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High monetary growth and buoyant asset prices

Period of falling house prices is now over

Asset prices have been rather strong

The current upturn in monetary growth has been accompanied - as so often in the past - by buoyant asset prices. Most obviously, share prices are at or near their all-time peaks. Various other asset classes have also seen sharp price increases in the last few quarters, notably farmland (at least until the BSE scare) and hotels (following the Granada's take-over of Forte). The monetary impetus to these asset price movements is easy to explain.

Excess money holdings concentrated in the financial sector,

As in similar cycles in the past, the acceleration in broad money growth has not been evenly spread across all sectors of the economy. Subdued inflation has meant that the personal sector does not need extra money balances, while companies have tried to rid themselves of surplus liquidity by buying other companies. As a result, the upturn in monetary growth has been particularly concentrated in the financial sector. (People have been eager buyers of PEPs, unit trusts, life policies and so on, which transfers their money balances to financial institutions, and companies buy other companies by acquiring their shares in the stock market, again boosting the money balances of the financial institutions which initially held the shares.) But the financial sector has only a finite demand to hold money balances. The evidence is very clear that, over the long run, life assurance companies and pension funds do not like their cash and other short-term assets to exceed 4% of total assets. So, in years like 1995 when financial institutions' money holdings soar by 25%, share prices are likely to rise strongly.

but people have also to judge money holdings against their housing equity

Rising share prices are a classic leading indicator of economic activity and are in fact one component of the official shorter leading index. But it is a mistake to focus too exclusively on the monetary behaviour of companies and financial institutions. While the financial sector has always to judge the right balance between its money holdings and the value of its assets, the personal sector is constantly thinking about the balance between its money holdings and its housing equity. At present the return on money holdings is meagre. With money growth increasing, it is therefore entirely logical that estate agents are beginning to talk about a livelier housing market. The latest quarterly report from the Royal Institute of Chartered Surveyors had a 60% positive balance of respondents who believe activity to be rising, with its spokesman commenting that "we think that the greater level of activity will soon show in the number of sales going through". Again as in similar past cycles, the house price increases at this early stage are sharpest in Central London, where (rich) people's financial position is particularly affected by the stock market. If base rates remain at 6% for several quarters, the UK economy will enjoy an extended period of above-growth growth.

Professor Tim Congdon

11th April, 1996

Summary of paper on

'Acceleration in M4 growth *does* matter'

Purpose of the paper

The Treasury Panel of Independent Forecasters presents the Chancellor of the Exchequer with forecasts of the British economy, so that these can be compared with the Treasury's own forecasts. Professor Congdon's latest *Submission* to the Panel argued that, after a slow period for the UK economy in early 1996, accelerating monetary expansion would lead to above-trend growth in demand and output. It also justified concern about medium-term inflation prospects.

Main points

* **As the level of national output remains beneath trend, perhaps by over 2% of trend output, the inflation outlook for 1996 - and probably 1997 - is satisfactory. The Government will reach, or come to close to reaching, its target of annual RPIX inflation under 2 1/2% at the end of the current Parliament.**

* **The trend rate of annual broad money growth has accelerated, from under 5% in the three-and-a-half years between mid-1991 and end-1994 to roughly 10% now. This higher rate of monetary growth looks set to continue.**

* **With inflation staying down for the time being, the upturn in nominal money growth has been matched by a similar upturn in real money growth. Balance sheets are in good shape across the economy and some asset prices are buoyant.**

* **Faster real money growth and buoyancy in asset prices are usually the prelude to above-trend growth in economic activity. After a slow start to early 1996, largely due to recession in the UK's European neighbours and some overhang of excess stocks, late 1996 and 1997 should see quite strong economic growth.**

* **Eventually, above-trend growth will eliminate the "negative output gap" (i.e., the 2% shortfall of output from its trend), and worries about overheating and rising inflation will re-emerge. If broad money growth stays at about 10% a year, inflation in, say, 1999 could well exceed 5%.**

This paper - which differs very slightly from the actual *Submission* to the Panel - was written by Professor Tim Congdon. Much of the work was done at Lombard Street Research, Gerrard & National's research subsidiary.

