Britain's money supply experiment, 1971-73

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Abstract: This article challenges the claim that monetary policy neglect was responsible for the unprecedented UK inflation of the 1970s. It departs from the historiography by showing the Bank of England following money supply objectives from 1971, two years earlier than is currently acknowledged and five years before Denis Healey first published a money supply target.[1] After missing its monetary objectives in 1972-73, the Bank concluded that tight control of the money supply was impracticable in the UK. Conservative policymakers drew the opposite conclusion, that only tighter control of the money supply would cure Britain of its economic ills. This failure to heed the lessons of 1970s monetary policy would have profound consequences for the British economy in the early 1980s and beyond.

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[1] For an alternative approach, please see F.H. Capie, *The Bank of England: 1950s to 1979*, (New York, 2010).

In September 1980 Bank of England Director John Fforde was summoned to Downing Street to explain why the money supply had overshot the government's published target.[2] There he was subjected to a Prime Ministerial lecture on the importance of controlling of the money supply in the fight against inflation, then running at sixteen percent.[3] Following Milton Friedman's dictum that 'inflation is always and everywhere a monetary phenomenon', Ministers had recently launched the Medium Term Financial Strategy (MTFS), placing a four-year series of target ranges for broad money (£M3) at the heart of economic policy.[4] While £M3 targets remained in place until 1987, Ministers had, by then, successively downgraded their importance. Inflation did eventually fall to four percent by the time of the 1983 election. However, this came at a heavy cost. The recession of 1980-1 was the worst in the UK since the 1920s.[5] With nominal interest rates at seventeen percent, the soaring pound priced exports out of global markets, making Britain a net importer of manufactured goods for the first time since the Industrial Revolution, and pushing unemployment above three million for the first time since the 1930s.[6]

Fforde was an ironic choice for a lecture on the importance of controlling £M3. In 1971, he had designed a previous failed attempt to control the money supply, Competition and Credit Control ('CCC' or 'the *New Approach'*) – 'the biggest change in monetary policy since the Second World War'.[7] Since the war, the authorities had sought to control the largest counterpart of the broad money supply (M3), bank lending to the private sector, with a raft of quantitative and qualitative controls.[8] The

[2] Fforde and the future Governor, Eddie George, were summoned as both the Governor and the Deputy Governor were overseas on business. Mrs Thatcher set the tone by asking 'who are these people?' W.J.G. Keegan, *Mrs Thatcher's economic experiment*, (Harmondsworth, 1984), p. 153.
[3] Lankester to Wiggins, 9 September 1980, London, The National Archives (hereafter 'TNA'), PREM 19/178.
[4] M. Friedman, *The counter-revolution in monetary theory*, (London, 1970), p. 24. £M3 comprises currency in circulation with the public and the sterling deposits of UK residents.
[5] In this article '1980-1' means the two calendar years 1980 and 1981. '1980/1' means the financial year ended 31 March 1981.
[6] Real interest rates were negative in 1980-81. However, with declining inflationary expectations, capital flows were largely driven by forward rates which are calculated from nominal rather than real interest differentials.
[7] Capie, 2010, p. 427.
[8] M3 comprises currency in circulation with the public (excluding cash in banks' vaults but including non UK residents' currency holdings) and (sterling and foreign currency) deposits of UK (public and private) residents with UK banks. Following the 'credit counterparts' approach, M3 can also be defined as the Public Sector Borrowing Requirement, less gilt sales to the non-banks, plus bank lending to the private sector plus flows from abroad.

New Approach swept all of these away. Henceforth, bank lending would be controlled on the basis of cost i.e. through interest rates. Loans would be granted to those companies and individuals that could pay the highest rate, rather than to those that fulfilled the authorities' qualitative criteria within the overall quantitative restrictions previously imposed on the banks. By allocating bank credit solely on the basis of cost, CCC replaced years of credit rationing 'by control'. Out went the restrictions on lending to less-favoured sectors and ceilings on bank advances that had been a feature of British banking for much of the post-war era. In came the 'interest rate weapon' - more active use of Bank Rate to control the demand-for-money.

In the recent official history of the Bank of England (the 'Bank'), Forrest Capie identifies three strands behind CCC: dissatisfaction with lending controls; a desire for more competition within banking; and a renewed emphasis on controlling monetary growth. He prioritises the first two, arguing that:

> it was 1976 when something drastic needed to be done and International Monetary Fund (IMF) financing was needed and the knowledge that this time the IMF would demand determined action on containing monetary growth before serious attention to monetary targets took place[9]

This article agrees that the catalyst for reform was Bank frustration with controls and its preference for a more competitive banking system. However, these were longstanding concerns that had already generated a number of unsuccessful proposals for monetary reform.[10] In 1971, the Bank believed it had identified a stable demand-for-money function in the UK and that it could control monetary growth by manipulating interest rates. This gave officials the intellectual confidence to sweep away the post-war system of controls and focus on the money supply instead. This was clearly acknowledged at the time by officials, practitioners and academics. The Governor announced in 1972 that, 'I accept, as most central bankers would, that control of the money supply is my principal, if not my most important, concern'.[11] The influential City analyst, Gordon Pepper of W. Greenwell & Co., informed his clients at the launch of CCC that 'the main emphasis will be placed on attempting to

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[9] Capie, 2010, p. 645.

[10] For example: *Methods of Credit Control,* London, TNA, T326/1063 and *Restraint on Bank and Finance House Lending,* London, Bank of England Archive, (hereafter, 'BOE'), 3A8/8.

[11] Quoted in G.T. Pepper, 'Investment Analysts Meeting on Thursday, 25th January. Gilt-edged: the future outlook', 1972, Cambridge, Churchill Archives Centre (hereafter 'Churchill'), Churchill College, THCRAS 3/17.

control the domestic money supply'.[12] And, as Brian Griffiths, one of the leading British monetarists of the day, pointed out: 'the intention of the new system is to move away from control of bank lending to control of one of "the broader monetary aggregates"'.[13] After outlining the transition towards M3 objectives before 1971, this article analyses the normative consequences of the *New Approach* for three of the four monetary policy instruments identified by Thomas Saving in 1967: the discount rate; bank reserves; and operations in the government debt markets.[14]

This early experiment was not a success. The unpublished M3 objective for 1972/3 was twenty percent. The outturn was thirty-one percent. By the time CCC was *de facto* abandoned in December 1973, M3 had grown by seventy-two percent. Two years later, inflation hit a record twenty-seven percent, apparently vindicating Friedman's claim that excess monetary growth led inexorably to higher prices after a long and variable lag. The Thatcher government, far more committed to (by then published) targets, experienced similar difficulty in hitting its monetary objectives. The target range for £M3 in 1980/1 was 7-11 percent; the outturn was eighteen percent. Treasury Ministers invoked Goodhart's Law, which states that 'any monetary aggregate ceases to be reliable the moment it becomes a target for policy purposes'.[15] But Goodhart's Law was not new in the 1980s. It was first outlined in 1975 in response to the authorities' failure to hit their money supply objectives between 1971 and 1973.[16] Conservative policymakers, Bank officials and Treasury civil servants drew very different lessons from the failure of the 1971-73 money supply experiment. This would have profound consequences for the British economy in the early 1980s and beyond.

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[12] G.T. Pepper, 'The gilt-edged market and the Bank of England's proposals', June 1971, Churchill, THCRAS 3/17.

[13] B. Griffiths, 'Resource Efficiency, Monetary Policy and the Reform of the U.K. Banking System', *Journal of Money, Credit and Banking*, vol. 5, no. 1, part 1 (Feb., 1973), p. 72.

[14] T.R. Saving, 'Monetary-policy targets and indicators', *Journal of Political Economy*, vol. 76, (1967), pp. 446-56. Saving's fourth instrument is the monetary base or 'high-powered money' comprising currency outstanding with the public, UK banks' till money and UK banks' deposits with the Bank of England. The Bank rejected monetary base control (MBC) after extensive analysis in 1977. MBC did not inform policy in 1971-3.

[15] N. Lawson, *The view from No. 11: memoirs of a Tory radical*, (London, 1992), p. 646.

[16] C.A.E. Goodhart, *Monetary theory and practice*, (London, 1984), p. 96.

