TIME, ANY MORE THAN THE MONETARY AGGREGATES.

BUT, OVER THE MEDIUM TERM, MAINTAINING A FIXED EXCHANGE RATE AGAINST COUNTRIES WHO SHARE OUR 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 SEEK TO LIMIT WILD SWINGS IN THE EXCHANGE RATE, PARTICULARLY AGAINST OUR EUROPEAN COMPETITORS.

AND A FIRM EXCHANGE RATE IS AN IMPORTANT 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 OF DOMESTIC MONETARY GROWTH AND THE EXCHANGE RATE THAT WILL DELIVER THE CONDITIONS NECESSARY TO KEEP DOWNWARD PRESSURE ON INFLATION.

THOSE WHO RECALL THE ECONOMIC HISTORY OF BRITAIN IN THE 'FIFTIES MAY NOTICE SOME RESEMBLANCE TO THE THINKING BEHIND THE ABORTIVE "ROBOT" PLAN - THE IDEA THAT THE KEY TO THE CONDUCT OF SOUND ~~SUCH~~ ECONOMIC POLICY LAY IN THE INTERPLAY OF INTEREST RATES AND THE EXCHANGE RATE.

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 MONTARY TARGETS; AND THOSE

OUTSIDE SUCH SYSTEMS STILL RECOGNISE THE NEED TO TAKE ACCOUNT OF THE EXCHANGE RATE.

AND AS A RESULT, INFLATION IS COMING 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 <u>NOT</u> AT 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.

IT WOULD HAVE BEEN SURPRISING INDEED IF THERE HAD NOT BEEN SOME CHANGES.
THERE HAVE BEEN PROFOUND CHANGES IN THE UK ECONOMY IN THE PAST 7 YEARS; AND NOWHERE HAVE THOSE CHANGES BEEN MORE PRONOUNCED THAN IN THE FINANCIAL MARKETS.

AND THE PLAIN FACT IS THAT 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, INCLUDING THE ABOLITION OF EXCHANGE CONTROLS ONLY SIX MONTHS AFTER WE TOOK OFFICE.

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 PLAY A PROGRESSIVELY SMALLER PART IN MONETARY POLICY DECISIONS - PARTICULARLY IN DAY TO DAY DECISIONS ABOUT SHORT TERM INTEREST RATES.
AND THE ROLES OF NARROW MONEY AND THE EXCHANGE RATE HAVE BECOME CORRESPONDINGLY MORE PROMINENT.

THE REDUCED ROLE OF BROAD MONEY HAS ALSO BEEN REFLECTED IN FUNDING POLICY.

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.

I HAVE MADE IT CLEAR THAT THE OBJECTIVE OF FUNDING POLICY IS TO FUND THE PSBR OVER THE YEAR AS A WHOLE: NO MORE NO LESS.

THUS WE CAN NOW SAY THAT FUNDING POLICY PREVENTS THE PUBLIC SECTOR FROM CONTRIBUTING TO INFLATION, WHILE THE ACTIVE USE OF SHORT TERM INTEREST RATES CONTROLS INFLATIONARY PRESSURE FROM THE PRIVATE SECTOR.

WE HAVE NOT HESITATED - AND WILL NOT HESITATE - TO RAISE INTEREST RATES AS AND WHEN NECESSARY; AND WE HAVE MOVED TO A POSITION WHERE CREDIT IS DETERMINED BY PRICE RATHER THAN BUREAUCRATIC CONTROLS.

THIS, OF COURSE, IS ALL PART OF OUR WIDER MOVE TO LET MARKETS WORK MORE FREELY, AND TO RESTORE THE ROLE OF THE PRICE MECHANISM.

BUT THE MOST IMPORTANT CHANGE IS PERHAPS THIS.

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.

IN THE PRESENTATION 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 MARKETS' PERCEPTION OF WHAT REALLY MATTERS.

OVER TIME, WE HAVE GRADUALLY SHIFTED THE EMPHASIS SOMEWHAT FROM THE FORMER TO THE LATTER, BUT THE NEED TO STRIKE A BALANCE IS STILL THERE.

ABOVE ALL, 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 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.

LOMBARD ASSOCIATION

1985-6

Produced by Barrie Gretton & Associates, Leigh-on-Sea, Essex

LOMBARD ASSOCIATION

A SHORT HISTORY

RULES

COMMITTEE

LIST OF MEMBERS

AUGUST 1985

RETIRED

J. Battersby
J. A. Bennet
F. S. Bignell
H. A. Brownsey
A. N. Burman
D. G. Burton
A. E. J. Butterworth
R. A. Copeman
D. M. Cowan
C. M. Dansey, M.B.E.
R. W. De'Ath
B. M. Dench
K. F. Einfield
J. P. Fahey
G. E. Field
A. E. Ford
J. E. Frazer
H. F. Goodson
G. D. Hannant
J. Hughes
J. D. Hughes
O. A. Jackson
J. A. Jebb
R. L. Jones
D. W. Kendrick
O. V. Michael
P. F. Miller
L. H. Mills
L. A. Mulford
E. F. Nightingale
R. T. Paice
J. R. Pook
L. T. G. Preston
R. A. Samuels
R. B. Scotcher
D. W. Smith
D. M. B. Stroude
R. A. Webster
R. S. Woodward, O.B.E.
A. J. Wright
Sir Philip de Zulueta

WINTRUST SECURITIES LIMITED
V. C. Malyon

YASUDA TRUST & BANKING COMPANY LIMITED
M. T. Alcock

ZENTRALSPARKASSE UND KOMMERZIALBANK
Dr. H. L. Tiefenthaler

ZIVNOSTENSKA BANKA
Z. David
C. Wackett

LOMBARD ASSOCIATION

A SHORT HISTORY

In the 1920's, officials holding positions of responsibility in the London banks had often discussed the possibility of forming an Association having as its object the fostering of social relationship between its members, but it was not until the early part of 1930 that any active steps were taken. In that year Mr. O. A. Jackson (Continental Illinois Bank & Trust Co.) spent several months trying to arouse interest in the London banks and kindred firms. Finally, after many preliminary discussions, a dinner was held at the Cannon Street Hotel in October 1930, at which eighteen Founder Members were present. It was then decided to form the Association and a Committee composed of Mr. F. A. Crump (National Provincial Bank Ltd., Chairman). Mr. C. Henderson (Kleinwort Sons & Co., Deputy Chairman), and Mr. O. A. Jackson (Secretary) was elected to draw up Rules and to decide on procedure. Meetings of the Association have been held monthly each winter and many distinguished guests have spoken on a wide variety of interesting subjects. In 1930 Mr. Jackson returned to the U.S.A.