Acceleration in M4 growth *does* matter

Professor Congdon's *Submission* to the Treasury Panel of Independent Forecasters, March/April 1996

Overview and discussion of the current situation

Favourable macroeconomic outcomes since 1992

In the last three years and a half years the UK has enjoyed good macroeconomic performance. On average output growth has been slightly above-trend, while inflation has been the lowest in any period of similar length since the late 1950s. Although the rate of growth has varied from quarter to quarter, there has not been a single quarter of declining output since the first quarter (Q1) of 1992. These heartening numbers are largely to be explained by the economy's position at the end of the last recession in late 1992. National output was then probably about 4% beneath trend. In accordance with previous cyclical patterns, it was possible in 1993, 1994 and 1995 for the *change* in output to be positive at a somewhat above-trend rate, which cut the excess of trend over actual output (i.e., reduced the so-called "negative output gap"), and yet for inflation pressures to remain subdued because the *level* of output was still beneath trend.

Worries about excessive growth in early 1995 have proved misplaced,

In early 1995 some commentators expressed alarm that the growth of output had accelerated too much and, even more disturbingly, that the level of output had returned to trend. (It could have returned to trend only if the trend growth rate has deteriorated quite markedly compared with the 1980s.) This alarm was partly justified by a clear acceleration in producer price inflation and a more muted rise in retail inflation. But, in fact, the rate of output growth was already declining at the start of last year, while the best evidence suggests that the economy was then still operating at a beneath-trend level. The slowdown was very welcome to policy-makers and has been accompanied by a moderation in inflation. The upturn in inflation in early 1995 now looks like a "blip". (See chart on p.4.)

with inflation improving in early 1996

In Lombard Street Research's last *Submission* to the Treasury Panel it was claimed that "the prospects for inflation in 1996 are bright" and that "the annual increases in the underlying retail price index, measured on both the RPI-X and RPI-Y formulas, are also likely to reach the lowest levels so far seen in the 1990s". Crucial to this outcome was the inclusion of the the electricity rebate in the RPI. In the event the relevant authorities have decided to exclude the rebate from the RPI. The headline and underlying RPIs will improve in early 1996, and the Government ought roughly to achieve its inflation target of 2 1/2% or less "by the end of the current Parliament" (whenever that is). But it is far from certain that inflation will reach the lowest levels so far in the 1990s.

Demand was quite weak in late 1995, hit by a combination of recession in the UK's European neighbours, a phase of reduced stockbuilding after unsustainably high stock accumulations in previous quarters, and the persisting *malaise* in the housing and construction sectors. The change in conditions compared with early 1995 was particularly pronounced in manufacturing.

The inflation blip in 1995

Inflation increased in early 1995, but the upturn was short-lived and now looks like a blip on the charts. The blip is more obvious with a sensitive measure of inflation pressures, like the annualised three-month increase in the producer price index, than with the retail price index.

