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Too much money chasing too few assets

Excess liquidity behind asset price inflation of 1996 and 1997

Asset price inflation related to change in money supply growth

The August issue of this *Review* included a memorandum to the Bank of England's Monetary Policy Committee arguing that it ought to be concerned about broad money growth at double digit rates. More specifically, it warned that extremely rapid growth in financial institutions' money balances was responsible for the return of asset price inflation. The central message was that, because asset prices move in line with the general price level in the long run, the acceleration in money growth since early 1995 would lead to rising inflation in 1998 and 1999.

and, as the Bank of England recognises, goods price inflation may follow

Is this message getting through? Or is there a danger that policy-makers have forgotten the sad lessons of previous boom-bust cycles? The minutes of the MPC's August meeting provide part of the answer. Paragraphs 48 to 50 contain quite a detailed discussion of trends in broad money, and paragraph 50 is about financial institutions' money holdings. It judged that the acceleration in M4 growth would be more disturbing if the money were concentrated in the personal or corporate sectors rather than the financial, but still concluded that the fast growth in financial sector liquidity "represented an upside risk to inflation".

The Bank's Monetary Policy Committee sees need for reducing money growth, but - strangely - will not use debt management for the purpose,

Compared with 1986 and 1987, the MPC's discussion is a sign of considerable progress. The key people at the Bank evidently think that wholesale liquidity held by financial institutions needs to be monitored, whereas ten years ago this was routinely dismissed on such grounds as "pension funds don't buy groceries". But the MPC is not perfect. In particular, paragraph 63 of the Minutes makes strange reading. Having conceded in paragraph 50 that excess financial sector liquidity represents an "upside risk to inflation", paragraph 63 rejects the use of debt management to withdraw such liquidity from the economy. Apparently the Committee did not "see much attraction in recommending to the Government a change in debt management policy towards restraining broad monetary growth". No reason was given for this statement. In principle, it will soon become the task of the House of Commons' Treasury Committee to press the MPC for a justification of its views on debt management, as on other aspects of monetary policy. But - frankly - the Treasury Committee is likely to find debt management complicated and boring, while the precise split of responsibilities in this area between the Treasury, the Bank and the new debt management agency is unclear. (See the accompanying research paper.)

with consequent risk of higher than necessary interest rates

With the useful instrument of debt management again neutralized by official neglect and incomprehension, short- term interest rates may in the late 1990s, as in the late 1980s, have to be higher than would otherwise be necessary to keep inflation under control.

Professor Tim Congdon | 8th October, 1997

Summary of paper on

"How should monetary policy be organized?"

Purpose of the paper

The Treasury Committee of the House of Commons is in future to review the work of the Bank of England's Monetary Policy Committee and thereby secure the Bank's accountability to Parliament. This research paper considers how best the Treasury Committee might perform its task.

Main points

Note that these points - in effect, recommendations to the Committee - make sense only if the behaviour of the money supply, on the broad definitions, is crucial to the determination of national income.

* **The Committee should ensure that in future, as in the last 20 years, fiscal policy is consistent with monetary policy, ideally with medium-term guidelines for the budget deficit and money supply growth. (See pp. 5 - 8.)**

* **The Committee should continue to focus on the public sector borrowing requirement as the central measure of fiscal policy, but it should also maintain a watch on the general government current account (as implied by the so-called "golden rule") and the general government financial deficit. (See pp. 8 - 9.)**

* **The Committee should regard debt management as an integral part of monetary policy and take powers to ask questions of the new debt management agency. It should be very suspicious of officials who tell it that debt management is not part of monetary policy. (See pp. 9 - 12.)**

* **A guideline for the growth of the money supply should be quantified and monitored by the Treasury Committee. Ideally, the Committee should set a guideline consistent with the Government's inflation target and ask the MPC to justify departures from it. (See pp. 12 - 14.)**

This research paper, written by Professor Tim Congdon, was submitted as a memorandum to the Treasury Committee, which has recently been considering how to organize its relationship with the Bank of England.

How should monetary policy be organized?

An agenda for the Treasury Committee of the House of Commons

Parliament's task to enforce Bank of England accountability

Mr. Gordon Brown's decision to grant operational independence in monetary policy to the Bank of England was welcome, but a number of details still have to be settled. In particular, the Treasury Committee of the House of Commons will have the power to question Bank officials, including members of the newly-formed Monetary Policy Committee, about the conduct of monetary policy. The purpose of this paper is to comment on how the Treasury Committee might best carry out its task. Inevitably, broader issues arise about the design of the institutional structure of economic policy-making.

The main comments will be in three areas:

I The interdependence of fiscal and monetary policy, and the need for continuing cooperation between the Treasury and the Bank in policy-making.

II The role of debt management in monetary policy, and the need for continuing cooperation between the Treasury and the Bank here also, despite the establishment of a new debt management agency ostensibly "at arm's length" from the Treasury. ("Bank to lose role in debt management", *Financial Times*, 30th July.)

III The case for the Bank to have a formal target (or "monitoring range") for money supply growth, either to be imposed on itself by the Monetary Policy Committee or perhaps suggested to it by an outside body such as the Treasury Committee.

Preliminary remarks on the economy's behaviour

Before developing the discussion in these three areas, a few remarks on "how the economy works" are essential. Recommendations about the institutional structure of policy-making cannot be made in a vacuum, but depend on beliefs about how policy instruments and targets relate to ultimate macroeconomic objectives. For example, in the 1960s and early 1970s many British economists thought that inflation was caused by cost-push pressures, such as the abuse of trade union power. They therefore regarded prices and incomes policies, combined with government-union negotiations, price control boards and other bureaucratic bodies, as the key institutions in inflation control. There was relatively little interest in the relationship between the Treasury and the Bank, and hardly any recognition that the terms of this relationship were germane to macroeconomic outcomes.