Since the Association was founded, three Honorary Members have been elected in appreciation of their valuable services to the Association; Mr. Crump in 1935, Mr. Jackson in 1950 and Mr. Boreham in 1963.

In October 1980 a dinner was held at the Great Eastern Hotel to commemorate the 50th Anniversary of the Association. The Governor of the Bank of England was the guest of honour and proposed the toast to the Association.

PAST CHAIRMEN

1930/35	F. A. Crump (National Provincial Bank Ltd.)
1936	F. H. Hope Simpson (Chase National Bank)
1937	H. V. Berry (Union Discount Co.)
1938/47	F. C. Ellerton (Barclays Bank Ltd.)
1948/49	F. W. Gray (Bank of China)
1950	R. S. Brittain (Bank of New South Wales)
1950 (July)	H. B. Chappel (Central Hanover Bank & Trust Co.)
1951/52	R. L. Ogg (Glyn, Mills & Co.)
1953	C. L. Messner (Bank of Adelaide)
1954/55	R. Davidson (Martins Bank Ltd.)
1956	G. R. Tobitt (Brown Shipley & Co. Ltd.)
1957/58	E. G. Woolgar (Lloyds Bank Ltd.)
1959	D. J. M. Frazer (Bank of New South Wales)
1960/61	R. V. Low (Bank of London & South America)
1962/63	R. G. Dyson (Barclays Bank D.C.O.)
1964/65	R. A. O. Bridge (Bank of England)
1966	A. E. Davies (Glyn, Mills & Co.)
1967/68	J. Battersby (District Bank Ltd.)
1969	C. P. Lunn (Barclays Bank Ltd.)
1970	C. J. B. Chalkley (Gillett Bros. Discount Co.)
1971	J. I. Kennan (Lloyds Bank Ltd.)
1972	H. M. Excell (National Westminster Bank Ltd.)
1973	D. C. Mootham (Hill Samuel & Co. Ltd.)
1974	H. Taylor (Manufacturers Hanover Trust Co.)
1975	M. E. R. Allsopp (Allen Harvey & Ross Ltd.)
1976	P. S. Ardron (Barclays Bank International)
1977	D. W. Kendrick (Lloyds Bank Ltd.)
1978	Lord Camoys (Barclays Merchant Bank Ltd.)
1979/80	B. M. P. Thompson-McCausland (Arbuthnot Latham & Co. Ltd.)
1981	G. Cathles (National Westminster Bank Ltd.)
1982	G. Z. Steffens (Dresdner Bank A.G.)
1983	R. A. Barnes (Bank of England)
1984	A. J. Buchanan (Cater Allen Ltd.)

TRUST BANK OF AFRICA LIMITED
H. E. Schulz

UBAF BANK LIMITED
P. J. W. Taplin

UNION BANK OF SWITZERLAND
R. G. Arend
K. Deutschle
E. Tangemann

UNION DISCOUNT CO. OF LONDON Plc
D. J. Lyons
S. A. Whitney-Long

UNITED DOMINIONS TRUST LIMITED
S. Ball

UNITED OVERSEAS BANK LIMITED
S. Kok-Thye
S. A. Scott
H. M. D. Woolley

VOLKSKAS LIMITED
A. G. Lewis

S. G. WARBURG & CO. LIMITED
T. C. Colville

WESTDEUTSCHE LANDESBANK GIROZENTRALE
T. F. Smith

WESTPAC BANKING CORPORATION
M. C. P. Beales
P. Brind
D. L. Murison
C. J. Shubrook

WILLIAMS & GLYN'S BANK Plc
W. Allen
R. W. Harrington
S. A. Jary
G. W. Leavold
A. G. Pollard

STANDARD CHARTERED BANK Plc
D. L. Millar
A. D. Orsich
P. W. Weller

STANDARD CHARTERED MERCHANT BANK LIMITED
R. D. Assender
R. A. M. Baillie
T. G. Gilkes
M. Madden
A. C. Storkey

STATE BANK OF INDIA
P. R. Bagchi
D. Basu

STATE BANK OF NEW SOUTH WALES
R. R. Courtney
M. K. Walker
G. E. Webster

SUMITOMO BANK LIMITED
Y. Okabe

SWISS BANK CORPORATION
R. E. Amstad
W. M. Gabitass

TAIYO KOBE BANK LIMITED
M. Yoshie

TEXAS COMMERCE BANK N.A.
M. T. Casper

THAI FARMERS BANK LIMITED
B. Damrongpiwat

TORONTO-DOMINION BANK
A. D. King

TOYO TRUST & BANKING CO. LIMITED
D. E. Miller

PAST SECRETARIES

1930/31	O. A. Jackson (Continental Illinois Bank & Trust Co.)
1931/34	H. W. Cook (Chemical Bank & Trust Co.)
1934/52	B. B. Boreham (Banque Belge pour l'Etranger)
1952/60	H. W. J. Mitchell (Glyn Mills & Co.)
1960/69	D. J. Kent (Glyn, Mills & Co.)
1969/72	W. L. Cockburn (Martins Bank Ltd.)
1972/74	G. W. P. Hastings (The Commercial Banking Co. of Sydney Ltd.)
1974/79	R. C. Sturmer (Banque de l'Indochine et de Suez)
1979/83	R. W. De'Ath (Jessel, Toynbee & Co. Ltd.)
1983	C. J. W. Frost (Cater Allen Ltd.)

PAST TREASURERS

(Until the end of 1946 the Hon. Secretary fulfilled this role)

1947/54	A. I. Thomas (Barclays Bank D.C.O.)
1954/64	A. H. Dargavel (District Bank Ltd.)
1964/66	R. F. Gray (National Provincial Bank)
1966/76	G. R. Roberts (National Provincial Bank)
1976/85	R. V. Norris (National Westminster Bank Ltd.)