1. The annualised three-month increase in producer prices

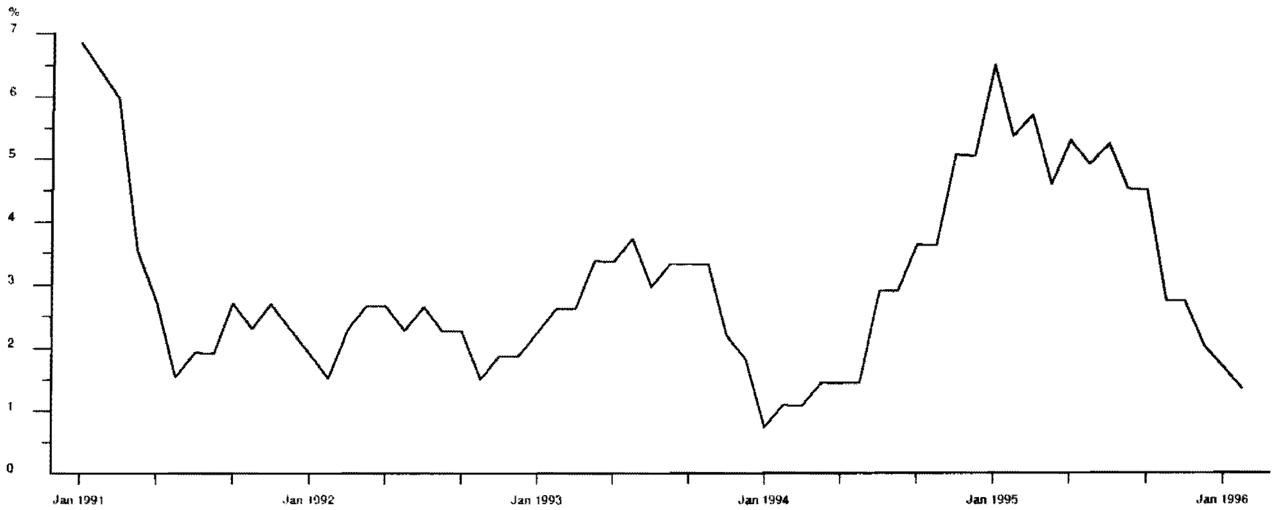


Chart relates to PPI, seasonally adjusted, excluding food, drink, tobacco and petroleum products. It refers to monthly data.

2. The annual increase in the retail price index

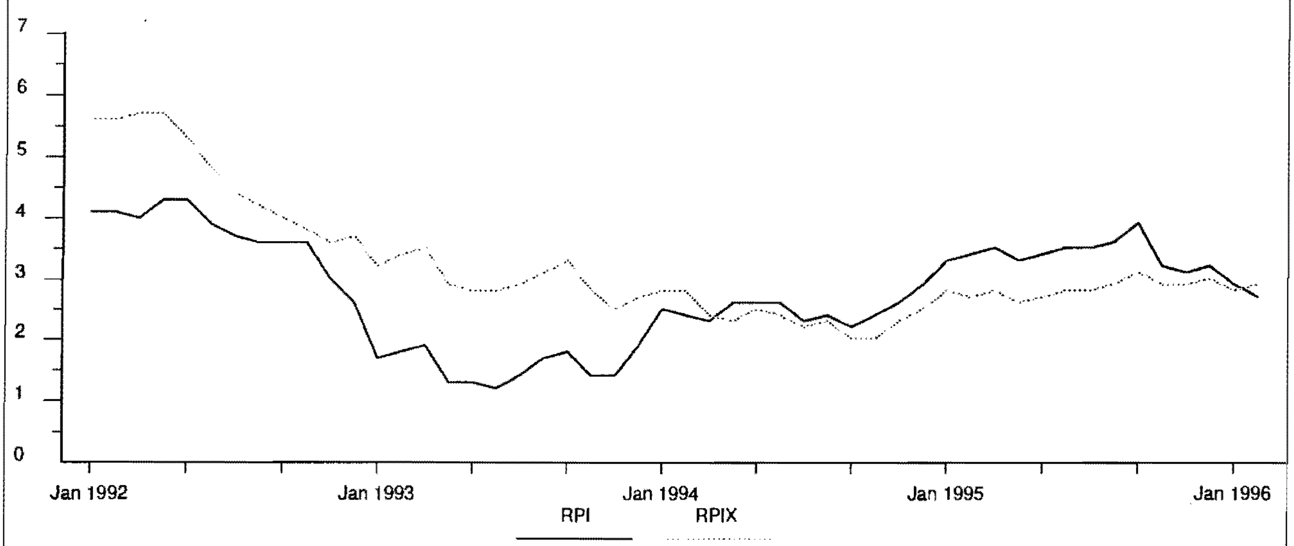


Chart refers to monthly data. RPIX is the "all items" retail price index excluding mortgage interest payments.

Whereas in February and March a net balance of over 30% of companies in the CBI's *Monthly Trends Enquiry* had plans to raise output over the next four months, the corresponding balance in November was 9% and in December a mere 2%. But the service industries, less vulnerable to external demand and the vagaries of the stocks cycle, continued to expand. Overall GDP grew at a slightly beneath-trend rate in the second half of 1995. Meanwhile unemployment went down by about 13,000 a month and the unemployment rate dropped to 8%, one of the lowest figures in Europe.

