



**THE CITY
UNIVERSITY**

Northampton Square London EC1V 0HB
telephone: 01-253 4399 telex: 263896

Centre for Banking and International Finance
Director Professor Brian Griffiths

PERSONAL AND CONFIDENTIAL

8 October 1980

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

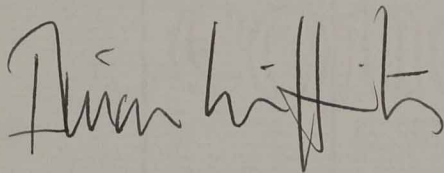
RW/WS

Dear Prime Minister,

After talking to Tim Lancaster, I am sending you a note on a subject about which I feel rather strongly.

With every good wish for the future.

Yours sincerely



Brian Griffiths

MONETARY CONTROL

1. I am delighted that you are taking a personal interest in this subject. Although it is frequently presented as a rather narrow and technical appendage of the government's overall policy, I believe it is absolutely vital for ensuring that the medium-term targets are met. It is very interesting to observe the number of occasions in the 1970's when it became an important matter for the then Prime Minister.

The danger at present is that two or three months of good money supply figures, plus important new problems arising elsewhere, will lead the bureaucracy to urge you to put the matter in your pending tray - so that once again it will not be dealt with at a fundamental level.

2. Why have short term monetary control?

If the investing public were assured that the government would stick, come what may to their annual money supply targets strict month to month control of the money supply would be unnecessary. The problem arises, however, because in the past published monetary targets have not been met, so that the public find it difficult to know if a sudden spurt in money supply growth is a new trend or a short term deviation from an announced trend which will be corrected in a few months. On the basis of past experience it is not surprising that they tend to be cautious and sceptical if not downright cynical about future trends when bad

money supply figures are announced. The only way this can be overcome is by ensuring that monetary growth targets are met in the short as well as in the medium term.

3. The primary reason for both the variability and the extent of money supply growth over the 1970's is a system of monetary control which requires the Bank of England to make judgements about such things as the appropriate level of interest rates which, quite frankly they are incapable of doing.

4. In view of the record of the Bank of England over the 1970's in designing mechanisms of monetary control, I have little confidence in their ability to come up with an appropriate system now.

In 1971, they designed Competition and Credit Control. I remember attending a conference at the Bank in July 1971 and, along with Harry Johnson, David Laidler and Michael Perkin, pointing out that the system suffered from crucial defects. My remarks are on record in popular and academic journals. The major criticism was the definition of reserve assets and the Bank of England's inability to control their supply. The experiment proved a disaster, partly because Mr Heath misused the system, but partly because it was in any case a very defective system.

When this was realised, the Bank tried to remedy the weaknesses of Competition and Credit Control by introducing the 'corset'. We now

have conclusive evidence that the major effects of the corset were:-

- (i) to reduce measured money supply growth without reducing underlying money supply growth.
- (ii) to distort relative interest rates, and
- (iii) to render the money supply statistics meaningless.

5. The disturbing fact is that those in the Bank responsible for these innovations - John Fforde, Charles Goodhart and Kit McMahon - are still there and that they show very little signs of dispensing with the intellectual framework which produced such schemes.
6. In the recent seminar (September 29th 1980) held at Church House I was impressed by the way in which Bank of England officials seemed to be looking for a "half-way house". In fact one of the questions for discussion was precisely as to whether it was possible to construct some 'half-way house' to a monetary base system.

My fear is that the Bank will put forward proposals which have the appearance of monetary base control (much as Competition and Credit had the appearance of controlling the monetary aggregates) whereas in reality they allow themselves sufficient loopholes to do what they want so that it will be business as usual.

{ Fin in Week
have. →

- 4 -

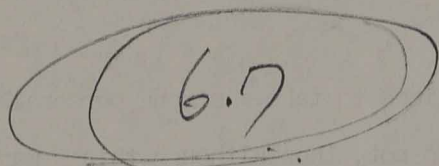
① M₃ - controllable?
or just not controllable.

7. In my judgement a proper system of monetary control will not be proposed by the Bank of England but will have to be imposed on them. Given our system it is inevitable that it will come from the Treasury. But in this area the Treasury is very weak staffed compared to the Bank and with one honourable exception, namely Peter Middleton, many of the staff, whom I know, seem far too agnostic to propose anything approaching a good workable system.
8. I believe it is of vital importance that you, as Prime Minister, are able to assess the Treasury proposals before they are published as a joint Treasury and Bank scheme, and that you seek the written advice of Brunner, Meltzer, et al at this stage.
9. When the proposals are published the critical points to watch are:-
- (a) the extent to which the Bank changes its lender-of-last-resort function; →
 - (b) whether or not MLR is tied to a market rate of interest;
 - (c) the extent to which the Bank are prepared to target the monetary base on a short run basis - so that effectively they reduce the options available to themselves in the conduct of policy.

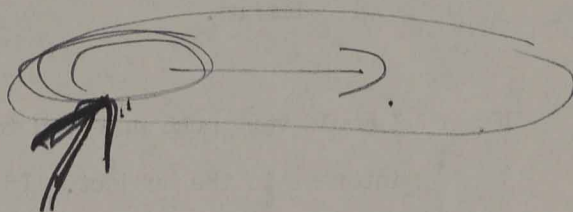
(d) the transitional arrangements - the City is an exceptionally innovative place and such reform could easily be introduced in a 3-6 month period: all this talk of years is sheer humbug.

10. I would very much urge you to continue to take a strong personal interest in the subject. If you do not, then although things may improve in the next few months I have no doubt that because money supply growth is pro-cyclical similar problems will emerge in the recovery from the present recession.

Brian Griffiths
8 October 1980



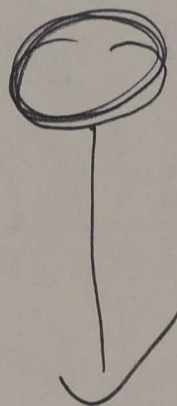
5.5



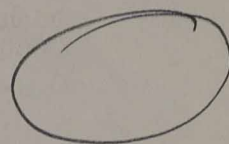
7.7

276 276

25 206



| 223



•••

1 1/2

8-9

13 13

HS

~~W.P.~~ 26/10/80
you may wish
to note P 26/10

Kevin Pdl.

16 October 1980

The Prime Minister has asked me to thank you very much for your letter of 8 October. She was most grateful for the paper which you enclosed with it: she found it extremely helpful.

TIM LANKESTER

Professor Brian Griffiths

HS