



10 DOWNING STREET

Prime Minister

My contacts in the Treasury
make me doubtful about the proposition
that opinion there is becoming more
enamoured with M₁ or M₀ ^{targets} (Terry Burns in particular) are bent
more on exploring the idea of a
target rate of growth for nominal
GDP.

Content for Alan to open up
discussions with them? Yes but

Mr. Heath was on
MUS 30/60 M₁ in 1973
MS.

30 October 1981

ALAN WALTERS

Econ PM

PRIME MINISTER

NEW FINANCIAL ARRANGEMENTS AND MEDIUM-TERM FINANCIAL STRATEGY

1. I believe we are now at a state where it would be wise to move forward in the next stage of the new financial arrangements. And I would like your permission to proceed, with Middleton and Burns, to plan the next stages.
2. We can claim that the new financial arrangements have been successful. During the course of the last two months we have had to deal with sharp changes in world interest rates. I think we may claim that the new arrangement enabled the markets to move interest rates quite rapidly. There was very little evidence of the delay which has caused such problems in the past.
3. One of the next steps is to set up a programme for widening the bands. There are also a number of technical issues in dealing tactics - but these are minor matters.
4. One of the big issues that was left in limbo in our July meeting was the appropriate targeting for the centre of the interest rate bands. As you know, I have always been of the opinion that sterling M_3 was an appropriate target for the long-run, or strictly medium-term target, but was misleading for indicating the degree of monetary stringency. M_3 is largely a credit magnitude and does not closely respond to the measure of money, as a means of payment, (see attached note for the distinction between money and credit). Opinion in the City (such as Gordon Pepper and Tim Congdon), and in academe (Patrick Minford and possibly Brian Griffiths), and in the Treasury is now becoming much more enamoured of a "means of payment" aggregate such as M_1 or M_0 . These would be much more sensitive to movements in interest rates than is sterling M_3 .
5. There are many problems of reconciliation. The new targets must be broadly consistent with MTF's sterling M_3 targets. I suspect that this can be achieved mainly by defining appropriate time periods for the targets. But this needs a great deal more thought.

/6. The appropriate

6. The appropriate time for these discussions is before we start the intensive exercises in the run-up to the Budget. And as far as we can see during the next two or three months we shall have no severe pressure problems of funding a large borrowing requirement. There is also every hope that American interest rates will begin to subside so that pressure at the short end of the yield curve will subside.

30 October 1981


ALAN WALTERS

cc Mr. Wolfson
Mr. Hoskyns
Mr. Duguid
Mr. Vereker
Mr. Scholar

THE DIFFERENCE BETWEEN MONEY AND CREDIT - THE CONSIDERATION OF CREDIT CONTROLS

1. Inflation, Money and Credit

It is often argued that credit controls will contain inflation. In order to show that the argument is false, we need to distinguish carefully between money and credit.

In essence, money is the means of payment, whereas credit is the deferment of a payment. Credit allows the purchaser to postpone payment. When payment is made it is with money.

Some credit instruments act as money because they are normally accepted as a means of payment. But most credit instruments do not act as means of payment, and do not circulate as does money. They have to be "encashed" before the purchasing power which they embody can be spent. The key distinction is that money circulates. Credit does not.

It is readily acknowledged that those credit instruments that form a sub-set of the circulating media, change from time to time. But such changes are relatively slow. There is normally a well defined set of money assets which act as means of payment and which circulate from one holder to another in the discharge of obligations.

2. An expansion of the volume of credit is neither a necessary nor sufficient condition for inflation

An expansion of credit is clearly not a necessary condition. If the Bank of England printed 50 million £100 notes and sent them to every person in the country gratis, then there would undoubtedly be some considerable inflationary pressure. But there would be no increase in the quantity of credit whatsoever.

It is obviously also not a sufficient condition. The lender must finance the credit. If there is no change in the stock of money, the lender can only finance the credit by reducing his own purchases by the amount of the loan. Or, alternatively, the

/lender can run down

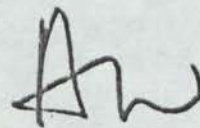
lender can run down his own money balances. But in the latter case all this does is increase the velocity of circulation of money. And we know that there is a definite limit to an increase in velocity. It cannot sustain a continuing inflation.

The only way in which we can plausibly argue that an expansion of credit causes a persistent inflation is if, by some means, we increase the quantity of money to "validate" the expansion of credit. But this amounts to no more than saying the inflation is generated by an increase in the rate of growth of the money supply.

3. Credit Controls

Apart from the fact that credit controls are not necessary or even useful in controlling inflation, they are unlikely even to achieve the proximate objective of controlling the growth of credit.

The first reason is that there are likely to be substantial leaks. They are difficult to police and the elaborate complexity of credit arrangements are such that attempting full policing would be prohibitively expensive. A second reason is that credit controls cannot conceivably cover all lending institutions. If we control banks, it is likely banking business will move out of the banking system. A very costly distortion of normal arrangements.



18 September 1981

ALAN WALTERS