Structural changes in the working of the labour market have complicated relationships between output and employment,

The conjunction of beneath-trend growth and falling unemployment may sound odd. In principle, growth at a beneath-trend rate ought to be accompanied by rising unemployment. However, the last 20 years have seen a change in labour force composition which alters and complicates the interpretation of the crude unemployment totals. There has been an underlying trend towards less employment of full-time males, particularly males in late middle age, and increased employment of part-time women. Part-time women are much less productive than full-time men. If all else were equal, this change in labour force composition would imply a slower trend growth rate of national output. But there is a difficulty here. This is to judge, at any particular moment, whether people out of work but not registered as unemployed (and indeed also people doing part-time work) have permanently left the full-time labour market. Presumably the shifts away from full-time and male employment will not continue indefinitely.

and have crucial bearing on the calculation of the "output gap"

No final answer on the issue will be ventured in this *Submission*, although it is crucial to the UK's economic prospects. The number of male "employees in employment" was virtually the same in September 1995 (11.062 million) as three years earlier (11.031m.), while the number of female "employees in employment" rose over the same period from 10.556m. to 10.849m. A pessimistic assessment is that these numbers conform to the pattern of the preceding 15 years, with a disappointing message for the trend growth rate. The alternative optimistic view is that many men willing to work have been by-passed by the recovery, so that national output remains well beneath trend. Thus, Professor Patrick Minford claimed in article in the November 1995 issue of the *Securities & Investment Review* that, "There is a great mass of unemployed or 'resting' people who are willing to work and can profitably be hired once recovery takes grip...This implies an 'output gap' - between actual and potential output - of about 6 1/2%."

A reasonable view is that output is still 2% beneath trend

A realistic compromise between the optimists and the pessimists is that unemployment remains above the natural rate, which may lie between 6% and 7% of the workforce, and that output is still 2% (or even 2 1/2%) beneath trend. If so, there is scope for several quarters of above-trend growth before inflation starts to accelerate. Assuming that the trend growth rate remains at, say, 2 1/4% a year, growth could run at an annualised rate of over 3% for two years before inflation would become a serious policy problem. *(It should be very heavily emphasized that to make this statement is not to recommend that policy be* *organized with a view to securing any particular growth rate over any particular period.)*

The upturn in monetary growth suggests that, after some stable years, the economy is entering another cycle

A fundamental principle in Lombard Street Research's approach to analysing the economy is that, in the long run, the demand to hold real money balances depends only on real forces. (This idea - which has survived countless statistical tests in dozens of countries - is of course basic to monetarism.) Since early 1995 the growth of nominal (broad) money has increased and is now running at just above 10% on a twelve-month basis. With inflation staying down for the time being, real money growth has accelerated markedly and is well ahead of 5%, also on a twelve-month basis. This positive rate of real money growth contrasts with the virtual stability in real money between 1991 and 1994. (See the chart on p.7.) On the face of it, there has been a well-defined change in the trend rate of monetary growth.

The outlook over the next 18 months to two years

Prospects heavily conditioned by monetary trends

The UK's short-term and medium-term economic outlook will depend critically on these monetary developments. If the dominant long- run determinant of real money holdings is the growth of real output, the upturn in real money growth will either have to be come to a halt or be accompanied - sooner or later - by an acceleration in real output growth. (This is not to deny that, from time to time, the relationship between money and economic activity can be disturbed by rapid institutional changes and/or large changes in the attractiveness of money relative to other assets.) Two questions arise, "will the recent acceleration in broad money growth persist?" and "how soon and how much will it impact on economic activity?".

Upturn in monetary growth largely due to higher lending to private sector,

The answer to the first question requires an analysis of the causes of the monetary acceleration. In terms of the credit counterparts, the banks' deposit liabilities (which form most of M4) have been rising more quickly because they have been finding it easier to expand their loans to the private sector, particularly to companies. In 1994 industrial and commercial companies repaid £1.8b. of loans from banks and building societies; in 1995 they took out £17.2b. of new loans. This change of £19b. was the dominant reason for the increase in new M4 lending, from £31.1b. in 1994 to £55.3b. last year.

especially by companies to finance take-overs

Companies' principal motive for the switch in their bank borrowing behaviour is also easy to identify. Whereas throughout the early 1990s most of them had been nursing their balance sheets back to health by avoiding new commitments, 1995 saw a decisive change of mood. Take-over activity surged, with the total value of all bids amounting to over £40b. (By contrast, in 1993 and 1994 acquisition expenditure had been £7.1b. and £8.3b. respectively.) In a number of well-publicised cases the take-overs were financed by bank borrowing.