British monetary policy in the decade before CCC was principally guided by the findings of the 1959 Radcliffe Report. The Report downplayed the importance of monetary policy: 'monetary measures cannot alone be relied upon to keep in nice balance an economy subject to major strains from both without and within. Monetary measures can help, but that is all.'[17] While the monetarist revival is often identified with Friedman's restatement of the quantity theory as a demand-for-money function in 1956, it took the intervention of the International Monetary Fund (IMF) for the UK authorities to pay serious attention to the notion that monetary policy had anything but a subordinate role to play.[17] Initially, this took the form of quantitative ceilings on bank lending to the private sector. The Radcliffe Report warned that ceilings were inimical to a competitive banking system.[18] Yet, ceilings were in place for most of the 1960s. This is because, with sterling fixed under the Bretton Woods regime, attempts to run the economy at full employment led to a succession of balance-of-payments crises as imports increased and exports were diverted to the domestic market. With a chronic shortage of foreign currency reserves in the 1960s, balance-of-payments deficits often meant recourse to the IMF. The $1.5 billion loan granted to the Macmillan government in August 1961, then the largest in the Fund's history, came after an 'IMF-friendly' statement by the Chancellor which included a request to the banks 'that all possible room should be left for the finance vitally needed for exports and productive industry'.[19] Stand-by facilities were renewed unconditionally in 1963 and 1964, although in the latter case, the Fund expressed its concerns about UK inflation.[20] The shift in emphasis came after IMF loans to the incoming Labour government of $1 billion in November 1964 and $1.4 billion in May 1965. This second loan was granted only after the Chancellor, James Callaghan, agreed to the Fund's request that sterling bank advances to the private sector over the next year be limited to 105 percent of the April 1965 total.[21] As the Treasury points out, 'the Government's undertakings to the IMF as a result of the extensive use of the Fund's

[17] *Committee on the workings of the monetary system,* (Radcliffe), Cmnd 827, (HMSO, 1959), para. 514.
[17] M. Friedman, 'The quantity theory of money: a restatement', in M. Friedman *et al* (eds.) *Studies in the quantity theory of money*, (Chicago, 1956).
[18] Radcliffe, 1959, para. 527.
[19] Hansard, HC Deb 25 July 1961, vol. 645, col. 227.
[20] B. Clift and J. D. Tomlinson, 'Negotiating credibility: Britain and the International Monetary Fund, 1956–1976', *Contemporary European History*, vol. 17, (2008), p. 554.
[21] *Treasury historical memorandum on the operation of monetary policy,* TNA, T267, p. 5.

resources during this period' meant 'greater attention was paid to money supply and to domestic credit creation'.[22] Devaluation in November 1967 was accompanied by a request for a further $1.4 billion stand-by arrangement. Callaghan agreed to limit the government's borrowing requirement to £1 billion in 1968/9 and acknowledged 'the expectation at present that bank credit expansion will be sufficiently limited to ensure that the growth of the money supply will be less in 1968 than the present estimate for 1967'.[23] Accordingly, the banks were asked to maintain lending at the mid-November 1967 level. This was the first time that a lending ceiling had been publicly linked to IMF assistance because of the stigma attached to having policy imposed by outside agency.

British officials were uneasy with the increased emphasis on monetary policy, and particularly with the IMF's preferred aggregate, Domestic Credit Expansion (DCE), which adjusted £M3 for official financing of the balance of payments. Addressing their concerns, the outgoing Permanent Secretary to the Treasury, Sir William Armstrong, organised a conference of IMF, Bank, Treasury, and Statistical Office officials in October 1968. Harold James argues that this conference, along with the adoption of a DCE ceiling seven months later, marked the 'beginnings of an intellectual conversion' within the Treasury.[24] The first public sign was a Treasury article in May 1969 which carefully avoided the suggestion that DCE was anything other than a British initiative. [25] As Charles Goodhart explains:

> to protect British *amour propre* there had to be some pretence that we, in the UK, had thought up this wonderful new wheeze, rather than had it foisted upon us, out of weakness, by the IMF.[26]

The Radcliffe Report had stressed that the demand-for-money was unstable since its analogue, the velocity of circulation, was potentially infinite.[27] However, DCE rested on the assumption, shared with the monetarists, of a stable and predictable demand-for-money function. In order to test this assumption, the Bank set

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[22] ibid.
[23] 'Letter of Intent', 23 November 1967, TNA, T326/730.
[24] H. James, *International monetary co-operation since Bretton Woods*, (Oxford, 1995), p. 191.
[25] 'Money supply and domestic credit: some recent developments in monetary analysis', *Economic Trends*, May 1969, p. xxiv.
[26] C.A.E. Goodhart, 'A central bank economist', in P. Mizen (ed.), *Central banking, monetary theory and practice*, (Cheltenham, 2003), p. 25.
[27] Radcliffe, 1959, para. 391.

up the Money Supply Group in December 1968 to investigate the UK experience. The Group formulated some rudimentary demand-for-money equations from the M3 data collected since 1963, and concluded that that 'the income velocity of money is reasonably stable and predictable, but not absolutely so'.[28] The Group further concluded that 'in the United Kingdom, movements in the money stock have preceded movements in money incomes' and that 'in the absence of evidence to the contrary, a consistent lead is *prima facie* indication of causation'.[29] Combined with the evidence that higher interest rates could contain monetary growth, either by restraining bank lending or by encouraging higher gilt sales, this was a powerful rejection of the Radcliffian approach. As Goodhart, the main author of the Group's report, points out, it also provided the intellectual justification for Competition and Credit Control:

> The main conclusions of this were that the chief intermediate objectives of monetary policy should be the rates of growth of the monetary aggregates, i.e. the money stock, in one or other of its various definitions, or DCE (and not particular components of these, such as bank lending to the private sector).[30]

The discovery of a relatively stable demand-for-money function in the UK came at an opportune moment. With the balance of payments taking an inexorably long time to recover after devaluation and an IMF delegation due in November 1968, the lending ceiling imposed on the banks was dropped to ninety-eight percent of mid-November 1967 advances. The clearing banks spent most of 1969 above this ceiling, prompting officials to set up the Working Group on Control of Bank Credit in November 1969. A month later this became the Monetary Policy Group (MPG), which, under the chairmanship of the new Permanent Secretary, Sir Douglas Allen, continued to examine alternatives to ceiling controls. In March 1970, the Group advised the Chancellor, Roy Jenkins, that 'the current ceiling controls, which continue to relate to the level of lending in November 1967, have been tacitly abandoned'.[31] Accordingly, in his 1970 Budget, Jenkins replaced formal ceilings with 'guidance' amounting to 105 percent of the March 1970 level for the clearing banks. After the Budget, the prospect of an imminent General Election put further policy change on

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[28] 'The importance of money', BOE, 17 February 1970, 6A151/1.
[29] ibid.
[30] Goodhart, 1984, p. 96.
[31] 'Interim report on controlling bank lending to the private sector', 25 March 1970, TNA, T326/1065.

hold. Therefore, Allen set the Group the more abstruse task of investigating the latest developments in monetary theory. In May 1970, members considered the Bank's work on the demand-for-money. Goodhart's paper, *The Importance of Money,* was given a sympathetic hearing, with the Treasury briefing noting that 'a stable demand function seems well established'.[32] The influence of *The Importance of Money* can be seen in the MPG's final report of January 1971:

> a monetary policy directed towards the establishment of some selected growth for the money supply seems to offer a more effective option than a policy designed to maintain a particular structure of nominal interest rates.[33]

In 1971, senior Treasury officials, concerned about a rapid increase in bank lending during the transition away from ceiling controls, were wary of implementing these recommendations. Therefore the Bank decided upon a direct Ministerial approach. A proposal to replace ceiling controls with more active use of the 'interest rate weapon' was drawn up within the Bank and presented to the Chancellor, Anthony Barber, at a private dinner in January 1971.[34] Having shied away from the less radical recommendations of the MPG, the Permanent Secretary was understandably discomfited when Barber declared himself in sympathy with the Bank's proposal 'before we had had time to study it at official level'.[35] However, Allen soon recovered his poise. Having examined the various alternatives, often in tandem with Bank officials within the MPG, he had reached similar conclusions about the practical difficulties of continuing with ceiling controls.

