10 DOWNING STREET

THE PRIME MINISTER

9 June, 1980

Dear Mr. Newton.

Thank you for your letter of 9 May. As you rightly say, monetary policy is at the heart of the Government's economic policies, and I welcome the opportunity to explain why this is so.

A progressive reduction in the rate of growth of the money supply is essential if we are to achieve the permanent reduction in inflation which in turn is vital for our economic revival. This is clear from observation of the relationship between monetary growth and inflation over many years and not just over a short period. It is true that over long periods of time there have been trend changes in the ratio between current price national output and the money supply (i.e. the income velocity of circulation) due, for example, to changing institutional arrangements. But these changes in velocity have been small by comparison with the accompanying changes in the money supply or the level of prices. Over a period of years variations in monetary growth and inflation <u>are</u> seen to be closely related, and the reasons for the crucial role of monetary growth in determining inflation have been set out in the very substantial volume of academic literature on the subject.

You attached to your letter a graph showing for this country the relationship between inflation and the rate of growth of the money supply over the past five years. The period over which you have chosen to draw your graph not only follows close on one of the biggest shocks to hit Western industrialised economies since the War, namely the fourfold increase in the price of oil in late 1973, but also the monetary expansion of 1972-73.

/There

There are many factors which affect prices in the short run, including world prices, and these can temporarily obscure the longer run relationship. They do not invalidate it.

Although special factors can be important in the short run, I cannot accept your suggestion that we should concentrate on them at the expense of the fundamental longer term influences. This is the kind of thinking that has bedevilled British economic policy since the War and the Government is determined not to make the same mistake. Moreover, it is simply not possible in practice to control many of the factors which bear directly on inflation in the short run even if that were appropriate. It is obviously not within our power to control the price of oil and other world prices. Attempts to control wages directly by means of incomes policies have clearly failed to cure inflation, and they have undoubtedly had a damaging effect on incentives and the operation of the labour market. Policy towards nationalised industry prices and the rate at which VAT is levied must be governed primarily by longer term structural considerations, and clearly inflation in the long run cannot be controlled by direct action on particular, individual prices.

Finally, you suggest that different levels of the money supply in relation to national income in different countries are inconsistent with the Government's view of the key role of monetary policy. I cannot agree; for it is rates of monetary growth that are relevant for inflation, not levels of the money supply in relation to income. The definition of money, the institutions which provide it, and the demand to hold it differ widely between countries. We would not expect there to be any simple relationship across countries between these ratios and inflation rates. We should instead look at rates of growth of the money supply and rates of inflation in different countries. If we allow for time lags, trend changes in velocity, and differences in rates of economic growth, it can be seen that countries with

/low

low monetary growth generally have low inflation and those with high monetary growth generally have high inflation. This is quite consistent with the Government's views on monetary policy.

I hope that this letter will help you to understand more clearly the basis for the Government's policies.

Yours sincerely

Margaret Thatcher

Michael Meacher, Esq MP