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The Right Honorable Mrs. Thatcher, Prime Minister
10 Downing Street
London
England

Dear Prime Minister:

The meeting at the Bank of England held on the last day of September was informative. There was general agreement on the need to lower the rate of inflation and to achieve greater price stability. There was also a general consensus on the necessity to use monetary control for this purpose. But the arguments and questions advanced by officials representing the Bank of England revealed substantial disagreements between officials and the visitors about the approach to monetary control.

The discussion centered basically on the procedure promising a reliable execution of the desired anti-inflationary monetary policy. The visitors emphasized that the traditional procedure elaborated in the Greenbook was an essential part of the inherited problem. It was designed for purposes of "controlling" interest rates and "credit conditions" with little attention to its monetary consequences. It cannot serve adequately the new purposes of monetary control imposed by an anti-inflationary policy. The traditional approach produces a highly erratic and very unreliable monetary growth with a built-in inflationary bias. The reliable execution of an anti-inflationary policy substantially lowering the rate of inflation over the next three to four years requires, as the visitors argued, a determined control over the monetary base. The steps needed to achieve such control were mentioned. It was also made clear that M-3 or other monetary aggregates could not run away for any length of time from a basic trend set by the monetary base.

Most of the questions and arguments advanced by officials reflected reservations and hesitations based on fears about the nature of the transition problems. They worried about the consequences for the operation and the accustomed arrangement of the financial system. These questions are not irrelevant. They are however of second and third order of importance compared to the central issue of controlling inflation. They reveal moreover a peculiar "mother hen" attitude by the Bank of England. We do know from many experiences that markets will adjust quite efficiently and bankers will learn very rapidly in their own interest the new rules of the game. English banks have operated for decades all over the world under shifting and very different rules of the game -- and survived most astutely. We also know that it is precisely the procedures cherished by the Bank of England and by some other Central Banks that have produced the large movements in interest rates observed over the past fifteen years. The shortest run volatility of call loan rates observed within a week or over a few weeks under a monetary control approach "washes out" to a large extent in the monthly data.

Other aspects of the transition were also covered in the discussion. Some officials of the Bank of England seemed to argue that the change in procedure could only be achieved over a five year period. There is however no ground for such an assertion. An effective control over the monetary base can be initiated within two months. It needs to be carefully articulated and explained to the financial community. Long delays and "half-way houses" are dangerous in my judgment. They raise the likelihood of continued and erratic inflation maintained over the next three to four years.

The newspapers reported a few days ago that Alan Walters was appointed to help you in matters of economic policy. I was very much delighted about this event. Alan is indeed by far the best choice for your purpose. We will meet in early November in Washington in order to discuss some of the issues. He will be in a good position to mobilize professional support whenever you may find it useful and appropriate. My friends and I do find that events in the United Kingdom are of great importance for the western world and we feel strongly obliged to help in any way we possibly can.

Sincerely,

Karl Brunner

Karl Brunner
Fred H. Gowen Professor of Economics

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