RULES

1. The name of the Association is LOMBARD ASSOCIATION.
2. The object of the Association is to promote social relationship amongst members and their friends.
3. Membership shall be confined to those engaged in foreign banking business and holding positions of responsibility in banks and kindred institutions having an office in the city of London. Such persons shall hold at least the position of a departmental chief in the office of the institution to which they belong and outside banking agents shall not be eligible for membership.
4. Persons to be proposed for election as Members shall be nominated by two Members. Election shall be in the hands of the Comittee, whose decision shall be final.
5. The Association shall be governed by a Committee of six consisting of Chairman, Hon. Secretary and four other Members elected at a General Meeting to be held in April of each year. The Deputy Chairman shall be elected from their number by the Committee. No member shall serve more than five consecutive years. The Honorary Secretary may continue indefinitely as a member of the Committee, subject to election. The Committee shall have power to fill any vacancy occurring during the year, such appointment to hold good until the following Annual General Meeting.
   Three members of the Committee shall form a quorum, but in the event of an equality of votes, the Chairman shall have a second or casting vote.
6. Meetings including dinner shall be held on the second Wednesday in each month from October to April inclusive. The Committee may cancel any of these meetings or hold them on such other days or in such other months as may serve the convenience of the majority of Members and the purpose of the meetings.

SAUDI INTERNATIONAL BANK
P. J. de Roos
G. H. N. Furzland
T. R. Mills

SCANDINAVIAN BANK LIMITED
R. F. N. Clark
D. M. Johnson
J. O. Steele

J. HENRY SCHRODER WAGG & CO. LIMITED
J. A. Lesser
J. B. Solandt

SEATTLE-FIRST NATIONAL BANK
C. A. Soudah

SECCOMBE MARSHALL & CAMPION Plc
C. A. Chapman
P. J. Pooley

S.F.E. BANK LIMITED
J. C. D. Tree

SHANGHAI COMMERCIAL BANK LIMITED
A. K. C. Chan

SIAM COMMERCIAL BANK
P. T. P. Chan
P. Dabbaransi

SINGER & FRIEDLANDER LIMITED
P. Brackfield
P. G. Cordrey
D. Ryder

SMITH ST. AUBYN & COMPANY LIMITED
M. C. Ness
Mrs. K. J. Morgan Thomas

SOCIETE GENERALE
M. Barat

OVERLAND TRUST BANK, SWITZERLAND
G. A. B. Conway-Gordon

PRIVATBANKEN LIMITED
C. Frigast

QATAR NATIONAL BANK S.A.Q.
W. M. Bennett, C.B.E.
J. M. Booth

QUIN COPE LIMITED
A. F. Gooda
J. F. London

REA BROS. LIMITED
J. Eversden

RESERVE BANK OF AUSTRALIA
L. J. Austin
K. W. Dawton

N. M. ROTHSCHILD & SONS LIMITED
C. B. Price
J. C. White

ROYAL BANK OF CANADA
J. G. R. Hastie
R. M. Kidney

ROYAL BANK OF SCOTLAND LIMITED
D. A. Gemmell
W. A. Horsey
J. M. Mather

ROYAL TRUST OF CANADA
A. A. Best
R. Molton

SAITAMA BANK
G. N. Pett

7. Such meetings shall be convened for 5.30 p.m. with dinner at 6.15 p.m., after which, except on guest nights, Members will be free to foregather for conversation or for open discussion on matters of general interest. At such meetings Members may submit to the Chairman subjects suggested for discussion.

8. In alternate months, or as may be otherwise determined by the Committee, the meetings shall be open to guests at the invitation of Members, and if practicable a guest of honour will be asked to address the company on a subject of general interest, after which a discussion may be held.

9. Members intending to bring guests must notify the Secretary as soon as possible the names of the persons to be invited.

10. The arrangements at all meetings shall be made by the Secretary.

11. It is understood that the meetings are private and that views expressed reflect the personal opinions of the speakers and must not be construed as representing the official policies of the institutions with which the speakers are connected.

12. The cost of dinners of Members and of their guests shall be paid by Members to the Secretary at the beginning of each meeting. Drinks at dinner shall be paid for by each Member for himself and his guests.

13. Notices of meetings shall be sent to every Member by the Secretary at least ten days before the meeting, and for guest nights shall, if possible, include the name of the speaker and the topic.

14. The Annual Subscription, payable on joining and each subsequent October 1st, shall be £5.00.

15. Guests of honour may be invited by the Committee to become Honorary Members of the Association.

16. Any Member intending to withdraw from the Association shall signify his intention so to do in writing to the Secretary as early as possible.

17. Any Member leaving the service of a bank and joining a firm the officials of which are not eligible for membership shall automatically resign from the association. It shall be within the discretion of the Committee to decide whether any Member of the Association be eligible to continue his membership.

18. Any alteration or extension of these Rules shall be submitted to a General Meeting of the Members and shall require for its adoption the votes of two-thirds of those present at such meeting. Seven days' notice of such motion shall be given to all Members.

COMMITTEE 1985/86

M. Madden	(Chairman)
H. W. Everitt	
C. J. W. Frost	(Hon. Secretary)
B. Quinn	
R. J. J. Wickham	

J. J. Botevyle	(Hon. Treasurer)
P. Brind	(Hon. Auditor)

NATIONAL BANK OF ABU DHABI
M. B. Bowles
P. S. Dreblow

NATIONAL BANK OF DETROIT
D. E. S. Babb
T. A. G. Smith

NATIONAL BANK OF KUWAIT S.A.K.
N. A. S. Mills

NATIONAL BANK OF NEW ZEALAND LIMITED
F. R. Adams
J. L. Pugh

NATIONAL CITY BANK — CLEVELAND
W. O. Wick, Jr.