The Bank's proposal rested squarely on a money supply objective, derived from the demand-for-money equations first outlined in *The Importance of Money*. Allen recognised this, opening the meeting to consider the proposal in February 1971 by declaring that 'it should be assumed that it was still desired to have a numerical target for the monetary aggregates'.[36] At that stage, the Bank's demand-for-money equations indicated that M3 would have to increase by 11-12 percent in 1971/2 to accommodate the Heath government's growth objectives.[37] Accordingly, Barber

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[32] 'Monetary policy group: meeting of 13 May', TNA, T326/1256.
[33] 'Report of the Group on Monetary Policy', TNA, T338/39.
[34] M.I. Reid, *The Secondary Banking Crisis, 1973-5: its causes and course.* (London, 1982), p. 31.
[35] Private communication with Lord Croham (formerly Sir Douglas Allen), 19 October 2009.
[36] Minutes of the meeting to discuss *A New Approach*', 18 February 1971, TNA, T326/1261.
[37] 'Monetary policy in 1971-72', 17 March 1971, TNA, T338/39.

announced in his March 1971 Budget that 'there would be dangers for liquidity and employment if we sought immediately to reduce the growth of money supply to much below 3 per cent per quarter'.[38] Financial journalists simply multiplied this quarterly 'guideline' by four and assumed that the Government was now working with an annual twelve percent M3 objective.[39] Their suspicions were confirmed two months later when the Bank announced an immediate change to the operation of the gilt market. Since the early 1960s, the Bank had 'leant into the wind', standing ready to buy (or sell) gilts of any maturity, ostensibly to increase their marketability by reducing price volatility. In May 1971, alongside the launch of the consultations for CCC, the Bank announced that the Government Broker would, with immediate effect, guarantee liquidity only in government securities of less than a year's maturity.[40] This came after criticism, not least from the IMF, that the Bank had failed to control the money supply during a period requiring austerity in 1968 by continuing to purchase large amounts of gilts in its attempts to smooth the market.[41] This was seized upon by the press:

> the new gilt-edged policy is the logical culmination of a process which began in the autumn of 1968, when the International Monetary Fund and independent critics began to place increasing emphasis on the money supply as a weapon of economic policy rather than on the level of interest rates, which had previously been the touchstone of the Bank of England's operations in the gilt-edged market.[42]

This was confirmed two days later when the Governor announced that 'we have increasingly shifted our emphasis towards the broader monetary aggregates – to use the inelegant but apparently unavoidable term, the money supply'.[43]

After four months of consultations with the banks, CCC became fully operational in September 1971. Quantitative ceilings were removed after several years of often-painful operation, the decades-old banking cartels were dissolved, and the liquidity ratio observed by the clearing banks since 1961 was replaced by a wider-

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[38] Hansard, HC Deb 30 March 1971, vol. 814, col. 1374.
[39] 'Money and wages', *Daily Telegraph*, 15 April 1971.
[40] The government broker, Mullens & Co., continued to provide a 'safety net' to the gilt market, committing to buy 'small amounts at specified limits at very penal prices' in a confidential arrangement with the two largest dealers, 'Page to Painter', 20 April 1971, TNA, T326/1261.
[41] 'Monetary seminar (International Monetary Fund): note of proceedings on third day of seminar', 18 October 1968, TNA, T326/875.
[42] 'Simpler plan to control the money supply', *Times*, 15 May 1971.
[43] Bank of England Quarterly Bulletin, (*BEQB)*, 11, 1971, pp. 195-98.

ranging reserve asset ratio.[44] Within the Treasury, the next practical consideration was the construction of the autumn 1971 financial forecasts. Before CCC, the Bank had framed a set of interest rate assumptions which were incorporated into both the financial forecasts and the thrice-yearly National Income Forecasts. The Treasury outlined the implications of following a money supply objective:

> following the 'New Approach' it was decided to define the 'thrust' of monetary policy in terms of an assumed growth in money supply, instead of an assumed level of interest rates. This is conceptually a better approach, since it enables changes in the forecast of national income to be reflected in interest rates rather than silently being accommodated by an increase in money supply.[45]

At this stage, sterling was still within the Bretton Woods system of fixed exchange rates. This leads Susan Howson to conclude that monetary targets 'could not seriously be adopted until the government had given up the commitment to the fixed exchange rate' in June 1972.[46] However, as Tew points out, the return to balance of payments surplus in 1971 was an important factor in the timing of the *New Approach* since, with less strain on the reserves, the authorities could increasingly direct monetary policy towards the domestic economy.[47] Nonetheless, Treasury economists were keenly aware of the constraints placed upon monetary policy by the exchange rate:

> if we want to hold the exchange rate around a certain level and keep the inflow of funds from abroad within certain limits, we have already in effect determined monetary policy. We cannot have targets for the exchange rate, the reserve inflow and the money supply. We can choose any two of these; and the third then falls out as the residual.[48]

Having successfully sterilised a large capital inflow with gilt sales in 1971, and anticipating continued balance of payments surpluses, officials decided to allow the currency reserves to fall out of the forecast as the residual.[49] They then had to decide

[44] The new ratio equated to 22% of the old ratio, 6% less than the previous statutory minimum. To soak up the liquidity released, £750 million of new gilts were pressed on to the banks in September 1971, Capie, 2010, p. 507.
[45] 'Financial forecasts 1971/72 and 1972/73', 9 December 1971, TNA, T338/68.
[46] S. Howson, 'Money and monetary policy in Britain, 1945-1990', in R. Floud and D. McCloskey (eds.), *The economic history of Britain since 1700*, (Cambridge, 1994), p. 157.
[47] J.H.B. Tew, 'Monetary Policy: part I', in F.T. Blackaby *et al*., *British economic policy, 1960-75*, (Cambridge, 1978), p. 239. Former Treasury official Peter Browning makes the same point, P. Browning, *The Treasury and economic policy*, (London, 1986), p. 276.
[48] 'Financial forecasts', Cassell, 17 September 1971, TNA, T338/68.
[49] ibid. This was entirely consistent with the credit counterparts approach to monetary control, with the reserves fulfilling the role of 'flows from abroad'.

what the money supply objective should be. Since the 1971 Budget represented the last Ministerial pronouncement on monetary policy, the forecasters chose to 'take at face value the government's pronouncements' and fall back on the three percent quarterly 'guideline' derived from the demand-for-money equations and announced by Barber in March.[50] There was some unease amongst Treasury officials at the emphasis being placed on the Bank's equations:

> to derive the implications for interest rates we had in the course of the forecast to place much more reliance than many of us would have wished on a reversed form of the Bank's demand-for-money equations.[51]

The Bank published these equations in its March 1972 *Quarterly Bulletin*. The accompanying article stated that the equations 'provide a sufficiently accurate statistical explanation of past movements in the stock of money to be a useful guide for monetary policy'.[52] This hypothesis would be tested immediately by the 'dash for growth'.

II

The Conservatives outlined the philosophy behind the dash for growth before the 1970 election:

> slow growth is both a cause and consequence of our problems. It is slow growth which both erodes the incentive to invest and makes it difficult for us to afford the level of investment needed for the future…The objective of tax reform and of our economic policy as a whole is to create conditions for a faster growth of national income as a whole in which everyone can share.[53]

However, the real impetus came in late 1971 when the measures already taken to combat the three-fold problems of inflation, industrial unrest and rising unemployment appeared to be having little effect. At a meeting of Cabinet Ministers, senior civil servants, and businessmen in December 1971, the Prime Minister, Ted Heath, warmed to Sir William Armstrong's suggestion that 'we should think big, and try to build up our industry onto a Japanese scale…We should ask companies what

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[50] 'Monetary assumption', Riley, 1 October 1971, TNA, T338/68.
[51] 'Financial forecasts', Cassell, 26 November 1971, TNA, T338/68.
[52] BEQB, 1972, p. 43.
[53] 'Return to prosperity', January 1970, Oxford, Conservative Party Archive (hereafter 'CPA'), CRD 3/7/7/5.

they needed in the way of financial and other help, and give it to them'.[54] As the financier Jim Slater pointed out at the meeting, what companies wanted was lower interest rates.[55] Heath responded by asking the Treasury how they might engineer a drop in long-term rates.[56] While accepting officials' advice that an administered reduction would threaten the three percent per quarter M3 growth guideline announced in the Budget, the Prime Minister's instincts were clearly for lower rates.[57] This created a problem. The 1972 Budget raised the estimated Public Sector Borrowing Requirement (PSBR) for 1972/3 to a record £3.35 billion.[58] This would require unprecedented gilt sales to ensure that there was no additional monetary stimulus to the economy. The Bank estimated that long-term rates would have to rise by 1.5 percent to induce the public to take up the additional gilts, taking them through the politically sensitive ten-percent level.[59] The alternative was to fund the PSBR by selling more Treasury Bills to the banks. Treasury Bills were a reserve asset and this would increase the banks' lending capacity and therefore the money supply. Heath's refusal to allow higher long-term rates would mean an estimated £700 million of additional Treasury Bill issuance in 1972/3. This could take M3 growth to an unprecedented twenty percent.[60] Nervous officials tried to build in some future interest rate flexibility by imposing a money supply objective on the government:

