HOUSE OF COMMONS

LONDON SWIA OAA

Confidential

21st February, 1979.

Current Monetary Policy

John Nott's letter of 15th February sounds a prudent warning, but I must confess to being a little alarmed at the conclusion he draws that we should "ease current monetary stringency"; in other words, that one of our first actions on taking office should be to increase the rate of growth of the money supply.

In my own opinion this would not only totally destroy our credibility, and make it infinitely harder for us to manage the economy sensibly subsequently; it would also have a most damaging affect on confidence which would far outweigh the benefits to private industry which John seeks to derive.

I do not accept that we shall find it impossible to reverse the growth of public expenditure "before the current cash squeeze hits British industry in the fiercest possible way": given the will, and the mandate we shall have, we shall certainly be able to make a start straight away - and indeed may well need to do so.

If despite this, it still proves necessary to take urgent action to improve company liquidity this should be done by special ad hoc measures geared to this end, rather than by increasing the rate of growth of the money supply.

In any event, I believe that John exaggerates the rate at which inflation is likely to be increasing when we take office. He does not quote a figure, but my own guess would be an inflation rate of the order of 12%, year on year, which would hardly be wildly out of line with the present money supply growth target of 8 to 12%.

Finally, if our financial measures are such as to boost confidence, then the consequence will be seen in a firm

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exchange rate, which is good news for inflation prospects, and (still more important) falling interest rates, which is good for private industry. If, on the other hand, our financial measures are such as to destroy confidence, which an increase in the rate of growth of the money supply most certainly would, then the consequence would be a falling exchange rate, which is bad for inflation prospects and (again more important) a rise in interest rates, which would intensify the problems of the wealth creating sector.

The Rt. Hon. Sir Geoffrey Howe, QC, MP.

cc: The Rt. Hon. Mrs. Margaret Thatcher, M.P.
The Rt. Hon. Sir Keith Joseph Bt, MP
The Rt. Hon. James Prior, MP
Mr. John Nott, M.P.
Mr. Adam Ridley