In long run demand to hold real money balances depends only on real variables

The recommendations about the institutions of policy-making in the present paper depend on the author's view on the economy's behaviour. Indeed, they have a clear and robust basis only if this one particular view is correct. Its crux is that the money supply, on the broad definitions, is central to the determination of national income. The statistical evidence is overwhelming, both in the UK and elsewhere, that in the long run the demand to hold real money balances depends almost exclusively on real factors, with real income being the most important.(1) It follows that, over the medium and long runs, a condition for inflation control is that the growth rate of the money supply must be restricted to a rate similar to the trend rate of increase in real output.

In short run excess or deficient real balances may affect expenditure and output

However, in the short run - which may be as long as two or three years - the relationship between money growth and inflation is complex, as well as being difficult to predict. A good rough-and- ready rule is that large and sudden accelerations (decelerations) in real money growth have a powerful positive (negative) effect on the propensity to make purchases of all kinds, as agents attempt to restore equilibrium real money balances. (The increase in real money is the increase in nominal money deflated by the rise in a price index.) The purchases may be in financial and property markets, where they affect key asset values, such as share prices, house prices and the exchange rate. These asset values in turn have a fundamental influence on volatile components of aggregate demand, like investment, stockbuilding and net exports. Macroeconomic instability (the "boom-bust cycle") is a curse on any society. The first principle - that in the long run the growth rate of the nominal money supply must be kept close to the trend rate of increase in real output - has to be qualified by a second principle, that in the short run the growth of the real money supply should be kept fairly stable.

"Real balances" here are real *broad* money balances

So the institutions of policy-making should be organized to facilitate both the long-run containment of money supply growth to a non-inflationary rate and the short-run stability of real money growth. To repeat, the concept of "the money supply" under consideration here is a broad one. Narrow money balances, such as notes and coin, are held largely in the black economy, while they are almost never used in substantial capital transactions. It is difficult to see how they can be of much significance in the determination of asset prices, investment or national income. The Monetary Policy Committee and the Treasury Committee will be wasting time if they pay a great deal of attention to M0, non-interest-bearing M1 and kindred aggregates. (2)

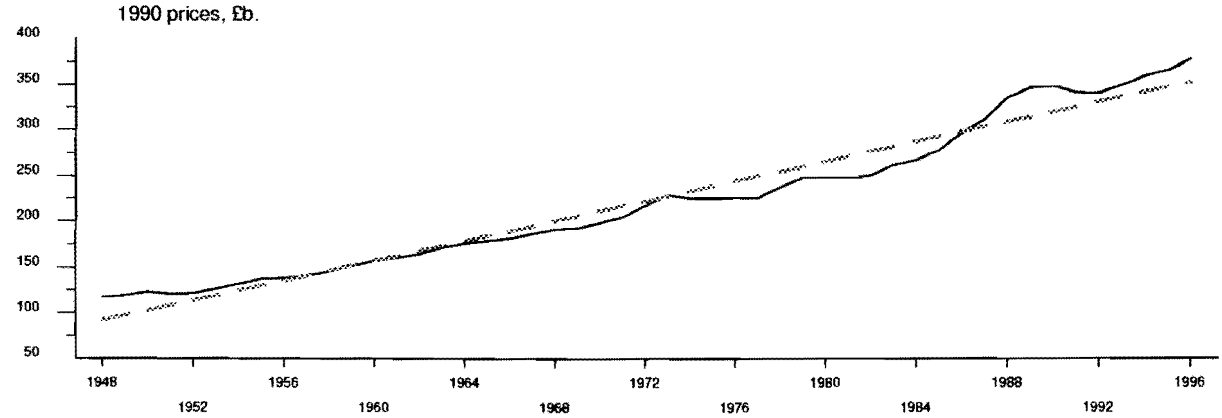
Exchange rate has some independent role, but in long run it also is determined by monetary forces

What about the exchange rate? Of course, it has a major effect on the tradables sector of the economy and inflation, and to that extent it is relevant to national income determination. But the tradables sector is smaller than the non-tradables part of the economy, while the statistical evidence appears to be that the output gap (i.e., the difference between the actual and trend level of national output) is more important than the exchange rate in determining inflation in the short run. Moreover, in the long run the exchange rate is merely a price, the price between two currencies. Like any other price, it depends on supply and demand, and in this context "supply" means the quantity of a particular currency in existence (i.e., "the money supply"). It follows that, if the quantity of money is consistent with the Government's objectives, the exchange rate ought eventually to move into line. However, the exchange rate may from time to time become very under- or over-valued, and policy-makers may then be justified in overriding money supply trends in their interest rate decisions.