NATIONAL COMMERCIAL & GLYNS LIMITED
A. Scoular

NATIONAL WESTMINSTER BANK Plc
J. J. Botevyle
I. R. Farnsworth
P. G. Harrold
D. Jude
Dr. D. F. Lomax
R. V. Norris
C. T. Redman
D. G. Russell

NEDBANK LIMITED
G. Elliott

N.C.N.B. NATIONAL BANK OF NORTH CAROLINA
B. A. Furlonger
P. C. James

NORDDEUTSCHE LANDESBANK
A. Legner

NORTHERN TRUST COMPANY
M. J. Cundy
S. M. Wolfe

MIDLAND BANK Plc
R. P. Baker-Bates
D. G. Barber
G. A. Freestone
R. Lombardini
P. J. Nicholson
I. L. Spight

MITSUBISHI BANK LIMITED
K. Kobayashi

MITSUI BANK LIMITED
Y. Hemmi
M. Nakajima
H. Soda

MITSUI TRUST & BANKING CO. LIMITED
F. B. Roycroft

SAMUEL MONTAGU & COMPANY LIMITED
D. R. W. Potter
C. J. Sheridan

MONTE DEI PASCHI DI SIENA
T. Guida

MORGAN GRENFELL & COMPANY LIMITED
A. J. Buchanan
J. G. Stanford
D. W. Wells

MORGAN GUARANTY TRUST CO. OF NEW YORK
T. A. Hewlett

MOSCOW NARODNY BANK LIMITED
T. Fitzpatrick
G. H. Stiles
A. G. Voronin

NATIONAL AUSTRALIA BANK
G. M. Ludecke
P. C. Taylor

LANDESBANK STUTTGART
H. Erdmann

LAZARD BROS. & CO. LIMITED
J. Garlick

LIBRA BANK
N. J. Simons

LLOYDS BANK Plc
P. B. Brockbanks
I. G. Brodie
J. W. Bullock
P. B. F. Emmerson
P. S. R. Gowen
G. P. Higham
P. D. Oldham
J. F. Whinfield

LLOYDS BANK INTERNATIONAL LIMITED
G. C. Crawshay
A. E. Moore

LOMBARD NORTH CENTRAL Plc
A. E. Keeler

LONDON & CONTINENTAL BANKERS LIMITED
G. Hoffman

LONDON INTERSTATE BANK
R. N. Bee
V. S. Pedersen

MANUFACTURERS HANOVER LIMITED
J. C. G. Lamb

MANUFACTURERS HANOVER TRUST COMPANY
C. K. Alexander
W. T. Robinson

MELLON BANK N.A.
A. J. J. Strevens

HONGKONG & SHANGHAI BANKING CORPORATION
A. Hacker
P. L. Tann
W. J. C. Wade
A. J. Webb
J. A. Wilson

INTERFIRST BANK DALLAS N.A.
C. Crispin

INTERNATIONAL COMMERCIAL BANK LIMITED
R. J. Easton
D. J. Hillbery
K. S. Parsons

INTERNATIONAL MEXICAN BANK LIMITED
G. Legrain

INTERNATIONAL WESTMINSTER BANK Plc
R. H. Haines
P. Nurse
E. J. Stamp

IRVING TRUST COMPANY
A. G. MacLaren
T. D. Sanford
B. M. Schofield

ISTITUTO MOBILIARE ITALIANO
L. Simonelli

KLEINWORT BENSON LIMITED
M. Defriend
B. W. J. Manning
P. J. M. Prain

KREDIETBANK N.V.
M. Bernaert

KREDIETBANK S.A. LUXEMBOURGEOISE
Mrs. M. Drabczynska

MEMBERS

F. R. ADAMS
National Bank of New Zealand Limited,
100 Pall Mall, London, SW1Y 5EL.

F. ADES
American Express Bank Limited,
P.O. Box 129, 30 Monument Street, London, EC3R 8LH.

M. T. ALCOCK
The Yasuda Trust & Banking Company Limited,
Garden House, 18 Finsbury Circus, London, EC2M 7BP.

C. K. ALEXANDER
Manufacturers Hanover Trust Company,
7 Princes Street, London, EC2P 2LR.

W. ALLEN
Williams & Glyn's Bank Plc,
International Banking,
5-10 Great Tower Street, London, EC3P 3HX.

R. E. AMSTAD
Swiss Bank Corporation,
99 Gresham Street, London, EC2P 2BR.

E. H. ANGELL
Credito Italiano International Limited,
17 Moorgate, London, EC2R 6HX.

H. ANGST
Dow Scandia Holdings Limited,
131 Finsbury Pavement, London, EC2A 1AY.

K. J. ANSELMINO
Commerzbank A.G.,
10/11 Austin Friars, London, EC2N 2HE.

DR. FRIEDRICH ANTON
Girozentrale und Bank der osterreichischen Sparkassen A.G.,
Morgan House,
1 Angel Court, London, EC2R 7AL.

P. S. ARDRON
Barclays Bank Plc,
54 Lombard Street, London, EC3P 3AH.

R. G. AREND
Union Bank of Switzerland,
117 Old Broad Street, London, EC2N 1AJ.

W. ARMSTRONG
Banque Belge Limited,
4 Bishopsgate, London, EC2N 4AD.

R. A. ARNOLD
Algemene Bank Nederland N.V.,
61 Threadneedle Street, London, EC2P 2HH.

R. ARTIGAS
Banco Exterior — U.K.,
60 London Wall, London, EC2P 2JB.

R. D. ASSENDER
Standard Chartered Merchant Bank Limited,
33-36 Gracechurch Street, London, EC3V 0AX.

J. B. C. ATKINSON
Bank of England,
Threadneedle Street, London, EC2R 8AH.

L. J. AUSTIN
Reserve Bank of Australia,
8-10 Old Jewry, London, EC2R 8DT.

D. E. S. BABB
National Bank of Detroit,
28 Finsbury Circus, London, EC2M 7AU.

P. R. BAGCHI
State Bank of India,
State Bank House, 1 Milk Street, London, EC2P 2JP.

FIRST WISCONSIN NATIONAL BANK OF MILWAUKEE
J. L. M. Gill
G. F. Taylor
J. Wakefield