> we believe that the right course is to adopt a quantitative (but unpublished) target for money supply, and not to feel that we must at all costs hold to a certain level of interest rates…At the moment, given the present prospects for prices and the intention for output set out in the Budget, the appropriate target for money supply would be a rise of 20% in 1972/73.[61]

Allen wrote to Barber on 21 March (the day of the 1972 Budget):

> we recommend the adoption of a quantitative (but unpublished) target for money supply, which in the light of present forecasts and objectives we would put as a rise of 20 percent in 1972/3.[62]

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54 E.E. Dell, *The chancellors: a history of the chancellors of the Exchequer,* 1945-90, (London, 1997), p. 384.
55 'Note of discussions at Chequers on Saturday 4 December 1971', TNA, T326/1254.
56 'Draft minute from Chancellor to Prime Minister', January 1972, TNA, T362/1562.
57 'Reducing long-term interest rates', January 1972, TNA, T362/1562.
58 'Post-Budget monetary forecast 1972/73', Cassell, 15 March 1972, TNA, T326/1562.
59 ibid.
60 'Monetary policy - post-Budget, Cassell, 20 March 1972, TNA, T326/1562.
61 ibid.
62 'Allen to Barber', 21 March 1972, TNA, T326/1562.

Barber declared himself 'content with the proposed policy towards the gilt-edged market over the next few weeks, and with the target of a 20 per cent rise in the money supply in 1972-73'.[63] This was confirmed a month later:

> Numerical targets for money supply were not given in the Budget speech. But the Chancellor has accepted our advice that for the present policy should be directed to a target rate of growth of money supply of 20% in the financial year 1972-73, 20% being the growth which the Bank of England's demand-for-money equations suggest will be required, given the outlook for real output and prices, if there is to be no significant rise in interest rates from their present levels.[64]

David Smith suggests that once the IMF was repaid and the DCE ceiling abandoned in 1971, 'no alternative monetary targets appeared in its place'.[65] He argues that 'had there been monetary targets in the following two years, it is difficult to believe that they could have been set so generously as to accommodate what happened'.[66] What happened was twenty-seven percent M3 growth in 1972, twenty-eight percent the year after and record inflation in 1975. The money supply, released from quantitative controls under CCC, began immediately to depart from the Bank's estimates. This was partly because of 'reintermediation' – lending that had been pushed out to the 'fringe' banks by quantitative controls on the 'banks proper' returned to be counted in the statistics. It was partly because of the changing relative returns on different financial instruments. The pre-1971 clearing bank cartel held relative returns on different assets fairly constant by maintaining a fixed tariff of lending rates to different sectors of the economy. With the abolition of the cartel, Bank officials anticipated that higher rates would prompt the banks to bid more aggressively for deposits, leaving margins fairly stable. They did not anticipate that banks, competing for market share, would allow their lending rates to become 'sticky' while bidding aggressively for funds in the growing wholesale markets. This provided customers with the opportunity to earn low-risk profits by drawing down overdrafts at pre-agreed (lower) rates, and immediately placing the money in the wholesale market at current (higher) rates, a process known as the 'merry-go-round'. Given the rudimentary state of banking statistics, it was difficult for the authorities to calculate how much M3 growth was due to 'reintermediation', how much was generated by the

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[63] 'Bailey to Maugham', 23 March 1972, TNA, T326/1562.
[64] 'Monetary policy', 26 April 1972, TNA, T326/1562.
[65] D. Smith, *The rise and fall of monetarism*, (Harmondsworth, 1987), p. 41.
[66] ibid.

'merry-go-round' and how much was driven by increased investment. Be that as it may, the money supply overshot its objective by eleven percent in 1972/3. Given the overshoot, it is legitimate to ask how far the authorities were committed to an objective which was communicated to only a small group of senior officials and Ministers (including the Prime Minister). Capie suggests that Bank officials were unfamiliar with Thomas Saving's lexicon of monetary instruments, indicators, and targets.[67] In the next section, we employ Saving's lexicon to show just how far the M3 objectives imposed after March 1972 did have normative connotations for operations on the following monetary policy instruments: the discount rate; bank reserves; and gilt sales to the non-bank private sector.

III

Having reconfigured the financial forecasts to reflect a 12 percent M3 objective in November 1971, and pressed a twenty-percent growth objective for M3 on the Chancellor in March 1972, the Treasury then convened a series of meetings to coincide with the release of the monthly money supply figures. The first of these took place in May 1972 and featured the same group of Bank and Treasury officials that had met since 1969, either under the auspices of the MPG, or to negotiate the details of CCC in 1971. The architect of the *New Approach*, John Fforde, opened the meeting by noting that 'money supply continued to rise at an annual rate of at least 20%, with bank lending to the private sector the dominant expansionary factor'.[68] With a consensus in favour of tighter monetary policy, Allen advised Barber that:

> in previous submissions to the Chancellor it has been emphasised that it may be necessary for interest rates to rise if we are to hold the growth of money supply to 20% whether through restraint on the demand for credit or through sales of public sector debt outside the banking system.[69]

However, despite M3 growth immediately overshooting the objective, Ministers continued to rule out rate rises. They were concerned that a rise in Bank Rate, coming just three months after the launch of the dash for growth might be construed as a return to the 'stop-go' policies of the 1960s.[70] On 16 June 1972, the Governor and the Permanent Secretary visited the Prime Minister to press for a one-percentage point rise

[67] Capie, 2010, p. 704.
[68] 'Monthly meeting on monetary policy', 19 May 1972, TNA, T326/1563.
[69] 'Monetary policy', Fogarty, 24 May 1972, TNA, T326/1563.
[70] 'Armstrong to Bailey', 12 June 1972, TNA, T326/1563.

in Bank Rate to be announced five days later, alongside the latest money supply figures which would show annualised M3 growth of twenty-three percent. Heath prevaricated, acknowledging that annualised money supply growth of 23 percent was above the 20 percent 'envisaged at the time of the Budget' while, at the same time, arguing that 'an increase in bank rate at this point in time would seem to public opinion to be a contradiction of the Government's policies for encouraging a high rate of economic growth'.[71] In the event, rates were raised on 22 June against the backdrop of the sterling crisis that saw the pound ejected from the European currency 'snake'.[72] The Treasury explained:

> The Chancellor saw the Prime Minister and, not without some argumentation, convinced him that Bank Rate should be raised to 6 per cent on the following day. The primary purpose was to curb the rate of increase in the money supply and so damp down inflationary pressures. The fact that the higher rate would help to remedy the weakness of sterling was a secondary consideration – almost an afterthought.[73]

Lest there should be any doubt, the Bank explained the hike in the September 1972 Quarterly Bulletin:

> The move was seen as consistent with the official monetary policy objective of restraining the growth in money stock – which was currently very rapid – to a rate that was adequate, but not excessive, to finance a 5% annual rate of expansion in real output expected at the time of the Budget.[74]

Early indications showed record monthly M3 growth of 3.5 percent in June 1972. Barber was advised that with the pound now floating 'the importance of external confidence in the new situation adds weight to the already strong domestic arguments for holding down the expansion of money supply during 1972/3 to a maximum of 20%'.[75] In a strongly worded memo, officials warned that the current rate of M3 growth was 'without precedent', and that it would add to 'inflationary psychosis'.[76] Once again, political considerations prevailed. The government's strategy of tackling wage inflation by pressing down on successive public sector pay settlements ('N minus 1') was in disarray after an independent tribunal recommended

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[71] 'Armstrong to Bailey', 16 June 1972, TNA, T326/1563.
[72] The European currency 'snake' was established in April 1972 to enhance currency stability by allowing just 2.25% variation between the major European currencies.
[73] *Treasury historical memorandum,* p. 55.
[74] BEQB, 12, 1972, p.
[75] 'Monetary policy', Hawtin, 11 July 1972, TNA, T326/1564.
[76] 'The pros and cons of acting now to slow down money supply', Cassell, TNA, T326/1564.