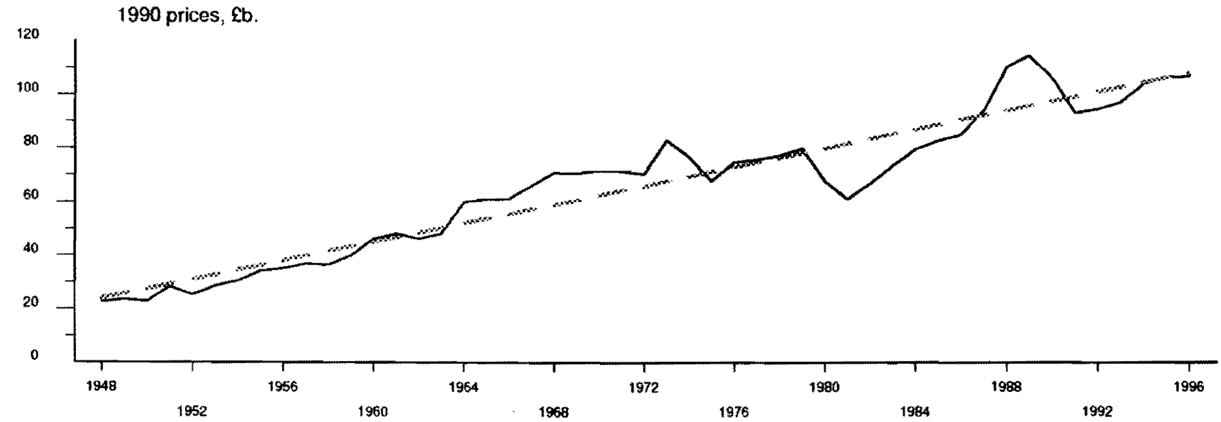
The nature of macroeconomic instability

The boom-bust cycle originates in instabilities in investment and asset prices

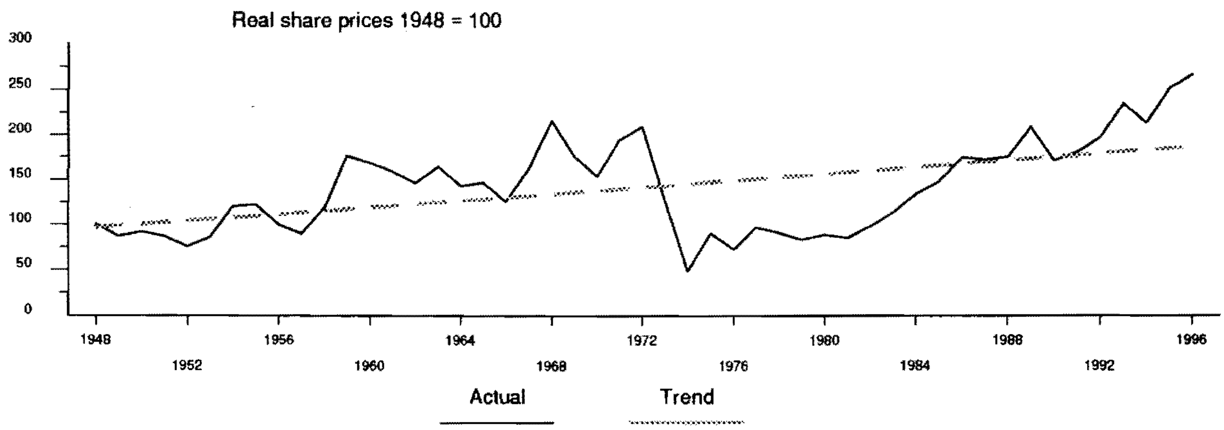
1. Consumption stays close to its trend line



2. Investment is much more volatile



3. And asset prices - which affect investment - are more volatile still



The charts compare actual figures for consumption, investment and real share prices with their trends lines.

Does anything need to be said about foreign exchange intervention? As changes in the foreign exchange reserves affect the quantity of money, a case could be argued that the MPC ought to decide the scale and timing of intervention, with its decisions subject to review by the Treasury Committee. But this possibility does not appear to be under consideration. Official thinking may be that the foreign exchange reserves are owned by the Government, so that the Treasury (i.e., the Chancellor of the Exchequer) must have the last word. But - if the UK were to rejoin the European exchange rate mechanism - intervention might become large, frequent and controversial. As on several occasions in the past (notably in September 1992), foreign exchange intervention might be the principal credit counterpart to monetary growth and the dominant consideration in monetary policy. As the MPC would be left as a mere spectator of the Chancellor's decisions, the Treasury Committee's monitoring role would be redundant. In the extreme case, the UK's whole-hearted participation in European economic and monetary union would take away both the MPC's job and the Treasury Committee's review function. An institution such as the MPC can have a substantive role in a medium- sized nation like the UK, where the exchange rate floats and monetary policy has some autonomy from that in other countries; it would be of much reduced importance if the UK fixed its exchange rate; and the MPC might as well be disbanded if the UK joined the single currency project.

If UK joined EMU, the MPC would become irrelevant

I. The interdependence of fiscal and monetary policy

A good starting-point for this part of the discussion is the macroeconomic shambles of the mid-1970s, when the UK suffered from inflation of over 15% a year and a wide deficit on the current account of the balance of payments, as well as the highest unemployment it had experienced until then in the post-war period. Several economists - from, for example, the Department of Applied Economics in Cambridge, and the National Institute of Economic and Social Research - routinely advocated fiscal expansion in order to boost demand and reduce unemployment. Meanwhile the Government, which had been persuaded that excessive money growth was the root cause of inflation, introduced the first money supply target in July 1976. Once the need for a money supply target on anti-inflationary grounds had been conceded, the rationale for fiscal expansionism became problematic. The existence of the money target put a clamp on the private sector's expenditure, because companies and individuals had to maintain some minimum ratio of money to their income and wealth. So an increase in the budget deficit would not increase total expenditure, but merely "crowd out" expenditure that the private sector might otherwise have undertaken.(3)

Debate about "crowding-out" in the mid-1970s

Method of deficit financing fundamental to this debate

One aspect of the "crowding-out" theme needs to be highlighted. A budget deficit can be financed in two ways, by borrowing from the banking system or from non-banks. When the financing is from the banking system, the banks' assets and, hence, their deposit liabilities increase. These deposits can be spent an indefinitely large number of times and are therefore money. With a money supply target in place, the scope for such monetary financing is necessarily limited. Indeed, an increase in the budget deficit may have to be financed by sales of long-dated gilts from non- banks, which puts upward pressure on bond yields. The rise in bond yields ("interest rates") discourages investment and other private sector expenditure, and is one symptom of crowding-out in practice. The implied policy recommendation is that fiscal and monetary policy should be seen as dimensions of a common "financial policy", and should be conducted in tandem.