Banks have keen to support deals, because of strong capital position

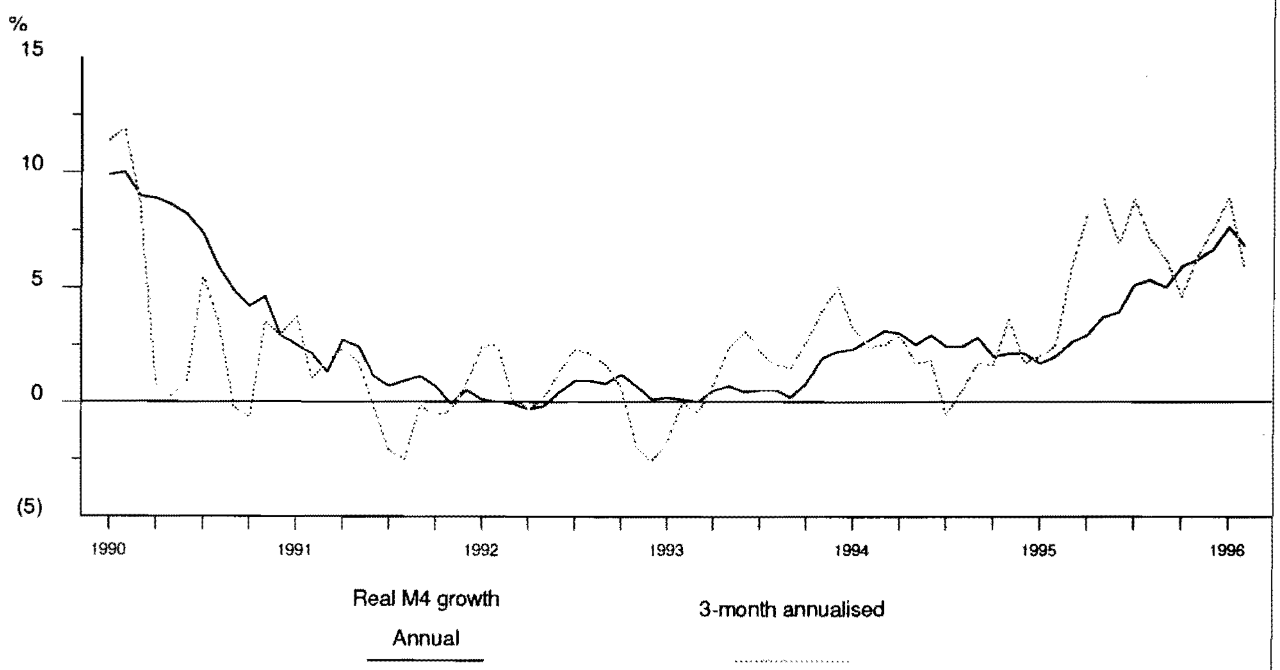
Companies would not have been able to engage in acquisition activity on this scale if the banks had not been keen to support them. The key influence here was undoubtedly the sharp improvement in the banks' capital position compared with the early 1990s. In 1991 and 1992 the operating profits of the large UK banks (i.e., the members of the British Bankers Association) were overwhelmed by their bad debt provisions, their retentions were negligible and they were trying to shed assets. But in 1995 the profits after bad debts of the same group of banks approached £10b. Even after paying tax and dividends, retentions almost certainly exceeded 10% of their capital. (The analysis is complicated by the treatment of the Standard Chartered and HSBC groups, which are UK-owned but have only a part of their operations in this country.) Unless they could expand their balance sheets by about 10%, they would start to have excess capital. The over-supply of capital is being aggravated by the de-mutualisation of several large building societies.

Take-over boom to continue

No early change in the over-supply of banking system capital is in prospect, implying that monetary growth will remain relatively high in coming quarters. The take-over boom also seems likely to continue, although the official attitude towards it might be less sympathetic under a Labour government. Moreover, the demand for credit from the personal sector may be reviving. Mortgage debt is still growing only slowly, because the outstanding stock of debt is excessive relative to the value of the houses that people own. But other forms of personal borrowing are growing quickly, perhaps fuelled by credit-based purchases of computers and office equipment. The verdict has to be that the sub-5% annual percentage growth rates of M4 seen between mid-1991 and the end of 1994 are over. The annualised growth rate of M4 seems much more likely to be in high single figures, or possibly even in double digits, in coming quarters.