a thirty-percent pay rise for the miners. Having ruled out a statutory incomes policy in its 1970 manifesto, the government spent the remainder of 1972 engaged in 'tripartite' talks with the Trades Union Congress (TUC) and Confederation of British Industry (CBI). Negotiations were at a delicate stage with a national strike planned for 26 July. Anticipating that Heath would rule out further rate rises, Treasury officials presented the Chancellor with a range of alternatives. Their concern was evident since, just ten months after the abolition of controls, they were prepared to countenance qualitative lending guidance to the banks, and even the re-imposition of lending ceilings. On 31 July, Heath expressed 'the hope that the fullest attention was being given to the money supply problem and to action that might help it, without involving an increase in Bank Rate'.[77] With higher rates still ruled out, the Governor was forced to issue the banks with the first qualitative lending guidance under the *New Approach* on 8 August.[78]

Ministers continued to reject Bank and Treasury recommendations for higher rates in the third quarter of 1972 because the figure of seven-percent Bank Rate was associated, in Conservative minds, with the 'Labour' crises of November 1964, July 1966, and devaluation in November 1967.[79] In order to defuse the political significance of Bank Rate, the authorities replaced it with the more flexible Minimum Lending Rate (MLR) in October 1972.[80] John Page, the Chief Cashier, explained:

> we adopted the Minimum Lending Rate technique basically because it was better than having Bank Rate completely frozen by Ministers, not because we thought it was technically a superior arrangement.[81]

The new technique did allow for more flexibility with MLR rising from six percent in October 1972 to nine percent by year-end. This surprised even Gordon Pepper, who commented in his December Bulletin, 'The authorities' resolve to control the money supply appears to be stronger than we thought'.[82] He would have been even more

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[77] Note of the Governor's conversation with Sir Douglas Allen', 4 August 1972, BOE, 7A139/4.

[78] 'Letter from the Governor of the Bank of England to the Chairmen of the Banking Associations', 8 August 1972, TNA, T326/1564.

[79] 'Monetary policy: alternatives to Bank Rate', Cassell, 4 September 1972, TNA, T326/1565.

[80] MLR tied the discount rate to Treasury Bill rates then prevailing in the market, by taking the rate at the previous weekly tender, adding 50 basis points and then rounding up to the nearest 25 basis points.

[81] 'Monetary Policy', J.B. Page, April 1973, BOE, 6A50/8.

[82] *Greenwell's Monetary Bulletin*, No. 7, December 1972, p.1, Churchill, THCRAS 3/17.

surprised to learn how hard both the Bank and Treasury had been pushing for higher rates since late-May.

Underlying CCC was the premise that the broad money supply would be controlled with more active use of interest rates. As it became clear during 1972 that Heath would not grant officials the interest rate flexibility they felt was needed, they shifted their emphasis towards other monetary policy tools. We therefore turn to the second of Saving's instruments, bank reserves.

The *New Approach* introduced an industry-wide 12.5 percent reserve asset ratio. Publicly, the ratio was intended to be both a prudential reserve of 'near money' assets for banks to meet customer withdrawals, and, with a nod to the Radcliffe Report, a mechanism to control overall liquidity in the economy. Privately, the Bank was more pragmatic:

> the basic justification for this choice is that, of all the alternatives, it is the one that most closely approximates a ratio which the banks currently observe. It is, therefore, the one which the banks would themselves be most likely to agree to.[83]

The question of a fixed versus variable reserve asset ratio attracted a rare Prime Ministerial intervention during the planning stages of CCC. Heath expressed a preference for a variable ratio, while accepting that a fixed ratio supplemented by the system of variable special deposits in place since 1958 offered 'no great difference of principle'.[84] Since both the composition and the level of the reserve asset ratio remained fixed throughout, we use special deposits as a proxy for changing bank reserve requirements.

Special deposits were designed to rein in lending to the private sector by requiring the commercial banks to post a percentage of their gross advances at the Bank until the period requiring restraint was over. Since special deposits had to be paid in cash, the banks, when faced with a call, would tend to sell down non-reserve assets, principally gilts. Rising gilt yields would then increase the cost of borrowing throughout the economy. The banks resented the 'tax' implied by their receiving the Treasury Bill rate on special deposits held at the Bank, rather than the more lucrative commercial rates available in the market, so the Bank preferred simply to raise Bank Rate. However, Ministerial unwillingness to sanction higher interest rates after July

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[83] 'The choice of ratios in the "New Approach", Crockett, 22 January 1972, BOE, 3A8/10.
[84] 'Armstrong to Ryrie', 11 May 1971, TNA, T326/1262.

1972 forced officials to turn to special deposits as a second-best solution. At the August money supply meeting, annualised M3 growth of twenty-five percent was described as 'alarming'.[85] Since 'there was no disposition to think of an immediate increase in Bank Rate', Treasury officials seized upon the Bank's suggestion of a call for special deposits:

> the most direct means of influencing the lending resources available of the banks was by squeezing their reserve ratios through a call for special deposits, and there was a strong case for making a call to get the message across that the rate of growth of bank lending should be slowed down.[86]

However, the gilt market was still in fragile condition after the June currency crisis, and a call for special deposits might simply encourage further selling, forcing a politically unacceptable rise in Bank Rate to keep it in line with wholesale rates. Officials were unable to recommend a call for special deposits until the switch from Bank Rate to MLR in October 1972. On 11 October, the Chancellor was informed that:

> The Bank's current view is that if the provisional estimate of a 2.25% increase in money supply in banking September is confirmed, a call of 1% should be recommended.[87]

Once again, politics intervened. The talks with the TUC and CBI were ongoing, and while monetary officials were attempting to deal with the inflationary consequences of excessive monetary growth by recommending calls for special deposits, the government was edging toward a statutory prices and incomes policy. The situation was summarised by a Treasury official:

> a favourable outcome from the Chequers talks could lead to big sales of gilts: on the other hand, if it implies a much lower rate of inflation, our target for money supply will need to be well below 20%.[88]

The outcome, another prices and incomes policy, did not generate increased gilt sales. With annualised M3 growth still above 20 percent, Barber announced a one-percent call of special deposits on 9 November. The former Governor, Lord Cromer, by then Ambassador in Washington, was briefed that:

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[85] 'Monthly meeting on monetary policy', 18 August 1972, TNA, T326/1564.
[86] ibid.
[87] 'Special deposits', Downey, 11 October 1972, TNA, T326/1565.
[88] Group on monetary policy', Downey, 18 October 1972, TNA, T326/1565.

> the call for special deposits – which in essence is rather like a raising of the reserve ratio in the US – is intended to maintain the recent progress in reducing the growth of money supply. With the government facing a heavy borrowing requirement over the remaining weeks of this year, and with the government bond market still a little hesitant, there was a danger that the reserve base of the banks might be unduly increased. To prevent this, a call for special deposits has been made.[89]

This first call for special deposits under CCC was swiftly followed by a second, larger, call. Bank economists had reworked their equations, and advice to the Chancellor was now that 'policy should aim to bring about a slower growth (of M3), limiting the increase to not more than 15% per year'.[90] However, Barber was also trying to curb inflation with prices subsidies. This inflated the PSBR and, on prevailing policies, M3 would increase by eighteen percent. The Chancellor was therefore encouraged to 'over-call' special deposits in order to create the impression of 'resolute action' on the money supply.[91] He played to Heath's pro-European prejudices:

> in the absence of further restraining action money supply is likely to grow at a rate which would carry considerable dangers for the economy and for sterling – and which would expose us to increasing criticism from our European partners, many of whom have already taken resolute action to slow down the growth of money supply.[92]

Heath agreed to the largest special deposit call to date, two percent, in December 1972. It quickly became apparent that the authorities had overdone this call, as bank reserves fell below the new statutory minimum in early 1973. A swift re-release of special deposits would be politically embarrassing. The Government Broker explained:

> the obvious remedy is to pay back sufficient of the Special Deposits to set the position right and apologise for having made a mistake. However, the powers that be, particularly the political ones, will not hear of it and (Fforde) says they are being run by politics against their better judgement.[93]

Just as the interest rate weapon was blunted by political concerns during 1972, so the authorities were constrained in their ability to manipulate bank reserves through

89 'Telegram to Lord Cromer', 10 November 1972, TNA, T326/1566.
90 'The options', Cassell, 15 December 1972, TNA, T326/1567.
91 ibid.
92 'Monetary policy', Barber to Heath, 19 December 1972, TNA, T326/1567.
93 Memo, 9 February 1973', Gore-Booth, BOE, C132/15.

flexible use of special deposits in 1973. By the time of the third and final call for special deposits under CCC in November 1973, the Bank was increasingly relying upon open market operations to control the money supply. We therefore turn to the third of Saving's monetary instruments, operations in the gilt market.