Link between budget deficits and money growth seen in credit counterparts identity

The relationships between the budget deficit and money growth are summarized in a so-called credit counterparts identity, which can be stated in various ways.(4) Nowadays money is almost entirely a liability of the banking system. The credit counterparts identity exploits the equivalence of the increase in banks' assets and liabilities. Their liabilities can be split into those that are money (in the UK, virtually all deposits) and those that are not (such as equity capital and bond issues), giving an initial statement

The increase in banks' assets = Increase in banks' monetary liabilities (i.e., broad money) + increase in banks' non-monetary liabilities,

This quickly becomes,

Increase in broad money = Increase in banks' assets - Increase in banks' non-monetary liabilities (also known as "non-deposit liabilities").

Banks can expand their assets by extending credit to the public or private sectors. Credit to the public sector can in turn be regarded as that part of "the budget deficit" not financed by borrowing from non-banks. The term "the budget deficit" is ambiguous, since it depends on the definition of "the public sector", and on which items of capital expenditure and asset transactions are included. A deficit concept known as "the public sector borrowing requirement" was introduced to the UK by the International Monetary Fund in 1968, precisely to fit the credit counterparts identity. In effect, it is the public sector's need for cash from the rest of the economy. The credit counterparts identity may be restated as,

PSBR introduced in order to fit into the identity

Increase in broad money = PSBR - Sales of public sector debt to non-banks + Increase in bank lending to the private sector - Increase in non-deposit liabilities.

The identity has an obvious consequence. If the maximum increase in broad money is fixed by a target, and if the change in non- deposit liabilities is taken as given, a rise in the PSBR must be offset by extra sales of public sector debt to non-banks (increasing bond yields) or by less bank lending to the private sector (which causes private sector expenditure to be different from what it would otherwise have been). The identity is stated in flow terms, but it is readily translated into terms of stocks. (So the "increase in bank lending" becomes the "outstanding stock of bank credit", and so on.) The same sort of conclusions can be drawn, but they are stated in a somewhat different way. Specifically, an increase in the ratio of the PSBR to gross domestic product leads to an increase in the rate of broad money growth (and so to higher inflation), unless the ratio

Linkages can be described in terms of *stocks* and well as *flows*

of public sector debt to GDP rises or the ratio of bank lending to GDP falls.(5) If the Government wants to control inflation, if it dislikes high public debt and if it expects bank lending to grow faster than GDP because of financial deregulation, it has to limit the ratio of the PSBR to the GDP.

Thinking crucial in substantiating the case for the Medium-Term Financial Strategy in 1980

Thinking of this kind lay behind the proposal of a medium-term financial plan in the mid-1970s, notably by the London Business School.(6) In the inflationary troubles of the mid-1970s it would have been unreasonable - as well as very deflationary - to have attempted drastic and immediate cuts in broad money growth and the PSBR/GDP ratio. But it was important to put handcuffs on politicians' fiscal vote-grabbing, to emphasize the medium-term nature of the task of inflation control and to convince business that a U-turn to monetary irresponsibility would not be allowed. The Medium-Term Financial Strategy announced in the 1980 Budget was framed with these ideas in mind. It set out a downward path over several years for both broad money growth and the PSBR/GDP ratio. The targets for the PSBR/GDP ratio were crude numbers; they were not cyclically-adjusted. This was unsatisfactory from an analytical standpoint, but could be justified as a matter of presentation in the highly political context of the times. (In retrospect, the lack of cyclical adjustment may have been a mistake.)

Case for MTFS was part of intense Parliamentary debate in 1970s

The ideas behind the Medium-Term Financial Strategy were highly controversial. The Treasury Committee's two predecessors - the General Sub-Committee of the Expenditure Committee, and (from 1979) the Treasury and Civil Service Committee - played a valuable role both as a stimulus to the policy changes of the late 1970s and early 1980s, and as a forum for debate. Incredible though it may now seem, in the early 1970s the Treasury's annual Expenditure White Papers projected future spending commitments in volume terms, without any serious figure-work on the cash implications or any numbers for revenue. The Expenditure Committee pressed for cash limits on spending and for the simultaneous publication of expenditure and revenue estimates, looking forward over several years.(7) Cash limits were introduced in 1976 and 1977, and were part of the explanation for the restraint over public expenditure achieved in 1977 and early 1978.

The Treasury and Civil Service Committee took a somewhat different tack. In its 1980/81 session it conducted an enquiry into monetary policy, inviting over 20 distinguished economists to answer a questionnaire. On the whole, the enquiry was unsympathetic to the ideas behind the MTFS, which by this stage - following Burns' appointment as the Government's Chief Economic Adviser in 1979 - were official orthodoxy. Nevertheless, the committee's report and the accompanying minutes of evidence were interesting as statements of economists' differing attitudes and beliefs, and are now useful historical documents. Some form of the MTFS survived until the last Clarke Budget in November 1996, although with material changes from one Budget to the next. But it made no appearance in Mr. Gordon Brown's first Budget and the assumption must be that it has been dropped.