ROBERT FLEMING & COMPANY LIMITED
A. C. Chambers
H. W. Everitt

FLEET NATIONAL BANK
J. L. Stone

GERRARD & NATIONAL Plc
The Earl of Eglinton & Winton
R. G. Gibbs

GIROZENTRALE UND BANK DER OSTERREICHISCHEN SPARKASSEN A.G.
Dr. F. Anton

GRINDLAYS BANK Plc
F. H. Brittain
P. W. Keating
R. Knight
J. A. Rutherford

GRUPPO NORDEST
C. Combi

HAMBROS BANK LIMITED
R. W. G. Harvey
D. J. Thomason
C. E. Wilson

HESSISCHE LANDESBANK GIROZENTRALE
H. E. Reiche
H. J. Schlichting

HOKKAIDO TAKUSHOKU BANK
J. F. Prince

HOKURIKU BANK LIMITED
S. Makino

DG BANK — DEUTSCHE GENOSSENSCHAFTSBANK
R. R. Garnham
P. P. Harvey

DOW SCANDIA HOLDINGS LIMITED
H. Angst
J. H. North

DRESDNER BANK A.G.
A. R. Hughes
G. Z. Steffens

ENGLISH ASSOCIATION TRUST LIMITED
J. R. Gilmour
M. J. Portlock

EULABANK LIMITED
J. B. Woodhead

EUROPEAN BRAZILIAN BANK LIMITED
J. W. Meredith
P. R. Sandringham

FIDELITY BANK
R. W. Ozmond

FIRST COMMERCIAL BANK
Y. N. Lai

FIRST INTERSTATE BANK OF CALIFORNIA
S. K Buster

FIRST NATIONAL BANK OF BOSTON
B. Ede
J. H. White

FIRST NATIONAL BANK OF MINNEAPOLIS
G. L. Ellis

FIRST PENNSYLVANIA BANK N.A.
T. L. Kirker

R. A. M. BAILLIE
Standard Chartered Merchant Bank Limited,
35-36, Gracechurch Street, London, EC3P 0AX.

R. P. BAKER-BATES
Midland Bank Plc,
110 Cannon Street, London, EC4N 6AA.

S. BALL
United Dominions Trust Limited,
Plantation House, (5th Floor E Section),
10-15 Mincing Lane, London, EC3M 3AH.

M. BARAT
Société Générale,
P.O. Box 513, 60 Gracechurch Street, London, EC3V 0HD.

D. G. BARBER
Midland Bank Plc,
27/32 Poultry, London, EC2P 2BX.

T. A. BARLOWSKI
Bank Handlowy w Warszawie S.A.,
4 Coleman Street, London, EC2R 5AS.

C. A. BARNES
Bank of Nova Scotia,
12 Berkeley Square, London, W1X 6HU.

R. A. BARNES
Bank of England,
Threadneedle Street, London, EC2R 8AH.

R. S. BARNES
Credit du Nord,
10 Old Jewry, London, EC2R 8DU.

D. BASU
State Bank of India,
1 Milk Street, London, EC2P 2JP.

J. BATTERSBY
2 Vine Row, Lancaster Park, Richmond, Surrey, TW10 6AF.

M. C. P. BEALES
Westpac Banking Corporation,
Walbrook House, 23 Walbrook, London, EC4N 8LD.

P. J. BECKETT
Canadian Imperial Bank of Commerce,
55 Bishopsgate, London, EC2N 3NN.

R. N. BEE
London Interstate Bank Limited,
Bastion House,
140 London Wall, London, EC2Y 5DN.

J. A. BENNET
19 Greenways, Esher, Surrey.

W. M. BENNETT, C.B.E.
Qatar National Bank S.A.Q.,
135/141 Cannon Street, London, EC4N 5AH.

M. BERNAERT
Kredietbank N.V.,
7th Floor, 40 Basinghall Street, London, EC2V 5DE.

A. A. BEST
Royal Trust Company of Canada,
48/50 Cannon Street, London, EC4N 6LD.

F. S. BIGNELL
53 Essendene Road, Caterham, Surrey.

G. L. BLACKTOP
Alexanders Discount Plc,
1 St. Swithin's Lane, London, EC4N 8DN.

H. A. BOLLOM
Banque Bruxelles Lambert,
St. Helen's, 1 Undershaft, London, EC3P 3EY.

COUNTY BANK LIMITED
G. F. Casey
D. H. Stewart

COUTTS FINANCE COMPANY
D. R. Locke

CREDITANSTALT-BANKVEREIN
N. R. L. Hudson

CREDIT DU NORD
R. S. Barnes

CREDIT LYONNAIS
M. Langdale-Kelham

CREDIT SUISSE
J. F. Burkart
D. R. Dziurzynski

CREDIT SUISSE FIRST BOSTON LIMITED
Dr. M. von Clemm

CREDITO ITALIANO
L. W. Durden
G. C. Schiavi

CREDITO ITALIANO INTERNATIONAL LIMITED
E. H. Angell
F. Petteni
M. Terenghi

CROCKER NATIONAL BANK
T. S. Newman
M. J. Spencer

DAI-ICHI KANGYO BANK LIMITED
K. Kano

DEUTSCHE BANK A.G.
M. A. ten Brink

CHARTERHOUSE JAPHET
C. Lee

CHASE MANHATTAN BANK N.A.
C. A. Browne
J. D. Phillipsborn

CHO HEUNG BANK LIMITED
I. C. Harris
C. H. Jang

CIC-UNION EUROPEENNE, INTERNATIONAL ET CIE
J. H. Thunnissen
H. L. A. Vermunt

CITIBANK N.A.
S. Crane

CITY MERCHANTS BANK LIMITED
D. C. Eley

CLIVE DISCOUNT COMPANY LIMITED
N. H. Chamberlen
R. N. Thomas

CLYDESDALE BANK Plc
I. Hay
R. H. Reith

COMMERCIAL BANK OF THE NEAR EAST Plc
R. F. Coyle
A. Hamid

COMMERZBANK A.G.
K. J. Anselmino
G. O. Bruder
D. W. Clark

COMMONWEALTH BANK OF AUSTRALIA
D. H. Fuller
W. J. Smallbone
J. A. Wiseheart

CO-OPERATIVE BANK LIMITED
J. Price-Haworth

J. M. BOOTH
Qatar National Bank S.A.Q.,
135/141 Cannon Street, London, EC4N 5AH.

J. J. BOTEVYLE
National Westminster Bank Plc,
National Westminster Tower,
25 Old Broad Street, London, EC2N 1HQ.

M. B. BOWLES
National Bank of Abu Dhabi,
90 Bishopsgate, London, EC2N 4AS.

P. BRACKFIELD
Singer & Friedlander Limited,
21 New Street, Bishopsgate, London, EC2M 4HR.

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ASSESSING MONETARY AGGREGATES

1. In his speech to the Lombard Association on 16 April, the Chancellor restated the Government's monetary policy. He said:

> "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 inflation".

Monetary targets are a means to that end.

2. In his Budget in March, the Chancellor set new targets for two of the measures of money - a narrow measure (MO) and a broad measure (£M3).

3. The Chancellor said in the Lombard speech:

> "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, since the boundaries are constantly shifting. So throughout my time as Chancellor I have chosen instead to set targets for 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 £M3, which has the advantage of familiarity.

