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The TCSC is to conduct an inquiry into the Future Conduct of Economic Policy and I will be appearing before the Committee at its meeting on Monday, 12 October. I thought it might assist the Committee if I set out the framework for monetary policy I propose to adopt now that sterling is outside the Exchange Rate Mechanism. In view of the public interest in this matter, I propose to release this letter to the Press.

ERM

2. The first point to clarify is whether and when sterling will return to the ERM. The Government has made clear its intention to resume Britain's membership of the ERM; but it will do so only when a number of conditions have been satisfied:

- (i) there will need to be an end to the current turbulence in the foreign exchange markets;
- (ii) At ECOFIN on 28 September it was agreed that the recent turbulence called for reflection and analysis in the light of developments in capital markets and in the European and World Monetary System. That work needs to be carried forward.
- (iii) Most importantly, the requirements of German monetary policy and those of the UK must come closer in line. The present wide differential in interest rates between



Germany and the US, which has contributed to strains in the ERM will need to narrow.

In the Government's view these conditions are unlikely to be satisfied soon. We need therefore to establish a framework for monetary policy to replace that hitherto provided by the ERM.

Inflation objective

3. The Government believes that the only lasting basis for sustainable growth and secure employment is low inflation. The objective of our policy remains, therefore, to bring inflation down and to hold it down. We wish to reduce inflation to the point where expected changes in the average price level are small enough and gradual enough that they do not materially affect business and household financial plans.

4. But given the central position that the control of inflation plays in our strategy, I believe it would be helpful to go rather further in quantifying this objective. This is not straightforward. Inflation is a rise in the general price level but our inflation indices measure particular baskets of goods, and different indices may grow at different rates.

5. Despite these difficulties, I believe we should set ourselves the specific aim of bringing underlying inflation in the UK, measured by the change in retail prices excluding mortgage interest payments, down to levels that match the best in Europe. To achieve this I believe we need to aim at a rate of inflation in the long term of 2 per cent or less.

6. The UK has not enjoyed price stability for more than a generation. We have made progress but must go further. The average rate of inflation between 1972 and 1982 was 14 per cent, varying between 6 per cent and 27 per cent. For nine of the last ten years the RPI excluding mortgage interest payments has fluctuated in a range of 3 to 7 per cent. That range is still too high and each time we have come to the bottom of the range, the improvement in inflation has not been sustained. Now is the time to make a conclusive break to permanent lower inflation.

7. For the remainder of this Parliament, I propose to set ourselves the objective of keeping underlying inflation within a range of 1-4 per cent, and I believe by the end of the Parliament we need to be in the lower part of the range.

8. In any particular year performance on inflation may vary. We have to acknowledge that events outside our control may take us temporarily outside the range. This could arise, for example, if there were a sharp movement in the terms of trade, particularly through commodity prices. If that occurred, the Government would



have a duty to explain how this had arisen, how quickly it intended to get back within the range, and the means by which it would achieve this.

Monetary policy

9. It is to the control of inflation that monetary policy must be directed, though the strength or weakness of the economy will affect the pace at which we should move towards the long term inflation objective.

10. In my speech to the IMF Interim Committee I indicated that rather than steering monetary policy - principally changes in interest rates - exclusively by reference to domestic monetary targets I will take into account a wide range of factors. My aim will be to reach a judgement on inflationary trends in the economy and whether the Government's objectives are likely to be achieved. If, on the basis of that assessment, I judge that the objectives are at risk interest rates will be adjusted.

Exchange rate

11. In my Interim Committee speech I said I would give full weight to the exchange rate in assessing monetary conditions. This is because movements in the exchange rate may reflect market perceptions of an easing in policy; can influence directly the level of prices in the economy; and influence too the tightness or looseness of conditions under which businesses operate.

12. I wish to make clear that I have not set a target range for the exchange rate, nor is there a value which is being shadowed. Equally I should make clear that I do not propose to adopt a policy of setting interest rates in relation to domestic criteria and then letting the exchange rate go where it will. The lesson from the 1980s is that exchange rates can move a long way, upwards or downwards if markets come to believe the authorities do not care. The test is whether we believe a movement in the exchange rate (as defined by the Sterling Exchange Rate Index) or a particular level of it sustained for a period is likely to jeopardise the inflation objective.

Domestic indicators

13. I have already set a target for MO for this year of 0-4 per cent. The latest figures show growth close to the centre of the range. MO has proved a reliable indicator and its relationship with current spending in the economy has proved remarkably stable. I therefore propose to retain the existing target. It is recognised, however, that MO's use is limited to providing a timely guide to current behaviour in the economy.



14. I have been urged by some to revert to the setting of a target for broad money, the principle aggregate being M4. Although I believe M4 and its components and counterparts, such as lending by banks and building societies, contain important information on monetary conditions, experience indicates that the relationship between these aggregates and either money GDP or future inflation is not close enough to justify establishing M4 as a formal target, in the sense that movements outside the target range would themselves be sufficient to justify changes in interest rates.

15. Nevertheless in taking the behaviour of M4 into account I think it would be helpful to give some idea of the values for the growth of M4 beyond which there would be increasing cause for concern. These might be termed monitoring ranges. I will return to this in the Autumn Statement.

16. There are advocates of composite or Divisia indices which attempt to weight different types of deposit according to their ease of use in transactions. I think it is premature to give such indices a formal place in the system of monetary assessment, but the Bank and Treasury will be undertaking further work on the way such indices are calculated and the predictive properties claimed for them.

17. There are other useful indicators of inflationary expectations which can be derived from various market rates of interest and the relationships between them; and from the behaviour of asset prices, particularly house prices. I propose to monitor all of these, paying particular attention to periods when house prices are falling or accelerating sharply.

Fiscal policy

18. If industry is to be able to take advantage of the opportunities which the lower exchange rate has now presented, it will be essential to keep tight control over public spending and borrowing. As part of this, the Government will be seeking to maintain firm downward pressure on the growth of public sector pay. This will also ensure that the public sector matches industry's efforts to contain its own wage costs and so hang on to the improved competitiveness.

19. In July the Government set itself demanding objectives for public spending. Discussions are now going on about how to allocate the available resources, consistent with the Government's long term priorities. I will announce the outcome in the Autumn Statement.



Explaining policy

20. I have indicated that the Treasury and Bank will continue to conduct regular assessments of monetary conditions, looking at the forecasts of inflation and the messages from the various indicators I have mentioned above. It will be important to explain clearly to Parliament and the markets how we assess the progress being made towards the Government's inflation objectives.

21. I will be happy to discuss these issues with the Committee on 12 October.

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