MTFS dropped in 1997 by Mr. Gordon Brown

Treasury Committee should seek continued cooperation between Treasury and Bank on fiscal/monetary coordination

This is not the place to attempt a final adjudication on the debates of the late 1970s and early 1980s. Nevertheless, some points are clear. On the practical front, the UK's financial circumstances have undoubtedly improved since the mid-1970s. This improvement may have been the result of the MTFS or it may not, but - whatever opinion one holds - the integration of fiscal and monetary policy over the last 20 years seems easier to defend than the mess which preceded it. On the theoretical front, one proposition cannot be disputed. If the PSBR rises substantially as a share of GDP, the task of monetary control will become more difficult. In the late 1990s the Treasury Committee ought therefore, first,

- *to advocate continued cooperation between the Treasury and the Bank so that fiscal policy remains consistent with monetary policy,* and, secondly,

- *to ensure that this cooperation takes place within quantified medium-term guidelines, just as the Expenditure Committee proposed over 20 years ago.*

Danger that the Government may fudge numbers on the budget deficit

The Treasury Committee needs to be particularly alert at present, because the newly-elected Government will want "to do its own thing". The present Government - like any other - may try to manipulate the fiscal numbers to its own advantage and there are many ways it can do this. It can change definitions when an old definition is inconvenient; it can emphasize a budget deficit concept which currently gives a "low" reading and downplay another concept which has a "high" reading; and so on. Given the more satisfactory outcomes on inflation and the public finances since the mid-1970s, the substance of policy must be to keep the deficit down over the medium term, so that it supports anti-inflationary monetary policy. The following recommendations seem in order,

- *the PSBR should be retained, because it is the deficit concept most relevant to understanding the interaction between fiscal and monetary policy,*

- *the golden rule implies that the general government's current account should be brought into balance and monitored in conjunction with the PSBR,* and finally

- *the Treasury Committee must watch out for and be suspicious of attempts by Treasury ministers to fudge the figures and present them in a favourable light.*

A great many fudging games can be played, including

- *describing grants and subsidies as "capital investment" or "equity injections" into publicly-owned enterprises;*
- *moving social security funds, or indeed any fund with a deficit, out of the government accounts into a separate account;*
- *differentiating between accruals and disbursements, and choosing whichever basis is most flattering at the time (or even choosing an accruals basis in one part of the public accounts and a disbursements basis elsewhere); and*

- revaluing capital assets owned by the state and including the revaluation surplus in current income.

New temptations to fudge because of PFI and EMU

One of the Treasury Committee's tasks will be to make sure the British Government - unlike its continental European neighbours - does not engage in these accounting tricks. Developments in other areas of policy - in particular, the official wish to comply with the Maastricht Treaty's fiscal criteria and the Private Finance Initiative - may tempt Treasury ministers to indulge in statistical gerrymandering. Sometimes there may be no interaction with monetary policy, but often there will be. Thus, an agency or public body with a Treasury guarantee can borrow easily from the banking system, which adds to the money supply.

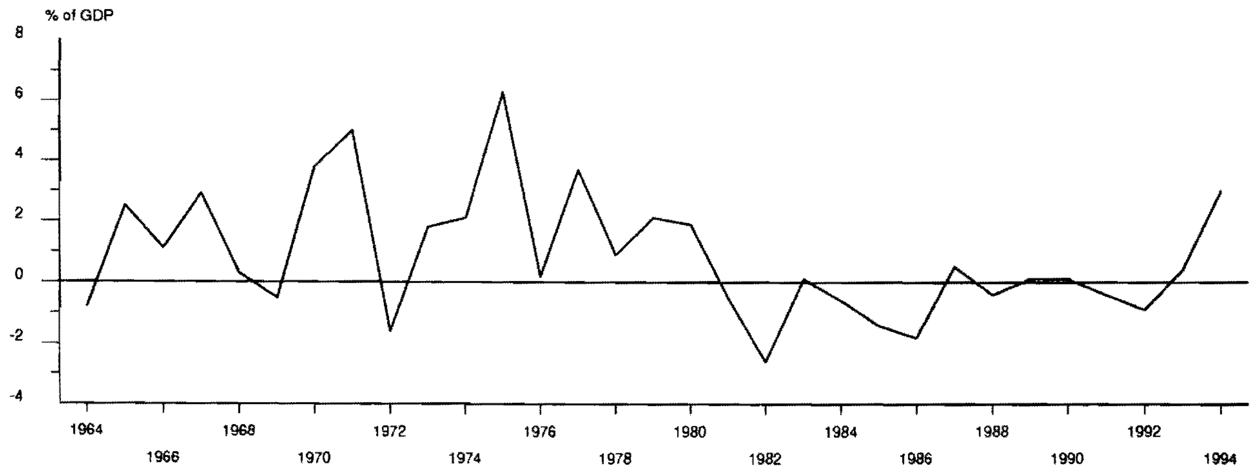
II. The role of debt management in monetary policy

The previous discussion referred in passing to the work played by debt management in monetary policy. It is clear from the credit counterparts identity that the effect of the PSBR on money supply growth depends on how the PSBR is financed. If sales of public sector debt to non-banks are equal to the PSBR, the public sector's financial transactions have no effect on money growth. But, if sales of debt to non-banks are less than or exceed the PSBR, money growth is affected. The notion of "the public sector's contribution to money supply growth" emerges. It is positive if the PSBR exceeds debt sales to non-banks, nil if it is equal to them and negative if it is less than them. (An ambiguity is that the debt sales could be to either domestic or foreign agents, but the resulting complications do not need to be discussed here.)

Over the last 20 years the public sector's contribution to money supply growth, and the related financial transactions, have been both important and controversial. As the terminology had shifted confusingly in the course of the debates, members of the Treasury Committee may appreciate a discussion of

How public sector financial transactions affected money growth, 1964-94

Chart shows public sector contributions to money growth as % of GDP. "Public sector contribution" is PSBR minus debt sales to non-banks minus external finance of the public sector.