4. In judging monetary conditions, it is necessary to assess how MO and £M3 are moving against their targets, and to examine the evidence of other measures of money and other indicators such as the exchange rate. The monetary aggregates are defined in the box.

5. Over time, monetary growth tends to be related to the growth of total spending power in the economy, commonly measured by money GDP. This article looks at trends in the relationship between money GDP and various measures of money.

Broad measures of money

6. Through the 1960s and 1970s £M3 and other measures of broad money grew, on average, 1 to 2 per cent more slowly than money GDP. Since 1980, on the other hand, they have grown between 2 and 6 per cent faster than money GDP. This is shown in table 1. There has been considerable variation from year to year. This is illustrated in chart 1 and table 2.

7. This major change in trend is probably attributable in large part to the freeing up of the financial system over the last few years and to the move from negative real interest rates in the mid to late 1970s to significantly positive real interest rates in the 1980s.

8. In the 1960s and 1970s, restrictions on banks reduced the amounts of broad money held by the private sector. Since 1979 however there has been major liberalisation. [Exchange controls were abolished in November 1979.] In June 1980 a restriction which had inhibited the growth of bank deposits (the supplementary special deposit scheme, commonly known as "the corset") was removed. In addition there has been much more aggressive competition for deposits between banks and building societies. All of these developments will have affected the growth rates of broad money. At the time it was thought that these changes would only have a one-off effect on monetary growth. But it is now clear that liberalisation has encouraged a chain of institutional and market developments with the longer lasting effects. (Some of these continuing developments are described in the preceding article ....). As a result broad money has persistently grown faster than money GDP in the 1980s.

9. The shift from low or even negative real interest rates in the 1970s to high positive real interest rates in the early 1980s has also made it more attractive to hold the interest bearing financial assets which make up broad money.

10. A further complication in assessing monetary growth has been "over funding" - selling more public sector debt than was necessary to finance the public sector borrowing requirement. This was designed to reduce the growth of £M3. Between 1981 and 1985 the public sector borrowing requirement was overfunded by £14½ billion. This tended to raise long interest rates relative to short rates, and discouraged the holding of broad money. Had the Government not overfunded, £M3 would probably have grown even faster relative to money GDP than it did. The Chancellor announced last autumn that he was ending the practice of overfunding, because it had tended to introduce distortions into financial markets. Ending overfunding will probably have increased the growth of ~~unwound some of the effect on~~ £M3.

11. Partly as a result of this, through 1985 and the early part of 1986 £M3 grew faster than money GDP by between 6 and 7 per cent. It is against this background that the Chancellor decided to set a target range for £M3 of 11 to 15 per cent for 1986-87.

Narrow measures of money

12. In principle there is a strong case for setting a target for total non-interest bearing money ie the non-interest bearing component of MI (NIB Ml). However since the mid 1970s NIBMl growth has become more variable, as is shown in chart 2. This is probably due mainly to institutional changes (discussed below) which have led to substitution between interest-bearing and non-interest bearing accounts. MO has grown along the same trend, but in a smoother fashion than NIBMl.

13. Table 3 shows that on average over the last 20 years, MO has grown about 4 per cent a year more slowly than money GDP in the same year. Table 4 suggests that a better comparison may in fact be between the growth of money GDP in one year and the growth of MO in the previous year: this shows less year to year variability. Over the last decade money GDP has generally grown between about 2 per cent and 5 per cent faster than MO in the previous year (after adjusting for strikes and other distortions).

14. Taking account of this trend, during the last 10 to 15 years M0 has usually given a good indication of the future path of money GDP. For example, in 1978 it signalled the rise that took place the following year. In 1980 and 1981, when £M3 was growing rapidly, M0 indicated the slow-down in the growth of money GDP through 1981 and 1982. And since then M0 has continued to give useful indications about the subsequent growth in money GDP, at times when £M3 has not.

15. M0 is influenced by many of the same factors that influence money GDP, but they affect M0 more quickly than money GDP. In particular M0 reacts quickly and unambiguously to changes in nominal interest rates. High nominal interest rates seen in recent years have made holding cash or non interest bearing money less attractive relative to the interest bearing assets.

16. In addition, just as with broad money, the demand for narrow money has also been affected by institutional changes and technological developments. Some of these factors are summarised in table 5:

- Since the mid-1970s the proportion of employees being paid in cash has steadily declined (from 59 per cent in 1976 to 35 per cent in 1985).

- Associated with this there has been an increase in the number of bank accounts and the number of transactions being made through banks.

- The spread of cheque cards has made payment by cheque easier.

- The use of credit cards and cash dispensers has become more widespread.

- Demand for NIBM1 has been reduced by the introduction in the 1980s of interest bearing cheque accounts.

17. Unlike the institutional changes affecting broad money, however, these developments, taken together, have been proceeding

at a fairly steady pace, over a long period. Growth of MO relative to money GDP has followed a fairly stable trend over many years. In the light of all these factors the Chancellor announced a target range of 2-6 per cent for MO in 1986-87.

Conclusions

18. The Chancellor set target ranges for two of the measures of money in the 1986 Budget - MO and £M3. £M3 has become familiar to outside commentators. But liberalisation and technical change in financial markets coupled with a return to positive real interest rates have led to a marked increase in its growth relative to money GDP in the 1980s.

19. MO has not undergone such a shift in its relation with money GDP. It has also been less volatile. The link between money GDP in one year and MO in the previous year has been more stable. It remains the best choice among the various narrow measures of money for targeting.

