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The Rt. Hon. Margaret Thatcher MP
Prime Minister
10 Downing Street
London SW1

Dear Prime Minister,

I am enclosing a short memorandum on the subject of monetary control and the revision of the government's medium-term strategy which I hope will be of some use.

With best wishes for a happy New Year.

Yours sincerely

Brian Griffiths

P.S. May I emphasise paras. 3, 5, 9, 16 and 17.

Mr. Walters

Prin Griffiths

I think the Chancellor ought to see this paper, but in view of his comments in para 17

**Centre for Banking and International Finance
Director Professor Brian Griffiths**

on personnel at the Bank,
8 January 1981

I will ask him only to show it to Douglas Lane and Peter Middleton. Contact?

*Rh
Jan 16/81*

PERSONAL

REVISING THE MEDIUM-TERM STRATEGY

THE PROBLEM

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1. Already there is sufficient evidence to show that the government's economic strategy is working: price inflation is falling and private sector wage increases are slowing down without any form of price and incomes policy; market interest rates have come down largely as a result of a lower inflation premium in interest rate levels; and because of pressure on corporate profitability resulting in redundancies, the productivity of the private sector is increasing. In addition, without any fiscal boost and largely because of the effects of a falling rate of inflation, leading indicators of economic activity are predicting a recovery in output.

2. However because of excessive money supply growth and excessive public spending in 1980 the government's medium-term strategy has begun to lose credibility. When the current rate of money supply growth is greater than the current rate of inflation, it is difficult to believe that inflation will continue to fall; and when British Leyland and British Steel seem set to get the subsidies for which they are asking, when local Councils seem so recalcitrant in terms of cutting public spending and when employment in the public sector holds up so well despite the recession, the fiscal target of the medium-term strategy begin to look rather hollow. At present the government has an official money supply target of 7-11% which carries no credibility because it will, on its own admission, be overshoot and a PSBR target which again could be £1-2 billion in error.

While many support the government's economic objectives, I believe there

is a growing scepticism about its ability to realise these objectives in view of the failure to control money supply growth and contain public spending.

3. The basic need at present, therefore, is for the government to re-establish the credibility of the medium-term strategy; this involves a revision of the numbers in the financial plan, a commitment to more efficient techniques of monetary control and cuts in public sector employment which can all be presented as part of a crucial spring budget. *I shall deal with the monetary aspect of these changes.*

THE MEDIUM-TERM STRATEGY

4. Because of the overshooting of money supply and PSBR targets in the first year of the plan, the original targets have become meaningless. It is important that a revised set of targets have credibility. For this to be so it is important:-

- (i) not to carry forward the failure of 1980 into the targets for the plan as a whole by allowing base drift but to correct these errors over the next two fiscal years;
- (ii) to keep the targets for the final year of the plan the same as at present.

If these are not done, why should people have confidence in a new set of targets? The assumption will be that future mistakes will be incorporated in a revised set of numbers.

5. Having devised a new set of medium-term monetary and fiscal targets the next problem will be their credibility. Without credibility the whole exercise is a waste of time. A repeat of 1980 would be disastrous and would seriously undermine both the political credibility of the government's conduct of economic policy and also the intellectual basis of the policy as well.

The restoration of confidence requires:-

- (i) that having announced new targets the government stick to them;
- (ii) the introduction of changes in the techniques of monetary control which make short term control possible.

At the time the government announces new targets the only basis for their credibility will be the commitment shown by the government to carry out the necessary institutional changes to make such control possible.

MEDIUM-TERM FINANCIAL PLAN

ORIGINAL PLAN

	1980/81	1981/82	1982/83	1983/84
Money supply growth (£M3)	7-11	6-10	5-9	4-8
PSBR (as % of GDP)	3 $\frac{3}{4}$	3	2 $\frac{1}{4}$	1 $\frac{1}{2}$
Public Spending	41.5	41	40.5	40

REVISED PLAN

	1980/81	1981/82	1982/83	1983/84
Money supply growth (£M3)	16 *	5-9	4-8	3-7
PSBR (as % of GDP)	5.5 *	3.5	2.25	1.00
Public Spending	43	41	40.5 $\frac{1}{2}$	40

*estimated outcome

MONETARY CONTROL

6. From the government's point of view the present system of control has proved disastrous. However the future could prove just as bad if not worse. The weaknesses of the system will be shown to their full only when the economy begins to revive and borrowing starts to pick up. The present method of control ensures that money supply growth is pro-cyclical. Unless therefore the system is changed we can look forward to a money supply 'explosion' when the economy next revives. Changing the system would not only provide credibility for new targets but also prevent money supply growth careering off-course some time in the next two years.

7. Money supply growth could be controlled more efficiently if the government were to :-

(i) move to a monetary base method of control in which the Bank of England controlled the cash base of the financial system rather than interest rates;

(ii) replace the present method of selling gilt-edged stock by regular weekly auctions.

These changes would ensure that potential excess borrowing - whether from private sector loan demand or the PSBR - did not automatically result in excess money supply growth.

