CHANCELLOR OF THE EXCHEQUER

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NOTES ON MEDIUM TERM FINANCIAL STRATEGY

1. The predicted monetary growth that is consistent with forecasts of GNP and interest rates shown in the Burns' draft of the financial strategy average about 13 or 14% over the three years from 1982/83 to 1984/85.

2. This contrasts dramatically with our present M1 trend. Over the past three years it has been about 8%, and has been running at something like 5 or 6% over the last six months or year.

3. It takes a leap of a sophisticated imagination to believe that a move from 8 or 6% to 13% in monetary growth is a counter-inflationary strategy. I suspect this is one of the main reasons why Terry Burns is unhappy with putting the strategy forward in such a form. As we saw last Thursday, thinking around the table, put into more or less precise form by Patrick Minford, was that the M1 growth should be round about 5 or 6% (or say a range from 4-7%). Clearly this very sophisticated group were not thinking in terms of rates which are in the 13-14% range.

4. The 13-14% rate is high mainly because of the predicted effects of falling interest rates. It is worth noting however that a fall in interest rates will have a once and for all effect on the M1 absolute figure. If interest rates then remain where they are, the rate of growth of M1 will resume its trend value with respect to nominal GDP.

5. Thus the high figures for M1 depend critically on first the predicted effect of interest rates on M1, and secondly on the detailed dynamic reaction and time path of the adjustment process. This contrasts with my figures which abstract from this adjustment process; they are so to speak agnostic with respect to the change in interest rates as distinct from their absolute level.

6. My difficulties with the Burns figures arise from a number of considerations. First they hinge critically on (a) a forecast of interest rates in the dynamic context of the next three years, and

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(b) the reaction of M1 balances to these interest rates, and
(c) the adjustment period and process of the adaptation to changed interest rates. I am nervous about making our MTFS hostage to all these dubious predictions. Interest rates have differed very considerably from our forecasts in the past, and there is no reason to suppose that they will be more amenable in the future. Similarly, the reaction of M1 to interest rates may change. (The experience over 1980/81 has shown us that in the short run there was some perversity in the relationship between M3 and interest rates.) Most important, however, is the period of adjustment. We are entering an environment very different from the history of the past decade. It would be dangerous to rely on relationships whichwere derived in the seventies and perhaps sixties in order to predict what will happen in the mid-eighties.

7. The Burns memo raises the prospect that the banks will start paying interest on sight deposits (para 26) and suggests that a low M1 target would be very risky. That indeed makes a point in favour of M1 since the banks argue that the transaction costs of checking accounts are about 9%, so as interest rates fall to 9-10%, the banks will reduce the interest paid on checking accounts to virtually zero thus contracting the M1 figures and not increasing them as interest rates fall.

8. In my view we should be concerned with the trend rates of growth of monetary aggregates and should not publish them for any particular year but only specify them for a period of three years. In broad terms, the numbers should be:

Currency about 3-4%

MO: 4-5%

M1: 5-6%

M3 say 8-10%

PSL2: 8-10%

These are the expected growth rates over a three year period. In any particular year the growth rates may deviate considerably from the three year average.

9. These growth rates are roughly for unchanged interest rates. We do not know in detail what interest rates will rule over this period, because of international factors etc, and the growth rate in any particular year, and especially the growth rate of M1, may be much affected by movements in interest rates. It is impossible, however, to predict with any certainty either the changes in interest rate and the effect which those changes are likely to have, transitorily, on the M1 growth rate.

10. Similarly, the figures do not take into account possible institutional changes which may affect the meaning of some magnitudes. These effects will have to be taken into account as they arise.

11. My preferred objective is really to carry on with the original version of the medium term financial strategy, but to remove those elements which gave rise to political criticism, occasionally, misleading monetary policy. In the main, however, I believe that the MTFS was a great success. Except for a brief period in 1980, it delivered very good monetary policy. The problem was that, in terms of the M3 targets, it did not look good. This is the main thing that needs to be revised. I believe the best way to do this is to announce the targets over a three year period and enter, indeed emphasise, the caveats which will allow amendment of the targets, yet be consistent with that steady downward monetary pressure which we all want to see.

AW

25 January 1982 ALAN WALTERS

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