Note contrast between the 1970s, when the PSBR was often financed by money creation and the 1980s, when public sector transactions reduced the money supply until 1986 and had little net effect thereafter.

Discussion confused by shifts in terminology, which requires discussion of etymology of the term "funding"

Orginally floating debt short-term and funded debt long-term

the historical context. For most of the time from the consolidation of the National Debt by Pelham in 1753, the debt had two main constituents, the "floating debt" and the "funded debt". According to the *Encyclopedia Britannica*, floating debt is "in essence...temporary or short-term indebtedness", whereas the term "funded debt" is "of English origin derived from the fact that the interest due was originally paid from the proceeds of certain taxes or funds".(8) Gradually the funded debt became synonymous with long-term debt, particularly irredeemable securities such as Consols. By the late 19th century the archetypical form of floating debt was the Treasury bill, an instrument first proposed by Walter Bagehot. The Treasury bill's standard term to maturity at issue was three months and the actual residual life of most bills was only a few weeks.

"Funding" first meant replacement of floating debt by funded debt, but - very logically - came in 1970s to be understood as sales of debt outside banking system

In the late 19th and early 20th centuries the practice of "funding the debt" was understood to be the lengthening of the maturity profile of the debt, by issuing long-dated or irredeemable securities instead of Treasury bills.(9) Long-dated and irredeemable securities were mostly in the hands of long-term investors, such as individuals and insurance companies, whereas Treasury bills were held inside the banking system. In the 1970s the term "funding" acquired a slightly different meaning, although a logical one given this historical background. Funding ceased to refer to particular instruments, but became "the net sale of public sector debt to non-banks". In other words, it was one item in the credit counterparts identity. (It was net, in the sense that it was after redemptions.)

In 1970s funding curbed money growth, but in early 1980s monetary growth due mainly to excessive private credit and was countered by "over-funding"

Supposed technical problems then led to "full funding rule"

In the 1970s - when the PSBR averaged more than 6% of GDP - it was often difficult to finance the deficit outside the banking system. The public finances posed a constant threat to monetary control. The aim of debt management policy was relatively simple, to sell as much debt as possible outside the banking system in order to restrict broad money growth. However, in the early 1980s the PSBR/GDP ratio fell sharply because of North Sea oil revenues and other tax increases, and unexpectedly the main threat to monetary control was buoyant bank lending to the private sector. In these circumstances the Treasury and the Bank of England started to sell more debt to non-banks than the PSBR (i.e., the public sector contribution to money growth was negative), a procedure known as "over-funding". This helped to curb monetary expansion, but by the mid-1980s it also started to cause new problems in the management of the short-term money markets. These problems were highly technical and of negligible macroeconomic significance. But - for reasons best known to itself - the Government decided that they were of great importance. It instituted a new rule, the "full funding rule", whereby the net sales of public sector debt to non-banks were to be kept more or less equal to the PSBR. In other words, the public sector's financial transactions were to have no effect on the growth of broad money

As the full funding rule made it more difficult to control the quantity of broad money, its introduction was the prelude to the suspension of the broad money target in October 1985 and abandonment in October 1986. In the author's judgement, the decision to end the broad money target was a catastrophic

and abandonment of broad money target, with the catastrophic sequel of the Lawson boom

blunder, since it removed the monetary discipline on the then Conservative Government. Broad money growth climbed sharply in late 1985 and continued to run at over 15% a year until 1989. The result was the Lawson boom and the return of double-digit inflation in 1990.(10) The author and other commentators attacked the Government. for its conduct of monetary policy, with the full funding rule coming in for particularly heavy bombardment. The rule had no precedent in either the previous 250 years of the National Debt or in any standard macroeconomic text, and it reduced policy-makers' ability to keep broad money growth at a low and stable rate.

Full funding rule led to perverse policies, including very high interest rates of the late 1980s

Moreover, in the late 1980s the full funding rule led to frankly perverse results. As the Government temporarily ran a budget surplus, and the PSBR became the "public sector debt repayment" (or PSDR), the full funding rule required the Bank of England to buy back gilt-edged securities from non-banks. Such purchases increased the stock of money, boosting private sector liquidity at just the time when monetary policy was supposedly being tightened in order to pre-empt the re-emerging inflation pressures. The burden of monetary tightening had to fall entirely on the "one club" of short-term interest rates, with base rates kept at 15% for just over a year, from 5th October 1989 to 8th October 1990, and at over 10% for more than four years, from 4th July 1988 to 18th September 1992. The bizarre conduct of funding policy therefore caused short-term interest rates to be higher for a longer period of time than would otherwise have been necessary, with a devastating effect on over-borrowed companies and households, including many small companies created in the Lawson boom.

Officialdom then tinkered with words to hide policy mistakes,

Monetary policy practitioners at the Treasury and the Bank realized that something had gone wrong, although the Chancellor of the Exchequer and the Governor of the Bank of England defended the full funding rule in a number of speeches.(11) Officialdom started to tinker with the rule, changing both its substance and the definition of the terms in which it was expressed. After a few years the sequence of changes left the rule unrecognisable, as well as incomprehensible except to a handful of experts. On translation back into ordinary language, it lost its original purpose. One version equated "funding" with "financing", so that the rule merely said "the PSBR will be financed by sales of debt to banks and non-banks".(12) Of course, this statement must always be true and is fatuous.

the (useful) term "funding" was dropped and "full funding rule" replaced by annual debt management *Remit*

Finally, the word "funding" was dropped and references to the full funding rule vanished from official statements. The new phrase was "debt management", which has continued until the present. The most comprehensive recent policy statement said that the central objective of debt management should be to minimize the cost of servicing the national debt, while supporting the Government's monetary policy.(13) The Treasury has given an annual *Remit* to the Bank, setting broad guidelines on the type of securities it would like issued and leaving the details to the Bank. A similar remit may be given to the new debt management agency, although this has not yet been announced.

