



MINUTES OF A MEETING HELD IN CHANCELLOR'S ROOM  
HM TREASURY AT 4.20 PM ON MONDAY, 5 OCTOBER 1992

Present:

[REDACTED]

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INFLATION & MONETARY POLICY

The Chancellor said that he wanted to address the outstanding questions in four parts:

- (a) exchange rate policy;
- (b) the inflation objective;
- (c) intermediate objectives;
- (d) presentation.

Inflation target

The Chancellor said that he was not greatly attracted to having an inflation target: year-on-year increases in price indices were backward looking measures and reflected the policy stance with a considerable lag. On the other hand, there was a case for having a more explicit inflation objective which would make it clear to the markets what the Government was hoping to achieve.



12. [REDACTED] said that there was a case for firming up the inflation objective, although he had not yet seen a formulation with which he would be satisfied. In the period 1982-92, inflation (measured as RPI excluding MIPs) had largely remained in the range 3-7 per cent, apart from the brief period when inflation rose as a result of the boom and the introduction of the community charge. The Government's aim in the 1990s might be to keep inflation within the range 1-4 per cent, with the aim over time of keeping inflation in the lower part of that range. To ratchet inflation down in this way would be a considerable achievement. He was not in favour of setting annual targets, or ranges that changed each year like the monetary targets in the MTFS.

13. The Chancellor asked what the effect of the sterling depreciation since 10 September would be. [REDACTED] said that estimates of the effect depended on which macro-econometric model was used, and were extremely uncertain. Broadly speaking, Treasury economists expected inflation to be higher than it would otherwise have been within a matter of months. However, the latest Treasury forecast was pessimistic about the prospects for output and had anticipated inflation falling quite sharply. Following the depreciation, inflation was now expected to be higher than it otherwise would have been, but it was still shown falling to about 3 per cent and then remaining steady until the end of the forecast.

14. The Chancellor said that this was a disquieting but not a terrifying prospect. [REDACTED] re-emphasised that it depended on a pessimistic view of output, in which output would be as much below trend in 1995 as it was in 1992.

15. [REDACTED] said that the first choice was whether to express the inflation objective in terms of the increase in the RPI, the RPI



[REDACTED]

excluding MIPS, or the GDP deflator. The Chancellor said that he preferred the RPI excluding MIPS.

16. [REDACTED] proposed an inflation target of 0-4 per cent, with the additional objective of hoping to be at the bottom of that range by the end of the Parliament. This was ambitious, being below what was achieved in the 1980s; the range had to be as wide as 4 percentage points given the significant variation in forecasts. The Chancellor said that he thought the range 0-4 was too wide. Furthermore, before sterling's membership of the ERM had been suspended, he had been hoping to move away from the objective of "zero inflation" which he had long thought unachievable. He was more inclined to a target of bringing inflation to "below the EC average", with the longer-term aim of bringing it to "below the G7 average" or to the "best performance in the Community". Although there might be a need to quantify these objectives, he could not envisage setting a target range of 0-4 per cent.

17. [REDACTED] said that it was important that the Government had a quantified objective to which to nail its colours; he agreed that the range 0-4 would not butter any parsnips. The upper end of the range did not imply a sufficiently ambitious performance, and the bottom end of the range was simply not credible.

18. [REDACTED] supported a range of 1-4 per cent. Inflation was at the top of that range, and the Government could say that inflation was presently at the top end of the acceptable range; the centre of this range was consistent with the best performance of our European partners. [REDACTED] thought that the objective should be set in terms of performing as well as the best of our European partners, with the explanation that this meant inflation averaging around 2 per cent. Inevitably, there would be

[REDACTED]



[REDACTED]

variations around the target and we would therefore set a target range of perhaps 1-4 per cent.

19. [REDACTED] suggested a presentation along the following lines:

- inflation had been roughly within the range 3-7 per cent between 1982 and 1992;
- it was the Government's judgement that this performance was not good enough for the 1990s;
- the Government had therefore set itself a range of 1-4 per cent;
- by the end of the Parliament, the Government expected inflation to fall to the lower half of that range.

20. He agreed with [REDACTED] that such a presentation might just be credible and meet market expectations.

21. [REDACTED] said that the target range had to be both achievable and credible. While he recognised the argument against a wide target range, it was likely that the Government could not aspire to keep inflation within a narrow range. If a range of 0-4 per cent were not acceptable, he would prefer to set a point target - say perhaps 2 per cent - and to accept that inflation would be around, but not necessarily at, that target point.

22. The Chancellor said that he would reflect further on the appropriate formulation of the Government's inflation objective. He was strongly averse to including zero inflation as part of that objective, and thought that a width of 4 percentage points for the

[REDACTED]



[REDACTED]

target range was too great and would, if anything, lead to an adverse reaction in the markets.

Intermediate indicators

23. [REDACTED] said that, for each intermediate indicator, the Chancellor would have to say whether he was setting targets (like those used by the Bundesbank) using monitoring ranges (like those used by the Fed), or simply taking account of the indicator. Targets involved a commitment to take action if the indicator moved outside the target range; a monitoring range did not commit the Government to action but, if the indicator moved outside it, this would count as a reason to change the policy stance. He was not attracted to returning to targeting the growth of M4: over the last two years, the Treasury had published a number of articles explaining why this approach was not likely to be successful.

24. The Chancellor said that he did not think that the Government could retain a completely discretionary policy: some sort of target or monitoring ranges would have to be set which the markets could assess. His preference was for monitoring ranges for narrow money and a Divisia index, while taking account of indicators such as the exchange rate and house prices. [REDACTED] said that it would be very odd to downgrade the M0 target from a target range to a monitoring range even though it had been kept it as a target throughout the UK's membership of the ERM.

25. [REDACTED] said that he was attracted to monitoring ranges. But he was beginning to see disadvantages in the use of a Divisia index: calculation of the index inevitably involved a degree of judgement. The Treasury would continue to work on a Divisia index, but he did not recommend the formal introduction a

[REDACTED]



monitoring range at this point. In place of Divisia money, it would be necessary to have a monitoring range for broad money.

26. Summing up this part of the discussion, the Chancellor said that he would retain the M0 target as a formal target range for the time being; other monetary targets would take the form of monitoring ranges. There would be no range for house prices or the exchange rate, although these would be taken account of in guiding the policy stance.

#### Presentation

27. After some discussion of the merits of giving an exclusive newspaper interview, an interview to the economics editors of the broadsheet newspapers or an interview to Channel 4 or "Newsnight", the Chancellor decided that the best way to set out the Government's policy would be in the form of a letter to the TCSC. He would approach John Watts MP and propose that he wrote to him in advance of Monday's TCSC meeting setting out the policy framework. He would say that, in view of the wider interest and market sensitivity of such a policy statement, it was necessary to make it public at the time the letter was written.

9 October 1992

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