Real broad money growth since 1990

Chart relates to monthly data, and shows twelve-month and annualised three-month change in nominal M4 deflated by increase in RPIX



The money numbers will no doubt fluctuate erratically from month to month and quarter to quarter, as they always do. But, with inflation constrained by the negative output gap at least until the end of 1996 and probably until mid-1997, a reasonable conclusion is that the annual rate of real money growth will run at a much higher rate over the next few quarters than was common in the early 1990s. In this monetary environment the UK economy is likely to enter a standard business cycle. Above-trend growth will resume quite soon, the negative output gap could well be eliminated by late 1997 or early 1998, and - unless corrective action is taken - inflation will increase thereafter. Unless the annual rate of nominal broad money growth is at some stage reduced to under 5%, inflation will keep on increasing until the real rate of broad money growth is brought into line with the trend rate of real output growth. With nominal M4 growth at 10% a year and the trend rate of annual output growth at 2 1/2%, *and in the absence of major institutional upheaval or special influences boosting the demand to hold money balances*, the implied inflation rate is above 5%. Apart from the italicised qualifications, a 10%-a-year growth rate of broad money cannot in the long run be reconciled with an inflation rate of 2 1/2% or less.

If institutional framework is stable, monetary growth at 10% a year cannot be reconciled indefinitely with inflation under 2 1/2%

What, then, needs to be said about institutional changes to the financial sector and special influences on the demand to hold money? Are there are any reasons why the growth rates of GDP and broad money might diverge widely over the next two or three years? Before considering more substantive issues, a comment is needed on the introduction of the gilt repurchase market. The effect of gilt repurchase transactions is often simultaneously to expand non-bank financial institutions' deposits and borrowings , which adds to both M4 and M4 lending. However, the deposits have in most cases to be held passively until the transactions unwind. Their growth has no wider macroeconomic significance. A sensible procedure is to deduct the OFI deposits created by gilt repurchase activity from M4 in order to arrive at the economically interesting monetary trends. At present the deduction of such deposits still leaves the growth of M4 over the last twelve months at almost 10%.

Gilt repo market has no wider macroeconomic significance

But rapid growth of financial institutions' money holdings is otherwise very important,

While the effect of gilt repurchase agreements is recognised to be a distortion, some debate has developed about the macroeconomic implications of the current sharp acceleration in other (i.e., non-bank) financial institutions' money holdings. The 10% increase in M4 in 1995 was not uniform across all sectors of the economy, but was instead marked by a wide divergence between OFI money holdings and those of other agents. The M4 holdings of the personal sector rose by 7% and industrial and commercial companies' by 6%, but OFIs' soared by 25%. Some commentators have claimed that the leap in OFI money holdings has no general macroeconomic importance and, consequently, that the acceleration in M4 also "does not matter". (See, for example, an article by Mr. Gerard Lyons 'Inflationary fears appear misplaced' in *The Times* of 5th February and an analysis by Mr. Roger Bootle 'M4: Leading us up the garden path again?' in *Greenwell Gilt Weekly* of 26th February.)

as financial markets are not separate from the rest of the economy

This dismissal of the significance of the OFI money explosion seems to depend on the notion that financial markets are separated, indeed almost hermetically sealed, from markets in goods and services. But this is utterly wrong. As taught by the leaders of monetary thought in the 20th century, such as Keynes, Friedman and Tobin, an equilibrium relationship between holdings of money and holdings of financial assets is an essential aspect of any general equilibrium. (In their discussions, this relationship is usually between money and "bonds", but "bonds" is just a short- hand for "financial assets as a whole".) There must also be equilibrium relationships between the price of financial assets and the price of capital goods, and then between the prices of capital goods and the overall price level. It is a naive misunderstanding to think that financial markets are segregated from the rest of the economy.

Money holdings and asset prices are related

In his analysis in the *Greenwell Gilt Weekly* Mr. Bootle concedes that the OFI money explosion and the market value of equity holdings are linked. (In his words, "the increased money holdings provided by the takeover boom may have brought institutions close to the level of bank deposits they would have liked to hold, given the rise in the equity market".) But he claims that the excess money holdings can "'disappear' without causing inflationary pressure" either through "increased issue of equities" or by repayment of bank borrowings. Repayment of bank borrowings can reduce M4, but - as already argued above - it is implausible that companies are about to resume the repayment of bank debt. On the contrary, the take-over boom is continuing, with February seeing the substantial Granada/Forte and Rentokil/BET deals. Further, Mr. Bootle is wrong that new equity issues by themselves reduce M4. Instead they merely transfer money holdings from OFIs to ICCs. This renews the problem of reaching an appropriate relationship between money holdings on the one hand and the appropriate levels of asset prices and aggregate expenditure on the other, except that it becomes a matter for ICCs instead of OFIs.