Because debt management is an important part of monetary policy, the Treasury Committee must ask questions about it,

The last few paragraphs have argued that debt management is a crucial element in monetary policy. In the 1970s heavy sales of debt outside the banking system were a routine part of anti- inflationary monetary policy; in the early years of the Lawson boom the misguided full funding rule was partly responsible for the upturn in monetary growth; and in the late 1980s the continued application of this silly rule necessitated excessively high interest rates, aggravating the monetary squeeze on small businesses and over-borrowed households. It follows that the Treasury Committee must take an interest in debt management. The precise meaning of the phrase, that the Treasury is to be "at arm's length" from the new debt management agency, is still not clear, but in any event,

- the Treasury Committee must have the power to interview senior officials at the debt management agency and to monitor its work, just as it will have with the MPC,

- it should ensure that the remit given to the debt management agency takes proper account of the importance of debt management to the control of the money supply, and

- it should suggest to the relevant parties that they reach agreements about the meaning of the key words in this subject area and that they then use them consistently, so that the verbal confusions of the full funding rule are not repeated.

and must not be bamboozled by official claims that debt management is incidental to monetary policy

In the aftermath of the full funding rule, official statements have tended to emphasize what might be termed the "administrative efficiency" of debt management, meaning such considerations as the ease of contact between officials and securities houses, the frequency, reliability and predictability of auctions, and so on. These considerations are relevant desiderata for official policy, as is the minimization of the cost of debt service. However, low and stable money supply growth is far more important to society than the convenience and profitability of the securities houses that participate in gilt auctions. The Treasury Committee must be suspicious if the debt management agency and the gilt-edged market-makers congratulate each other on the efficiency of their operations, while simultaneously broad money growth is high and volatile. It must be particularly wary if the agency denies that its activities have any relevance to monetary conditions.

The main objectives of debt management policy - as of monetary policy as a whole - should be to smooth the rate of money supply growth over time and to keep the rate of money supply growth low enough to prevent inflation. If the transfer of executive powers to a new agency were to weaken the connection between debt management and monetary control, it would be a retrograde step. The Treasury Committee must ensure that this does not happen.

The virtues and vices of money supply targets have been debated for over 20 years. In the 21-year period from July 1976 to July 1997 the British Government continuously had a target (or a "monitoring range") for one or more monetary

III. Case for quantified money supply growth objective

aggregate, but in his first Budget Mr. Brown did not continue the practice. This omission is open to various interpretations. One possibility is that the Government feels it has delegated the presentation as well as the conduct of monetary policy to the Bank of England. If so, the MPC has now to decide whether to announce further money supply targets or monitoring ranges.

Various practices on money supply targets in other countries

In other large and medium-sized countries the practice is mostly for the legislature (via a specialist committee) or the central bank itself to announce a target. In the USA the Humphrey-Hawkins Act said that Congress should set a money supply target for the Federal Reserve, although in fact the Federal Reserve more or less sets the target for itself; in Germany the Bundesbank announces its own target, with (apparently) only quite limited accountability to the Bundestag and the Bundesrat. Despite the variations, a quantified target of some kind is found in virtually all other significant industrial nations. In the author's judgement,

- *the Treasury Committee ought to give the MPC a quantified objective for money supply growth*,

as there cannot be much doubt that in the long run a low rate of money supply growth is a necessary and sufficient condition for low inflation.

Quantification of money growth objectives, and inclusion in policy specification, since the mid-1970s have led to global slowdown in inflation

Whether this objective is a binding target or a loose monitoring range is important, but perhaps less important that the principle that quantification of some sort is beneficial. Despite all the controversies about monetarism, the central facts of the two decades since the mid-1970s speak for themselves. The widespread adoption of money supply targets in the industrial world in the mid-1970s has been followed by an almost universal decline in money growth and inflation, which is now at its lowest levels internationally since the 1950s; those countries that have been most committed to money supply targetry - such as Germany and Switzerland, and to a lesser extent the USA - have had the best inflation records; and the ending of the UK's broad money target in 1985 preceded the disastrous Lawson boom.

The case for a target rather than a monitoring range,

The author's preference would be for a target, not a monitoring range. The best target would be specified as a point (for example, "4% a year"), but with some leeway for noise and error, perhaps 2% either side of the central point ("4% as the central figure, but with a 2% margin either side of it, giving a band of 2% to 6%") . The target should be binding, in the sense that above-target money growth would be expected to prompt a rise in interest rates unless circumstances were plainly exceptional. Of course, this begs the question of the meaning of the phrase "plainly exceptional". Extremes of currency over- and under-valuation are certainly relevant. The author has argued elsewhere that

with an override for exchange rate extremes

over-valuation (of the trade-weighted exchange rate relative to its purchasing-power-parity value) of more than 15% justifies a decision not to raise interest rates, despite above-target money growth. Similarly, an under-valuation of more than 15% justifies a decision to raise interest rates, despite beneath-trend money growth. This suggestion for an exchange rate over-ride is intended as a compromise between the needs of long- run domestic monetary stability and exchange rate stability. Often money supply trends and the exchange rate give the same message for interest rates.

