Prime Minister (2)
I have sent copies to Alan Walters and the Chancellor.
AT 17/6

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

Dear Prime Minister,

I was invited by Andrew Turnbull to submit a very short note to you on the subject of monetary policy. It is a little longer than I had intended but I hope it may be of some use. In view of the fact that the subject is a highly complex one, you may feel at times that it over simplifies the issue. I would naturally be delighted at any subsequent stage to expand any of the points which I have made.

Yours sincerely

Brian Griffiths

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UK MONETARY POLICY AND TECHNIQUES OF MONETARY CONTROL

Introduction

1. Increasing concern is being expressed at present regarding the current thrust of UK monetary policy and the rise in the rate of inflation. This concern raises two major questions:

   (i) how temporary is the current increase in inflation when judged against existing monetary policy? and

   (ii) are the techniques of monetary control which were introduced in 1981 working well or not?

Monetary policy and rising inflation

2. Inflation has remained at a rate of approximately 5 per cent since 1983. There is no reason to think that the present increase is other than temporary, reflecting the fall in sterling in late 1984 and early 1985 and the increase in mortgage rates by 3 per cent in April. This expectation is based on (a) the recovery in sterling, (b) the correction of a rather lax monetary policy towards the end of 1984 through higher short term interest rates, and (c) the possible strengthening of sterling against the dollar.

   Given the present stance of interest rate policy there is good reason to think that inflation will fall again to around 5 per cent, even though it may take some time. While inflation should fall from its current rate of 7 per cent it is doubtful if it will fall to 3 per cent on the basis of present policy.

3. Against this general background, there is nevertheless cause for concern over the behaviour of unit wage costs and the rapid growth in liquid assets. Unit wage costs have risen from around 1 per cent in the second half of 1983 to over 5 per cent in the first quarter of

this year. Because of the rise in inflation this trend could continue throughout the next wage round. If monetary policy is to be set to achieve an inflation rate of 5 per cent or even 3 per cent, then rising unit labour costs, while not necessarily implying a rising inflation trend, may have serious short term implications for unemployment.

4. The growth in liquidity over the past twelve months, measured by any of the broad aggregates (£M_3, PSL2), is considerably greater than the growth in money income. These growth rates, however, are not a good predictor of inflation because of the high level of interest rates which makes various kinds of interest-bearing bank and building society deposits especially attractive. Put differently, there has been a rise in the demand for broad money at the same time as the supply has been increasing.

But if these liquid assets are used at some future date by individuals and companies to finance expenditure, they could have a nasty - if short term - inflationary impact. As a consequence, it is important that monetary growth judged by M_0 should not rise much above its present level and that bank interest rates be allowed to rise to the appropriate levels to contain the growth of money.

5. **Techniques of control**

There are a number of reasons for thinking that the present techniques of monetary control which were introduced in 1981 are not working well. Symptoms of the problem are:

(a) the need to raise interest rates abruptly - for example the rise in base rates in June 1984 by 2 per cent and then in January 1985 by 4 per cent;

(b) the rise in £M3 of no less than 3 per cent in one month (April 1985);

(c) the size of the 'bill mountain' - which has now reached £15bn.

6. The present system of control works by the authorities announcing a £M3 target, influencing the level of short term rates, overfunding if the growth of assets backing £M3 is greater than the target figure, and then relieving the shortage of cash in the money markets by purchasing bills (so enlarging the 'bill mountain').

7. Writing in 1981, shortly after the new system was introduced, my firm expectation was that the new system had the same ingredients for creating distortions as the old.

> In fact, it turns out that the new system of control is open to all of the objections of the previous system. By operating in the money markets within an interest rate band the authorities are still forced to choose a particular interest rate range in order to influence money supply growth. Yet we know from the past ten years that this is the very thing the authorities find it very difficult to do successfully. Why, then, continue with a system which makes it virtually certain that money supply growth will proceed by fits and starts as it has done over the past decade? The fact is that there is nothing in the new system which gives one any confidence that the authorities will perform more efficiently in controlling the money supply in the eighties than in the seventies. The Bank still retains enormous discretion over interest rates and over the rate of growth of its own balance sheet. Not until this is removed can we expect to see a more stable and lower pattern of money supply growth.

Annual Monetary Review, December 1981

The reason for this judgement was that in introducing change the authorities were concerned primarily to introduce a new system of short term interest rate determination, rather than a system which would control the cash resources of the banking system and so provide a constraint on the growth of bank deposits.

8. It also turns out that even though the reforms of 1981 were an attempt to create greater flexibility in short term rates, they have not succeeded in this respect, so that we know no more now than we did then about the banks' demand for cash.

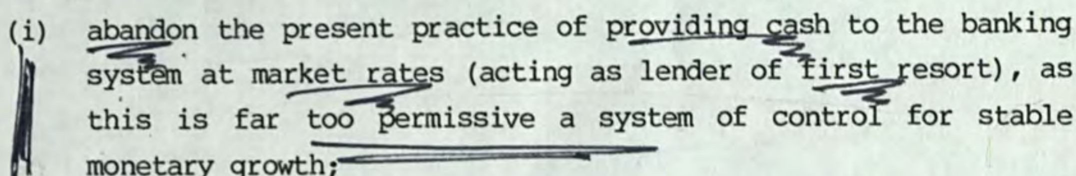
Options for change

9. The present system of control depends on the authorities targetting £M_3. The important reason for targetting £M_3 is that it is a way of controlling inflation. Because of distortions such as round-tripping and high interest rates £M_3 is less useful as an indicator of monetary policy than previously. Nevertheless for the Chancellor to drop £M_3 when its rate of growth is above target and inflation is rising may have a perverse effect on confidence; and previous experience in ignoring broad money, namely 1971-73, was disastrous.

The argument which is sometimes put forward - that £M_3 is a convenient way of linking monetary policy to fiscal policy, interest rate policy and debt management policy - while understandable, may well be counter-productive if it provides the authorities with a set of explanations for failing to hit monetary targets which crucially omits their own lack of control of cash being supplied to the banking system.

My own judgement is that while it is presentationally useful to retain £M_3 as an indicator, it is an increasingly unreliable target for monetary policy.

10. The fundamental feature of change, however, should be a change in the target and operating procedures of the authorities. The authorities should be required to:



(i) abandon the present practice of providing cash to the banking system at market rates (acting as lender of first resort), as this is far too permissive a system of control for stable monetary growth;

(ii) provide cash to the banking system only at penal rates;

(iii) retain £M_3 as an indicator but adopt Mo as an operational target

For this policy to work, the authorities must be explicit in announcing their intentions to the market. On the basis of the announced penalties which banks would face if they were to borrow cash from the Bank, the banking system will clearly wish to increase its holding of bank reserves. At present the authorities know very little about the banking system's demand to hold bank reserves.

If arrangements could be devised for the transition from the present system of monetary control to one in which the authorities targetted the cash base, so that there was no risk of the money supply careering off-target (and I for one see no reason why not), then I believe that monetary policy under such a system would be subject to less uncertainties and would therefore be more stable than under the present system.

In order to create the condition in which the authorities can pursue a more flexible interest rate policy, it would be useful to fund the 'bill mountain'.

11. There are, however, two institutional implications of trying to achieve a more stable monetary policy which must be emphasised:

(a) it requires that short term interest rates, and especially base rates, should be allowed to move freely and without intervention of any kind; and

(b) in the transitional period, but not subsequently, the banks and discount houses should expect to find that short term interest rates move rather more quickly than they have come to expect - which for some could be uncomfortable.

Any attempt to intervene in the money markets to prevent or affect these developments could well render the system ineffective.

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