Before CCC, the Bank had 'leant into the wind' in the gilt market both to ensure the continued marketability of government debt and to control interest rates. The Chief Cashier explained the rationale behind the partial withdrawal from the market in May 1971:

> some time before the reappraisal of monetary policy which led up to Competition and Credit Control had been completed, the conclusion had been reached that the Bank's operations in the gilt-edged market should pay more regard to their quantitative effects on the monetary aggregates and less regard to the behaviour of interest rates.[94]

The November 1971 financial forecast was the first to be predicated on a money supply objective. It started with the twelve-percent guideline for M3 implied in the March Budget, and finished with gilt sales to the public as the balancing item:

> the main residual in constructing this financial forecast is gilt-edged sales to non-bank investors. We have allowed bank lending to the private sector to be effectively demand-determined, and hence, given the public sector borrowing requirement and the external flow, the figures inserted for gilt edged (or more widely, sales of public sector debt as a whole) are simply those that would be required to keep money supply to its assumed growth rate.[95]

With the guideline still at twelve percent in January 1972, Barber was advised that:

> for 1972/73 net sales of about £1000m of public sector debt to non-banks would be required to keep the growth of money supply at 3% a quarter. If the borrowing requirement were increased this 'target' for debt sales would also be revised.[96]

The new twenty-percent objective in place after the 1972 Budget required the authorities to raise their target for gilt sales. In April 1972, the Chancellor was informed that 'gilt-edged sales of about £900 million would be required (out of total public sector debt sales of £1350) if money supply is to rise by 20%'.[97] This created an immediate problem. The Budget had fuelled inflationary expectations, and the gilt market was thoroughly demoralised:

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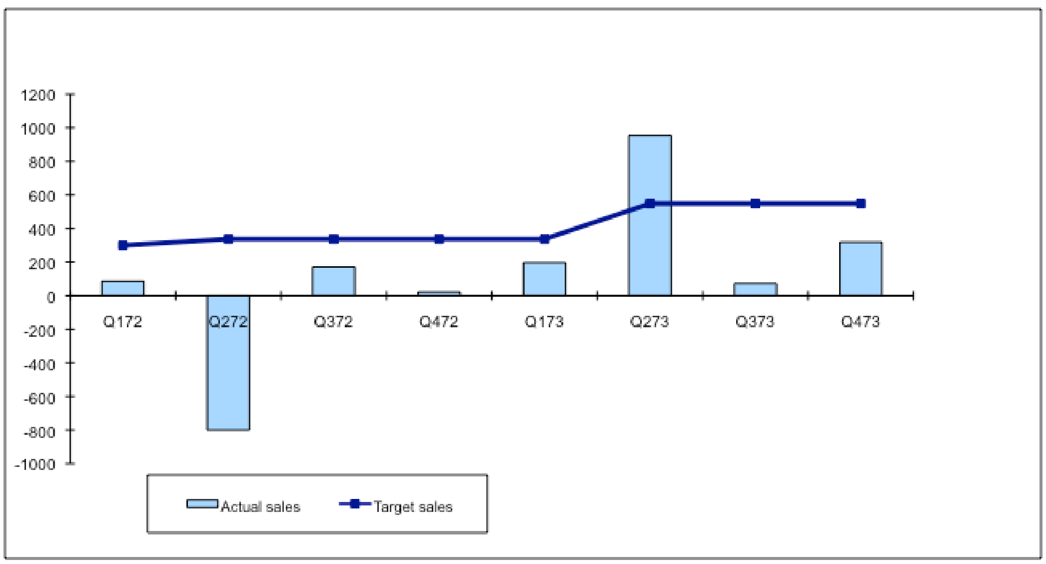
[94] BEQB, 1971, pp. 477-81.
[95] 'Financial forecasts', Cassell, 26 November 1971, T338/68.
[96] 'Financial forecasts and monetary policy', Cassell, 6 January 1972, TNA, T326/1562.
[97] 'Monetary policy, 1972/73', 26 April 1972, TNA, T426/1562.

we have made no significant sales since late January, and the process of buying in the next maturities has meant that on balance we have made substantial purchases of gilt edged. For the current quarter to date, we are now about £23 million down (whereas to fulfil our requirement for the year, we ought to set our sights on selling something like £200-£250 million in this quarter).[98]

The situation deteriorated with the June 1972 sterling crisis. The outflow of capital left the banks below the new 12.5 percent reserve requirement. The Bank arranged a sale-and-repurchase agreement, taking in £358 million of gilts in exchange for sufficient reserves to take the banks back over the ratio.[99] As Figure 1 shows, far from selling sufficient public sector debt to meet the twenty-percent M3 objective, the Bank was a net buyer of £800 million.

Figure 1. Net sales of public sector debt to the non-bank public (£ millions).



Source: *Financial Statistics* and Treasury financial forecasts. The data are for target and actual sales of *all* public sector debt.

The Bank was unwilling to meet its M3 objectives by pressing gilts onto a falling market. Dropping the price to encourage sales would mean higher rates which the Prime Minister had ruled out. In any event, the Chief Cashier did not believe that

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[98] 'Monetary policy', Cassell, 12 May 1972, TNA, T338/99.
[99] 'Monetary policy', Downey, 12 July 1972, TNA, T326/1564.

'there is a rate of interest determinable by the authorities in abstraction from the behaviour of the market at which investors will buy gilt-edged in large quantities'.[100] Page felt that substantial sales would come only after a successful conclusion to the tripartite talks on prices and incomes with the TUC and CBI. In addition, price volatility had increased since the partial withdrawal of the Government Broker, making gilts a less-attractive investment. Nonetheless, increased gilt sales were central to the new monetary regime. Officials explained this to Barber ahead of the 1973 Budget:

> with a public sector borrowing requirement of, say, £4,350 million in 1973-74, and a target growth of money supply (M3) of not more than 15%, it seemed likely that sales of public sector debt to the non-banks would need to be of the order of £3,000 million. This is a formidable objective.[101]

As Figure 1 shows, sales in 1973 fell short of the target. By October 1973, a note of desperation had crept in. Eschewing any attempt at quantification, the Chief Cashier noted that 'policy is clear: to sell as much stock as possible'.[102]

From the outset under CCC, target sales of gilt-edged to the non-bank public were derived from the money supply numbers, whether the twelve-percent 'guideline' announced in the 1971 Budget, the twenty-percent objective adopted a year later, or the fifteen-percent objective adopted in late 1972. Actual sales fell short of target sales for a number of reasons. While the Bank could force Treasury Bills onto the Discount Houses, this was not the case with gilts where the market could call a 'buyers strike'. The situation was further complicated by the increasing use of open market operations. In May 1973, 'to ease the acute shortage of money', the Government Broker bought local-authority bonds from the Discount Houses.[103] By October 1973, open market operations, previously regarded as exceptional, had become commonplace:

> the Bank are planning to invest heavily in local authority deposits next week, as the need arises...the Chief Cashier is pretty confident that they will find means of getting by without a sharp increase in interest rates. He is, I think, rather enjoying the exercise and beginning to look upon it as a challenge.[104]

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[100] 'Page to Downey', 14 February 1973, TNA, T233/2505.
[101] 'Monetary policy', Downey, 16 February 1973, TNA, T233/2505.
[102] 'Issue Department portfolio', Page, 22 October 1973, BOE, 3A92/2.
[103] 'Discount market – local authority bonds', Gore-Booth, 15 May 1973, BOE, C132/15.
[104] 'Downey to Wass', 4 October 1973, TNA, T233/2508.

The *New Approach* was predicated on controlling M3 through more frequent use of the interest rate weapon. When Heath ruled out higher rates in 1972, officials shifted their focus to the reserves and more flexible use of special deposits. As this tactic was, in turn, ruled out during 1973, the Bank turned to open market operations to relieve liquidity shortages, having throughout based its targets for gilt sales on objectives for the broad money supply.