No virtue in target for narrow money

The target should be expressed only in terms of broad money and it should refer to annual periods. It should extend some years into the future, in line with the principle of medium-term financial planning recommended earlier. A reference to narrow money is unnecessary and could cause confusion. As a supplement to the broad money target, the Treasury Committee might set a guideline for domestic credit expansion. (There is no great merit if low money supply growth is secured through massive foreign borrowing by the banking system, as in some South-East Asian countries in recent years.)

The current monetary situation

This paper has been concerned with the Treasury Committee's purposes and procedures. However, it may be useful to conclude with some comments on the current monetary situation. As so often in the last 25 years, a fascinating debate is under way between economists who think that the broadly-defined money supply matters and those who think that it does not.

Recession-mongers (National Institute and narrow-money monetarists)

In its July *Review* the National Institute of Economic and Social Research said that the UK economy might be on the threshold of a monetary squeeze similar to that in the first two years of the Thatcher Government. It drew attention "to the magnitude of the contractionary forces already in place" and estimated that "there is a 25% chance of a fall in output during next year, with a 15% chance that average output is lower in 1998 than in 1997". Similar concerns have been expressed by economists who focus on narrow money. In an article in *The Sunday Telegraph* (17th August) Sir Alan Walters said that "we would find ourselves slipping into a 'growth recession' in late 1998". He also claimed to see "signs of incipient recession, even deflation" coming from the over-valued pound. Professor Patrick Minford shares Walters' views.

vs. forecasts of continued above-trend growth from broad-money monetarists

Against this, the high rate of broad money growth since early 1995 has been associated with a return of asset price inflation, strong company balance sheets and favourable "wealth effects" for the personal sector, including the now notorious de-mutualisation windfalls. Since late 1995 Lombard Street Research - which pays close attention to broad money growth and asset prices - has consistently forecast that above-trend output growth would emerge in late 1996 and continue until checked by a large rise in interest rates. The above-trend growth of the economy would take the level of national output above its trend level, causing an increase in inflation in 1998 and 1999, probably against the background of a depreciating pound.

The Treasury Committee will start its work of monitoring the MPC at a very interesting juncture in British monetary policy.

Notes

(1) See, for example, Alan (later Sir Alan) Budd and Geoffrey Dicks 'Inflation - a monetarist interpretation', pp. 104 - 31, in Andrea Boltho (ed.) *The European Economy* (Oxford: Oxford University Press, 1982).

(2) For further discussion, see Tim Congdon 'Broad money vs. narrow money', pp. 13 - 27, *The Review of Policy Issues*, vol, 1 , no. 5, Autumn 1995.

(3) The point was argued in Tim Congdon 'The futility of deficit financing as a cure for recession', *The Times*, 23rd October 1975.

(4) The key articles on the relationship between the credit counterparts and the increase in the money supply appeared in the September 1970 and March 1977 issues of the *Bank of England Quarterly Bulletin*. Before the late 1960s money supply statistics were not published on a regular basis. The first newspaper story reporting on UK money supply growth was written by Mr. Peter Jay in *The Times* of 24th September, 1968.

(5) See the paper 'The analytical foundations of the Medium-Term Financial Strategy', pp. 65 - 77, in Tim Congdon *Reflections on Monetarism* (Aldershot: Edward Elgar, 1992), based on a paper which originally appeared in the May 1984 issue of *Fiscal Studies*.

(6) See, for example, Budd and Terence (later Sir Terence) Burns 'The role of the PSBR in controlling the money supply', pp. 26 - 30, of *Economi Outlook* (Aldershot: Gower Publishing for the London Business School, November 1979).

(7) Mr. Denis (later Lord) Healey proposed "cash limits" in 1974, a development welcomed by the General Sub-Committee of the Expenditure Committee of the House of Commons in its Ninth Report of the 1974/75 session. The system of cash limits became operational in 1976 and remains in place today.

(8) See the entry 'National debt', p. 138 in vol. 16 of *Encyclopedia Britannica* (Chicago and Edinburgh, 1951).

(9) See, for example, pp. 186 - 7 of Sir Herbert Brittain *The British Budgetary System* (London: Allen & Unwin, 1959), which describes "funded debt" as that "part of the debt which...has been made permanent", in the sense that the stockholder "has no right to repayment" of capital, but only to receipt of interest. On this basis "funded debt" is necessarily undated. However, Brittain implies an alternative definition of funding on p. 150 of the same book, where it is understood as the sale of medium-dated securities to non-banks, in conjunction with the purchase of short-dated securities. Brittain approves such lengthening of maturities on the grounds that it postpones the date when the Treasury "will have to pay out cash to the public". (Such payments increase the public's deposits, i.e., the money supply, and might be inflationary.)

(10) Tim Congdon *Reflections on Monetarism* (Aldershot: Edward Elgar, 1992).

(11) See, for example, Mr. Nigel (later Lord) Lawson's Mansion House speech in October 1989 and the speech by Mr. Robin Leigh-Pemberton (later Lord Kingsdown) at Durham Castle in April 1990. Lawson's speech was criticized in the November 1989 issue of this *Monthly Economic Review* and Leigh-Pemberton's speech in the May 1990 issue.

(12) The 1993/4 *Financial Statement and Budget Report* said that "from now on" the Government would "allow sales of debt to banks and building societies to count as funding, in the same way as sales to other sectors". In view of the understood meanings of the term "funding" over the previous 200 years (as discussed in the text and previous footnotes), the Treasury's use of words was - to say the least - very unusual.

(13) *Report of the Debt Management Review* (London: H. M. Treasury, 1995), p. 8, with the statement, "funding at least cost and risk is the primary objective of debt management policy". The *Report* also said that "debt management is not a major tool of monetary policy". This remark is contradicted by *hundreds* of statements in official documents before 1985.