Money's importance does *not* stem from its alleged status as "an indicator of credit availability"

A common feature of recent criticisms of the importance of the current upturn in monetary growth is that money's role is thought to reside in its being an indicator of "credit availability", with agents somehow supposed "to finance themselves with credit". For example, Professor Minford claims in a recent *Daily Telegraph* article that, "As interest rates fall the incentive to take and give credit rises, and as the banks create it so activity expands and their deposits rise." So - on this view - it is credit that determines both economic activity and deposits, not money (i.e., the total of deposits) that determines the course of the economy. Minford's emphasis on credit ignores the standard account of the monetary determination of national income, in which agents keep on adjusting their expenditure until the aggregate of all individual expenditures (i.e., aggregate demand) is in equilibrium with their aggregate money holdings. In this process the level of credit is irrelevant. Of course, the money stock can be increased by a variety of means - such as heavy foreign exchange intervention, monetisation of the budget deficit and open market operations which monetise the existing stock of government debt - while credit to the private sector is unchanged. The equilibrium levels of asset prices and national income still rise in step with the increase in the money stock. An upward adjustment of national income is necessary for the restoration of equilibrium, regardless of what has happened to credit. If the level of real output is given by technology, demographics and so on, this upward adjustment can occur only through a larger increase in the price level than would otherwise have been found.

Financial deregulation does *not* mean that the equivalence of money demand and supply can be ignored, as it remains an integral aspect of any general equilibrium,

The central lesson of monetary economics has to be reiterated. This is that monetary equilibrium - the equivalence of the demand to hold money balances with the supply of such balances - is an integral part of national income determination. (The point was elaborated in my two Open Letters to the Treasury Panel in March and April 1993.) Minford's assertion, again in his *Daily Telegraph* article, that "deregulation and financial competition has [sic] ... made it impossible to use the traditional broader measures of money to explain spending" in no way invalidates the lesson. Deregulation may have de-stabilised the link between money and money national income, but it must still be true that broad money holdings have to be appropriate relative to aggregate expenditures for national income to be in equilibrium. Instability in the demand to hold money does not end the need for expenditures to adjust to monetary shocks, such as clear accelerations or decelerations in monetary growth. It implies rather that observing economists are even less certain about the consequences of any particular rate of broad money growth for nominal national income. To suggest that "economists face greater uncertainty in forecasting the link between money and nominal GDP" is emphatically *not* to say that "the link between money and nominal GDP has disappeared, so that changes in monetary growth have no effect on nominal GDP".

and in any case underlying relationships have been reasonably stable

Anyhow Minford's claim that deregulation has de-stabilised the relationship between money and the economy is false. The last three cyclical recoveries have been associated with sharper increases in the money holdings of OFIs and ICCs than of the personal sector. So the current behaviour of the sectoral distribution of money holdings is very much in line with previous cyclical patterns. (In fact, the current divergence between OFI and ICC deposit growth and the growth of M4 as a whole has been routinely forecast by Lombard Street Research for the past two years.) It is also well-known that the personal sector's money holdings are more stable than OFIs' and ICCs'. The ramifications of this contrast for the elimination of monetary disequilibrium were explored at some length in a note accompanying the Lombard Street Research *Submission* to the Panel in July 1993. The behaviour of asset prices and the economy at present - with rising share prices, high prices of agricultural land, a rather under-valued exchange rate and recent large revaluations of hotel property, accompanied by incipient signs of recovery in spending on big- ticket items of personal spending - is entirely consistent with the analysis set out in that note.