IV

The retreat from the money supply experiment was long and painful. In July 1972, the Bank was already reporting 'considerable problems with the equation used to predict the demand for money'.[105] The re-worked equations indicated that M3, having already grown by 7.75 percent in the three months since the Budget, should now be restricted to seventeen percent for the year as a whole.[106] Pepper was not far from the truth when he wrote to his clients:

> Recent answers by the Chancellor and Treasury Ministers to questions in Parliament confirmed that the new objective was the slow the rate of growth of the money supply from an excessive 20% per annum to a rate in line with the growth of the economy in money terms i.e. about 12½%.[107]

The first hint from the Bank that all was not well came a month later with the Governor's qualitative guidance to the banks. As *The Guardian* pointed out:

> it is only a short step from this to the thought that the Bank has recognised that the philosophy in Competition and Credit Control at least in its naked simplicity, is incompatible with the management of the economy.[108]

This was acknowledged by the Deputy Governor, Jasper Hollom, in an often-misinterpreted speech in April 1973. In private, Fforde was lamenting that 'the defects of M3 as a simple aim have become manifest'.[109] In public, Hollom was more circumspect: 'relationships that appeared to be established in the past have not held good more recently'.[110] Sir Douglas Wass naturally cites this speech as 'a statement

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[105] ibid.
[106] ibid.
[107] G.T. Pepper, 'Monetary Bulletin No.2, July 1972', Churchill, TCHRAS 3/17.
[108] 'Banks ordered to channel credit to industry', *Guardian*, 9 August 1972.
[109] 'Unhappy monetary policy', Fforde, 27 March 1973, BOE, 6A50/8.
[110] 'Does the money supply really matter?', BEQB, 1973, p. 196.

of the Bank's attitude to the money supply at the time'.[111] However, to suggest that the speech was representative of a continuing Radcliffian scepticism towards the monetary aggregates is entirely to miss the significance of the first eighteen months of CCC.[112] As Sir Douglas points out:

> CCC had by then been killed by the hostility Ministers showed to any suggestion that short-term interest rates should be increased to meet the monetary targets they had earlier been persuaded to accept.[113]

Hollom's speech coincided with the completion of the Bank's internal review of the *New Approach*, ordered by Heath after the 1973 Budget. The review highlighted a number of technical difficulties with M3. The major problem was that once the controls on lending and the banking cartel were dismantled, the demand-for-money function became unstable. As Goodhart admitted in 1975:

> the monetarist edifice rests largely on the stability, and predictability, of the demand-for-money function. Econometric study of the data in the 1960s had suggested that in the UK we, too, could build parts of our monetary policy on this basis. Subsequent experience has revealed weakness in this foundation.[114]

The second major mistake was to assume that Ministers would allow the interest rate flexibility that the *New Approach* demanded. Margaret Reid suggests that 'some Ministers, it seems, afterwards felt that it had never been brought home to them that it might be necessary to raise interest rates above the then politically sensitive level of 10 per cent to get an adequate grip on a later upsurge in credit'.[115] However, as Sir Douglas Allen subsequently explained:

> I pointed out to (Barber) that, given the lax fiscal policy that the PM had insisted upon, a significant rise in interest rates would soon become necessary and that if he adopted the C and CC proposal he would have to agree to it. He said that he understood that and would accept rate rises if necessary.[116]

Barber did accept this. He informed the Prime Minister in June 1972 that:

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[111] Wass, 2008, p. 64.
[112] Capie suggests that Hollom's speech showed 'not really much change from the old days', Capie, 2010, p. 508.
[113] Private communication with Sir Douglas Wass, 16 April 2012.
[114] Goodhart, 1984, p. 113.
[115] Reid, 1982, p. 32.
[116] Private communication with Lord Croham, 19 October 2009.

> under the new arrangements for competition and credit control, the main emphasis is on money supply and it has always been recognised that this will necessarily entail wider swings in interest rates than we have had in the past.[117]

Nonetheless, Heath failed to grasp the full implications of CCC. After refusing to raise rates in July 1972, he 'repeated his inability to understand the new system' saying that he 'distrusted the argument that higher interest rates would help us'.[118] As well as being intellectually opposed to rate rises, Heath had a number of political objections. Higher rates might choke off industrial investment. They might alienate mortgage-payers. But most importantly, they might upset the ongoing negotiations with the TUC and the CBI. Interest rates were specifically exempted from prices and incomes controls because of their importance to monetary policy. However, with instant-access deposit accounts paying zero interest, higher rates meant large, politically unacceptable endowment profits for the clearing banks, leading Heath to question in October 1973 'whether the basic premises to competition and credit control are acceptable from a political point of view'.[119] He may, unwittingly, have hit upon another point. The Bank's demand-for-money equations failed to predict the full extent of the monetary explosion of 1972-3. In 1977, despite 'a touching faith that improved econometric techniques would save the day', Bank officials finally admitted that 'there is no obvious simple, single equation, demand for M3 balances'.[120]

Ironically, given the retreat from M3 objectives, CCC was *de facto* abandoned with the adoption of a quantitative control that was all about limiting the broad money supply. In May 1973, officials were informed that 'Ministers were searching for arrangements which would keep money supply under control without explicit increases in interest rates'.[121] The solution, Supplementary Special Deposits (the 'Corset'), involved a shift from trying to control bank assets (loans) to controlling

[117] 'Bailey to Armstrong', 14 June 1972, TNA, T326/1563.
[118] 'Note of the Governor's conversation with Sir Alan Neale', 25 August 1972, BOE, 7A139/4.
[119] 'Wass to Downey', 2 October 1973, TNA, T233/2508.
[120] A.C. Hotson, *British monetary targets, 1976 to 1987: a view from the fourth floor of the Bank of England,* (March, 2010), p. 6.
[121] 'Reappraisal of Competition and Credit Control', 4 May 1973, BOE, 6A50/10.

their interest-bearing deposit liabilities. The Bank explained: ‘the main reason for the choice is that banks’ liabilities have the closer relationship with M3’.[122] Indeed:

> The prime objective of this device is, quite simply, to contain the growth of M3. A second objective is to avoid producing any perceptible further upthrust in the general level of interest rates.[123]

Under the new scheme, the banks were required to make deposits at the Bank as their interest-bearing deposits grew above pre-agreed limits. With quantitative controls back in place, the money supply experiment was over

V

Different institutions drew different conclusions from the failure of Competition and Credit Control. The Bank concluded that M3 was a ‘decidedly defective’ measure and began a long campaign to shift the emphasis to the narrower monetary aggregate, M1.[124] The Treasury had always been sceptical of the Bank’s ability to forecast and control the money supply. Nonetheless, both institutions successfully pressed a public M3 target on the Labour Chancellor, Denis Healey, in July 1976. This was in a very different context to the unpublished objective pressed on his predecessor four years earlier. By 1976, the PSBR had overtaken bank lending as the largest counterpart of M3, and the Bank saw a published target as ‘a tighter rope around the Chancellor’s neck’ on the spending ambitions of the Labour government.[125] A reluctant Treasury acquiesced primarily because of the confidence effects the target might have on troubled financial markets.[126] Healey’s own views are clear: ‘I have never met a private or central banker who believed the monetarist mumbo-jumbo. But no banker could afford to ignore monetarism so long as the market took it seriously’.[127]

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[122] ‘Controlling growth in M3’, 29 November 1973, BOE, 6A50/12.
[123] ibid.
[124] ‘Monetary Policy’, Page, April 1973, BOE, 6A50/8.
[125] ‘Monetary policy’, McMahon, 26 September 1975, BOE, EID4/200.
[126] Wass, 2008, p. 212.
[127] D. Healey, *The time of my life*, (London, 1989), p. 434.