CHART 1
VELOCITY OF BROAD MONEY

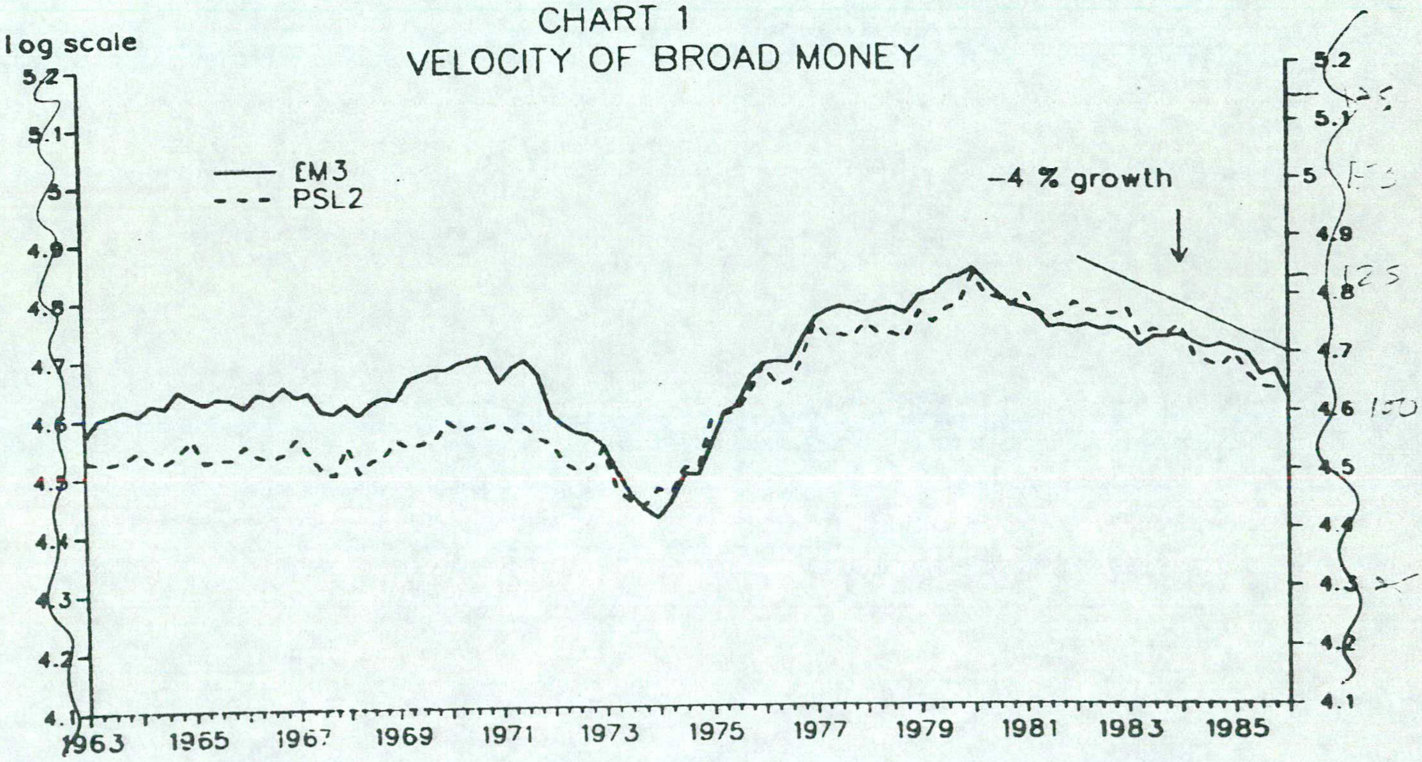

CHART 2

VELOCITY OF NARROW MONEY

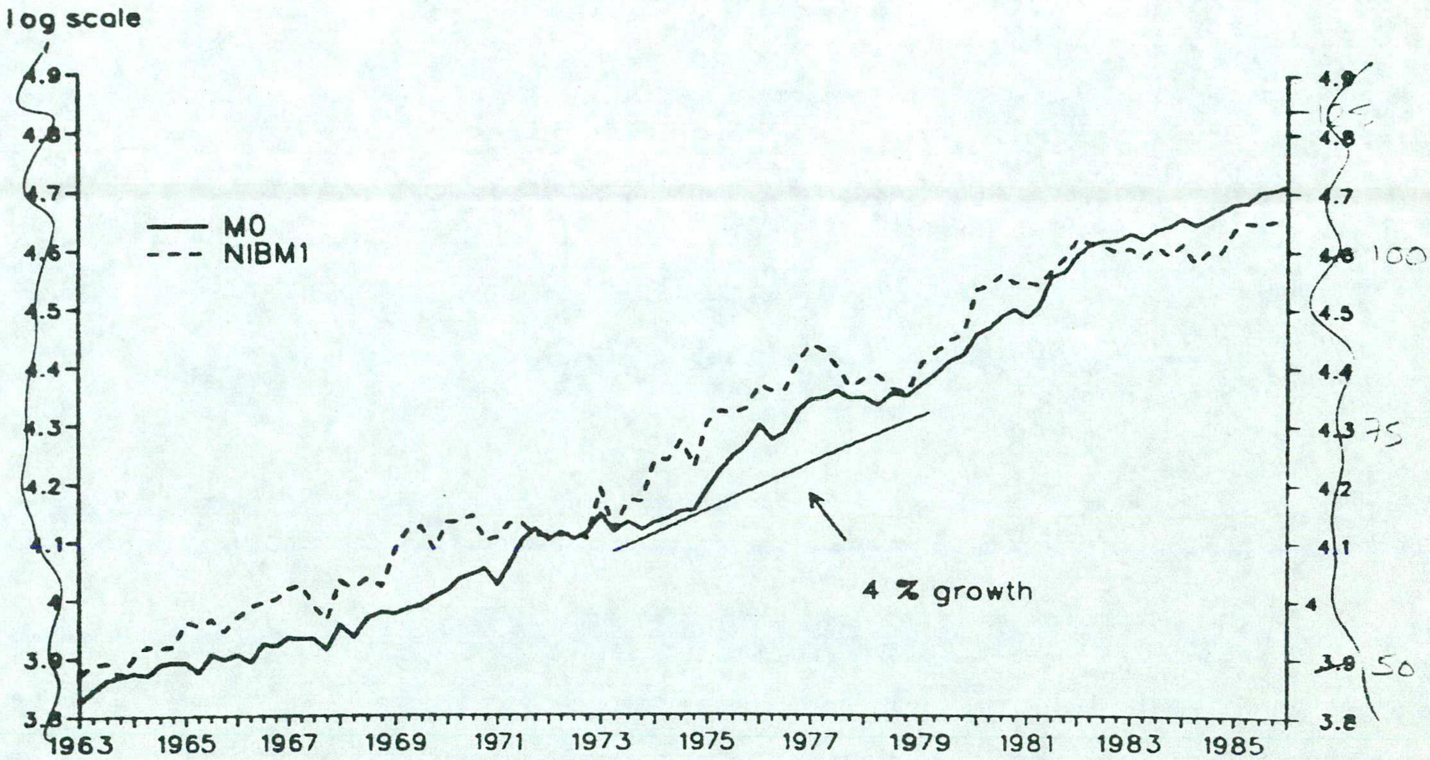

TABLE 1

BROAD MONEY

Averages of annual growth rates

	£M3 (1)	PSL2 (1)	MONEY GDP (2)	Velocity of: £M3	Velocity of: PSL2
1964 to 1980	[ ]	[ ]	[ ]	[ ]	[ ]
1981 to 1985	12	12	9	-2½	-3

(1) Calendar year averages of seasonally adjusted end-quarter data.