Special factors do *not* argue that monetary acceleration is incidental to the economic outlook

To summarise, neither institutional changes nor any prospective special influences on the demand to hold money balances argue that the current upturn in monetary growth can be ignored. The UK economy today - as in late 1958 and early 1959, in 1963, in 1972, in 1977 and in 1986 - appears to have embarked on another business cycle. In all these cycles higher credit growth led to faster monetary growth. Asset prices, economic activity and the price level of goods and services then had to adjust to the acceleration in monetary growth. The UK is currently in a fairly happy economic position, with the persisting negative output gap curbing inflation for the time being. But ultimately the annual rate of broad money growth will have to be reduced to under 5% if inflation is to be kept at 2 1/2% or less.

UK economy stronger than expected in early 1996

The argument set out in the last few paragraphs may seem implausible, even incredible, just as did similar arguments in 1972, 1977 and 1986. The short-run prospect appears so benign that it is foolish to warn about rising inflation in late 1998, 1999 and 2000. But it is interesting that some recent news points to resilient, even buoyant economic activity in early 1996. First, unemployment fell by 29,000 in January, despite the adverse effect of bad weather. Secondly, the CBI surveys for January, February and March reported positive balances on output plans of 16%, 20% and 24% respectively, above the average value since 1974 of 9%. On this basis manufacturing should enjoy satisfactory and possibly above-trend growth in early 1996. Secondly, confidence in the retail sector has improved strongly, with spending expected to be boosted in 1996 by tax cuts, utility rebates and the windfall distributions from building society de-mutualisations.

Policy recommendations

Recent PSBR news has been disappointing

Recent news on public sector borrowing has been disappointing. The PSBR in the first ten months of 1995/6 was £19.7b. and for the year as a whole may exceed £30b. This compares with an official projection of £29b. in the November 1995 Budget and £21 1/2b. in the November 1994 Budget. The slowdown, and the consequent loss of tax receipts, undoubtedly provides part of the explanation for this setback. Nevertheless, the message for the long-run sustainability of the UK's public finances is unwelcome.

Cyclically-adjusted PSBR still rather high, even though reduced by cuts in capital expenditure and privatisation

The PSBR seems likely to be about 4 1/2% of GDP in 1995/6. If GDP is running at about 2% beneath trend, and if the effect of a 1% (downward) deviation of output from trend is to increase the PSBR by 0.7% of GDP (as suggested in 'Fiscal developments and the role of the cycle', in the *Treasury Bulletin* of winter 1990/91), the cyclically-adjusted PSBR may still amount to 3% of GDP. In the long run this cannot be reconciled with both stability of the ratio of public debt to GDP and stability of the price level. It follows that further attempts must be made either to reduce public expenditure in relation to GDP or to increase the tax burden. This conclusion is reinforced by changes in the structure of public finances since the early 1970s. The last 20 years have seen a large cut in public sector capital expenditure and, since 1979, a massive programme of privatisation. As the PSBR is reduced by both developments, it exaggerates the health of the Government's underlying financial position. In 1995 the public sector financial deficit, which is unaffected by privatisation, was probably about £35b., virtually 5% of GDP. Meanwhile the general government's current account position, unaffected by privatisation and fluctuations in capital expenditure, was almost £25b. (about 3 1/2% of GDP) in deficit. By contrast, in the 1970s and 1980s the general government's current account was usually in approximate balance or surplus.

High money growth implies that interest rates will have to rise, eventually

Caution is also required on monetary policy. If monetary growth is unlikely to decelerate with interest rates at their present levels, then sooner or later interest rates will have to be increased. Admittedly, there is no great rush. Growth in 1996 should start quite slowly, before moving to an above-trend rate later in the year and in early 1997. But the bias in monetary policy should no longer towards ease.

Debt management should attempt to finance the PSBR entirely outside the banking system

The implications for debt management are also clear-cut. Whereas in 1992 and 1993, it was desirable to finance the PSBR to some extent from the banking system (and so to increase broad money growth), it is now prudent to finance the PSBR entirely outside the banking system in order to dampen monetary expansion. Unfortunately, debt management policy is being guided only to a limited extent by the behaviour of the money supply. Two other objectives, namely the minimisation of debt interest and the authorities' wish to give annual guidelines on the funding position to market participants, are more prominent. These are valid *desiderata*, but they are secondary to the need to maintain stable non-inflationary monetary growth.

Postscript The above *Submission* was written before the latest BSE scare. No allowance has been made in the accompanying macroeconomic forecast for the Government's response to the scare, and the possible ramifications for GDP, the balance of payments and inflation.