Conservative policymakers drew very different lessons from the experience of 1971-73. Heath may have been 'a Keynesian by instinct and by intellectual conviction' who upon meeting Friedman in the early days of his administration found him to be 'wholly unconvincing'.[128] However, his junior Treasury Ministers became increasingly enthusiastic targeters, even as the Bank was in headlong retreat from a single M3 objective. The Financial Secretary, Terence Higgins, responded to Allen's recommendation of a fifteen-percent target ahead of the 1973 Budget by arguing that 'we are aiming too low and should go for 13% rather than 15% as a target growth of money supply'.[129] The Minister of State, John Nott, was only persuaded against publishing this target because he felt it would look too high when compared to the six percent recently announced by EEC Finance Ministers (albeit on a narrower measure).[130] After Margaret Thatcher's victory in the February 1975 leadership election, Conservative economic planning was dominated by a small clique of 'believing monetarists'. Nott co-chaired a group on monetary policy with the City University economist Brian Griffiths which pronounced in favour of a published target in June 1976.[131] Griffiths was a vociferous opponent of the view that the demand-for-money was unstable, blaming in almost equal measure the Bank for failing to control reserve assets and the politicians for refusing to raise rates. The group's recommendation was taken up and published in the policy document, *The Right Approach*, four months later.[132]

There was little further consideration of monetary policy by the Conservatives in opposition.[133] However, the seeds of the Medium Term Financial Strategy were sown with the $3.9 billion loan granted by the IMF to the Callaghan Government in December 1976. The Letter of Intent included a multi-year series of DCE and PSBR ceilings. This formed the basis for the medium term framework for inflation, output, money supply, and DCE laid out in the October 1977 edition of the London Business School's *Economic Outlook,* cited by chief architect of the MTFS, Nigel Lawson, as

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[128] A. Denham and M. Garnett, *Keith Joseph*, (Chesham, 2001), p. 180.
[129] 'Kelly to Bailey', 19 February 1973, TNA, T233/2505.
[130] 'Haig to Bailey', 22 January 1973, TNA, T 233/2505.
[131] 'Minutes of a meeting of the Economic Reconstruction Group held on 11 December 1975', Churchill, RDLY 2/1/2/1.
[132] *The right approach,* (London, 1976).
[133] Lawson admits that an 'error, in hindsight, was to do so little work in Opposition on the conduct of monetary policy'. Lawson, 1992, p. 17.

his intellectual source.[134] Detailed planning had to wait until after Howe's first Budget in June 1979, by which time Treasury officials had warned that 'no one has succeeded in establishing a relationship between M3 and money incomes which has proved to be stable during the 1970s'.[135] This did not trouble the Minister of Sate, Lord Cockfield, who was in little doubt about the transmission mechanism:

> Control of the money operates through the simple but brutal means of butchering company profits. Ultimately insolvency and unemployment teach employers and workers alike that they need to behave reasonably and sensibly.[136]

Confidently asserting that 'control of the money supply will over a period of years reduce the rate of inflation', Sir Geoffrey Howe laid out a four-year series of declining target ranges for £M3 in his 1980 Budget.[137] As the Permanent Secretary pointed out, the 'crux of the thesis' was 'a rational expectations approach which relied on economic agents, particularly wage bargainers, quickly adjusting to the new monetary conditions'.[138] It was not at all clear that the unions had grasped the implications. Healey's monetary targets had always worked in tandem with incomes policy. With incomes policy discredited after the Winter of Discontent, monetary policy was left to shoulder the burden alone. Despite a target range of 7-11 percent for £M3 growth in 1980/81, average wages rose by 21 percent. With nominal interest rates peaking at seventeen percent as the authorities tried to rein in the money supply, and the pound at its highest level since 1975, company profits were indeed butchered.

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[134] A.P. Budd and T. Burns, 'Economic viewpoint: how much reflation?', in *London Business School Economic Outlook*, October 1977, pp 7-11. Lawson, 1992, p. 69. Sir Adam Ridley recently described the MTFS as 'the embodiment of a rejuvenated IMF framework', A.N. Ridley, '*The 1981 Budget and lessons for 2011'*, talk given at the Cambridge Union, 29 November 2011. A medium term plan predating the IMF loan was laid in *The Times*, 'Programme for economic stability', *Times*, 20 September 1976.

[135] 'Problems of monetary control', 30 April 1979, T386/524 and 'Monetary targets and control: note by the Home Finance Group', T388/93.

[136] F.A. Cockfield to Chancellor of the Exchequer, 'The money supply and inflation', 21 January 1981, TNA, T386/549.

[137] Financial statement and Budget report, (HMSO, London, 1980), p. 16. In private, the Chief Secretary, John Biffen, belying his own monetarist reputation, protested that was no mechanistic relationship between the PSBR, the monetary aggregates and inflation and criticised Lawson for possessing a 'a certainty about pace and direction that we do not possess, either technically or politically', W.J. Biffen to M.H. Thatcher, 4 March 1980, TNA, PREM 19/177

[138] 'Commitment to a programme of declining monetary targets', 21 June 1979, TNA, T364/179. Lawson, *per contra*, downplays the influence of rational expectations, Lawson, 1992, p. 69.

Manufacturing output fell thirteen percent in 1980/81. With the bellwether Imperial Chemical Industries reporting its worst results since 1930, and the Director-General of the CBI threatening a ‘bare-knuckle fight’ with the Government, it was clear that monetary policy was too tight.[139]

Nonetheless, confirmation that much of the damage done to industry was an unnecessary consequence of pursuing £M3 targets came as a ‘bombshell’ to Ministers in January 1981.[140] In a report commissioned by the Centre for Policy Studies, the Swiss economist, Jürg Niehans, suggested that rather than worrying about the seven percent £M3 overshoot, they should have been focusing on the monetary base undershoot.[141] Flatly contradicting the Treasury view that the strong pound was an inevitable consequence of North Sea oil, Niehans argued that the shrinking monetary base was responsible for British exports being priced out of global markets, via its impact on the exchange rate. He told Ministers to ignore the £M3 overshoot and loosen monetary policy immediately. His former colleague, Alan Walters, recently arrived as Margaret Thatcher’s economic adviser, confided in his diary:

> Told MT about JN’s seminar and his findings. MT very defensive: NO ONE must know about it – especially Bank of England. Why? Frightened of calls for relaxation or sops to the wets. Am rapidly learning the political game – never admit an error.[142]

His colleague in the Downing Street Policy Unit, John Hoskyns, elaborates:

> Niehan’s advice was not politically welcome. Despite the diplomatic language in which it was couched, it advocated actions that could be seen as a public admission that the Government had done the economy a great deal of damage by mistake.[143]

Lawson claims that the Niehans’ report had little impact at the Treasury.[144] However, it was harder for Ministers to ignore the conclusions of a recently-completed Treasury

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[139] Source: Office for National Statistics. ‘Director-General’s National Conference speech’, 1980, Churchill, PREM 19/490.
[140] A.A. Walters, ‘Diary’, 7 January 1981, Churchill, WTRS 3/1.
[141] J. Niehans, ‘The appreciation of Sterling – causes, effects, policies’, Churchill, WTRS 1/4. Niehans’ claim to have isolated a robust relationship between the monetary base and the exchange rate was not supported by the Bank’s econometric work.
[142] ibid.
[143] J.L.A.H. Hoskyns, *Just in time: inside the Thatcher revolution*, (London, 2000), p. 279.
[144] D.J. Needham *et al*, *The 1981 Budget: facts and fallacies*, p. 33. Published online at <http://www.chu.cam.ac.uk/archives/exhibitions/Witness_seminars.php>, last accessed 20 August 2012.

study into the causes of inflation.[145] This reaffirmed another lesson from the Competition and Credit Control era, that relationships which appeared to be established in the past do not always hold in the future:

> The simple account of inflation in terms of monetary growth two years previously, which received a lot of public attention in the mid-seventies, has not stood up well to closer inspection, or to the test of time.[146]

The need to retain political credibility militated against immediately abandoning the £M3 target. Instead, Howe announced in the 1981 Budget that, henceforth, he would monitor a range of monetary aggregates. A year later, he completely recast the MTFS, raising the £M3 target range by three percent and formalising targets for both the narrower and broader aggregates, making no attempt to 'claw back' the overshoot of the previous three years.[147] £M3 targets remained nominally in place until 1987 but, by then, they had been subordinated to Lawson's exchange rate target. UK monetary policy had come full circle. But in 1987, the lodestar was the Deutschmark, not the Dollar.

Reflecting on the early-1980's money supply experiment, Lawson quotes Robert Burns: 'The best-laid schemes o' mice an' men/Gang aft agley'.[148] If the Prime Minister had allowed him to explain in September 1980, John Fforde, the architect of the previous money supply experiment, would no doubt have agreed.

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[145] Report of money supply and inflation research group', 9 December 1980, TNA, T388/195.
[146] A.J.C. Britton, Conditionality and money supply targets', 16 January 1981, TNA, T388/187.
[147] After a battle lasting several years, the Bank finally got its M1 target, as well as a target for the broader PSL2 measure which adds a range of 'money-like' short term instruments to £M3.
[148] Lawson, 1992, p. 72

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