(2) Seasonally adjusted average estimate, market prices. Figures in brackets are adjusted for strikes.

TABLE 2

BROAD MONEY

Annual percentage increases

	£M3(1)	PSL2(1)	MONEY GDP(2)	Velocity of: £M3	PSL2
1975	8½	10½	26(24½)	16(15)	14(12½)
1976	8	11	18	9½	6½
1977	8	9	16½	8	7
1978	15½	15½	15½	0	0
1979	13	14	17½(18)	4(4½)	3(3½)
1980	16½	13	17(16)	0(-½)	3½(3)
1981	16	13	10	-5	-2½
1982	11	9½	9½	-1½	0
1983	10½	12	8½	-2	-3
1984	9	13	7(8)	-2(-½)	-5½(-4)
1985	12½	13	9½(9)	-2½(-3½)	-3(-4)

See footnotes to table 1.

TABLE 3

NARROW MONEY

Averages of annual growth rates

				Velocity of:	
	MO(1)	NIBM1(2)	MONEY(3) GDP	MO	NIBM1
1964 to 1980	[ ]	[ ]	[ ]	[ ]	[ ]
1981 to 1985	5	6½	9	3½	2

(1) Calendar year average of seasonally adjusted banking month data, adjusted for changes in reserve ratio requirements in 1971 and the change in definition of bankers' balances in 1981.

(2) Calendar year average of seasonally adjusted end-quarter data.

(3) Seasonally adjusted average estimate, market prices. Figures in brackets are adjusted for strikes.

TABLE 4

NARROW MONEY

			Annual percentage increase	
			Velocity of MO	
	MO(1)	MONEY(3) GDP	MO in current Year	MO in previous Year
1975	14	26(25)*	10½(9½)	n.a
1976	10½	18	7	3½
1977	11	16½	5	5½
1978	15½	15½	0	4
1979	13	17½(18)	4(4½)	2½
1980	8	17(16)	8½(7½)	3
1981	5½	10	4	2
1982	3½	9½	6	3½
1983	6	8½	2½	5
1984	5½	7(8)	1(2½)	2
1985	4½	9½(9)	5(4)	2½

See footnotes to table 3.

TABLE 5

INNOVATIONS IN CASH USAGE

Annual percentage change in

	(1) Percentage of number working paid in cash	(2) Number of bank current accounts per capita	(3) Number of items processed through clearing	(4) Number of credit cards	(5) Real value of credit card transactions	(6) Number of cash dispensers
1976	59	3.0	7.5	-2.6	17.2	6.1
1977	56	2.0	6.8	14.2	14.6	9.3
1978	54	4.0	8.1	13.9	23.3	5.4
1979	54	4.1	7.4	21.3	18.6	0.5
1980	50	3.5	10.0	18.5	14.9	12.9
1981	44	3.5	4.3	12.2	15.6	27.8
1982	42	4.4	4.7	11.1	22.3	24.6
1983	39	2.2	7.0	8.7	24.2	30.5
1984	37	0.0	6.3	10.8	18.5	12.8
1985	35	6.6	6.5	11.5	25.7	17.4

Sources: Column (1) - Financial Research Services Method of Payment Survey. 1985 - nine months data only.

Columns (2)-(6) - Annual Abstract of Banking Statistics (Committee of London and Scottish Clearing Bankers), Monthly Digest of Statistics and Economic Trends.

33/1770

Box.

THE MONETARY AGGREGATES
DEFINITIONS AND SOURCES

NARROW MONEY

MO Notes and coin in circulation with public plus banks' holdings of cash (till money) plus banks' operational balances at the Bank of England (bankers' balances).

~~Series are adjusted to take account of the change in bankers' balances and till money requirements in September 1971 and the change in the definition of bankers' balances included in MO in September 1981.~~

NIBM1: Notes and coin in circulation with public plus non-interest bearing sterling sight bank deposits held by UK residents in the private sector less 60 per cent of net debit transit items.

M1 Notes and coin in circulation with public plus all sterling sight bank deposits held by UK residents in the private sector less 60 per cent of net debit transit items.

~~**M2** Notes and coin in circulation with public plus UK private sector residents' holdings of:~~

~~- all non-interest bearing sight bank deposits less 60 per cent of net debit transit items~~

- all other bank deposits on which cheques may be drawn or other payments to third parties made (eg standing orders)
- other bank deposits of less than £100,000 with residual maturity or minimum notice of withdrawal of less than one month.
- deposits with building societies which are within one month of maturity
- deposits with the National Savings bank ordinary account.

BROAD MONEY

£M3

Notes and coin in circulation with public plus all sterling bank deposits (including certificates of deposit) held by UK residents in the private sector less 60 per cent of net debit transit items.

PSL2

£M3 plus UK private sector residents' holdings of:

- money market instruments (Treasury and commercial bills, local authority deposits)
- certificates of tax deposit
- building society deposits
- National Savings (excluding certificates, SAYE and other long-term deposits).

less Building Society holdings of bank deposits and money market instruments etc.

NB The series used for PSL2 excludes

bank deposits with original maturity greater than two years, term shares and SAYE with building societies prior to 1984Q4.

Sources : Bank of England Quarterly Bulletin. ~~The published Bank data have~~ There are numerous breaks of coverage and definition in the published data. ~~eg the switch from the old banking sector to the monetary sector in November 1981. To obtain consistent long runs of data suitable for this article it has been necessary to adjust growth rates to take out the effects of these.~~ The data used in ~~the data~~ this article have been adjusted for these breaks. A more detailed description of the series is available on request.

VELOCITY BOX

One way to measure the relationship between money GDP and the money stock is to look at trends in the velocity of circulation of money. Velocity is defined as the ratio of money GDP to the money stock, and can be calculated for each measure of money. A rise in velocity indicates that the money stock is growing more slowly than money GDP.