(a) Monetary Base Control

8. The advantage of moving to a monetary base method of control is that it gives the government greater certainty of being able to meet its monetary targets. The major disadvantage is the possible variability in the relationship between the monetary base and the money supply. As a result of this possible disadvantage, the Bank announced in the November measures a number of tentative moves which would enable it to discover the nature of this relationship. In my judgement, it is impossible for the Bank to find out this kind of information from the present regime of monetary control because the critical factor - namely its own lender of last resort operations - remains so uncertain.

In a world of uncertainty, therefore, in which it is impossible for the Bank to know in advance how any method will work in practice the key decision is whether the probable working of a monetary base system is preferable to the present system. I believe that sufficient evidence exists to suggest that it is and that the government should introduce a monetary base method of control in the Spring Budget.

9. It is quite wrong of the Bank to suggest that it would take a number of years to change to a monetary base method of control. The City is highly adaptable and innovative and a change could be effected quite easily in a matter of 3-6 months. What is crucial is that the authorities give as much information as possible to the banking system regarding the rules by which they will in future operate.

10. The question of whether monetary base control should be mandatory or non-mandatory is a little more complicated. There is no doubt that in the long run a non-mandatory form of control is superior as it leads to fewer distortions within the financial system.

In order to ensure that the system is introduced successfully within a matter of months, however, there is a case for introducing a mandatory form of control for the transition but putting a time limit of 1 year or 18 months to the transitional period.

The key features of the transitional arrangement would be:-

- (a) the government would announce a set of annual money supply targets as part of the medium-term financial plan;
- (b) the government would also announce intermediate monetary base targets which were compatible with the medium term monetary targets;
- (c) the banks would be required to hold x % of their assets in the form of cash;
- (d) interest would be paid on the holding of required bankers balance at the Bank of England at a rate related to inter-bank rate but not on excess reserves.

The object of (d) would be to prevent the unnecessary growth of the Euro-sterling market.

(b) Techniques of Funding Gilt-Edged Stock

11. The November money supply fiasco was the result of a defective system of funding gilt-edged stock. It need not have happened. A higher than expected PSBR need not result in excessive money supply growth. However, this episode was by no means unique: it has happened before (summer 1976, April 1977, Summer 1978, autumn 1979) and if the present system continues will doubtless happen again.
12. The present method of issuing gilt-edged stock could be improved on with a relatively minor change. The government could inaugurate a weekly auction in gilts similar to its present weekly auction of Treasury bills. The amount on offer would be decided in the light of its borrowing requirement and the targetted growth of the monetary base. Both institutions and individuals would be free to submit bids and the stock would be allotted to the highest bidders. Such institutional changes could again be announced as part of a Spring Budget.
13. Between now and then, however, it is important if another fiasco is to be avoided that the Treasury lay down the tactics of gilt-edged funding. While this does not require taking over the Bank it does require day-to-day supervision by the Treasury of the Bank's intervention tactics in order to ensure that excess or less than average borrowing each month - and preferably each week - are matched by comparable gilt-edged sales. This could be facilitated if stock were issued more frequently and in smaller amounts.
14. The objection to an auction system by the Bank is that it might undermine the present structure of the gilt-edged market. I personally would attach very little weight to this argument. Even if the doomsday scenario were to occur and the present jobbing system disappear, it

would not affect in any significant way the Bank's ability to
raise capital for the government.

More generally, if the Stock Exchange moved to a system of dual rather than single capacity, such as happened on the New York Stock Exchange in May 1975, this would put us in a similar position to the US and there are very good grounds for thinking that it would be a far more efficient system of doing business.

15. In this connection it is also important for the Treasury to find out the views of market participants directly rather than having always to to via the Bank. This fact should be recognised by the creation of a regular meeting between senior Treasury officials and senior gilt-edged brokers, jobbers and fund managers.

THE TIMING OF THE CHANGES

16. Although these changes are clearly desirable it is by now abundantly clear that the Bank of England is opposed to making them. The Bank has expressed its opposition to auctioning gilts and to introducing monetary base control. Although its official position is that it remains agnostic on this latter issue, the changes announced in the November Budget require the Bank to wait for a period of something like two years before a decision can be reached.

While Bank officials can afford to be extremely cautious in their attitude to institutional change the government cannot afford such a luxury. The timetable which the Bank has set for considering change in this area is hopelessly out of phase with the government's need to continue to reduce inflation.

The only way, therefore in which sufficient progress can be made so as to ensure that money supply can be controlled is for the Treasury to present the Bank with the detailed reforms which are necessary and with a set of deadlines by which they are to be implemented. The less detailed the reforms are made, the greater the discretion which the Bank then has and the greater therefore the probability that change will be stymied by the Bank querying niggling points of detail.

CONCLUSION

18. The next budget is critical for government economic policy. The major priority must be to re-establish confidence in the medium-term strategy by providing a revised set of targets accompanied by monetary and fiscal changes which give them a credibility in the eyes of the public. In the monetary sphere the critical changes - monetary base control and gilt-edged auctions - should be introduced as part of a package in this year's Spring Budget.

Brian Griffiths
January 7th, 1981