



10 DOWNING STREET

MR. MIDDLETON

I did not realise that the Chancellor read Griffiths' papers. It so happens that I had a discussion with Griffiths about these matters and I wrote him the enclosed letter on his presentation.

Obviously I did not deal with all the points on which there was disagreement. That would have taken for ever. But I think there is still a substantial common ground between us. What I am more worried about is the methodological and, in some cases I think logical slips in Griffiths' arguments.

Please show this to the Chancellor if you think he would like to see it!

AW

28 April 1981

ALAN WALTERS

cc Mr. Lankester ✓
Mr. Wolfson
Mr. Hoskyns
Mr. Duguid



10 DOWNING STREET

22 April 1981

Dear Brian,

Thank you for sending me your Supplement 1 to your Annual Monetary Review "How Tight Was Monetary Policy in 1980?". As you might imagine, although there is a great deal of common ground between us I cannot follow some of your arguments and I thought it might be useful if I put one or two issues down on paper.

First, I agree with you that the most unambiguous indicator of monetary policy is usually some measure of the quantity of money. That is common ground between us. When I worked on the quantity of money from 1865-1961, I found that all the main monetary magnitudes, at least on an annual basis, moved broadly in a similar way. In fact when I fitted demand for money functions there was very little difference between them. Even when one extended the definition of money to readily encashable assets, the parameters did not change very much. But I am sure you would agree that there is a possibility of a particular measure of money being rendered if not useless then very misleading by either Government restrictions or by movements in interest rates, applicable to certain items in the aggregate, far far outside their normal range. I believe that this is what happened in 1980 and I think that your Table 4 results are consistent with that. On the other hand I have never been enamoured of the savings ratio account of the difference, which Meltzer and indeed the Treasury put forward. It seems to me the stock effect would dominate the flow effect of a change in the savings ratio. Again your results seem to bear this out.

Secondly, I find it difficult to understand your argument that the "exchange rate has jumped without any changes in monetary policy". You seem to attribute it to a large extent to the oil price shocks and the fact that the UK is somehow insulated from such shocks. But if this is true for the United Kingdom, should it not also be true for Canada? Yet we know Canada has a very weak dollar and it has slumped relative to the US dollar over the period 1975-80. Similarly, I cannot find evidence of the bolivar increasing in value, and I believe the rial is a weak currency. I am sure one could go round the world looking at other oil exporting nations and find both strong and weak currencies among them. The important point is I do not wish to deny that the presence of oil makes UK assets somewhat more attractive than they would be in the absence of oil. But I would argue that the massive appreciation of sterling,

/unprecedented

unprecedented in any currency since the period of floating, is not conceivably attributable only to oil. Whereas I cannot for the life of me find an occasion where since 1971 there has been a monetary squeeze (relatively) which has not been accompanied by an appreciation of the currency. And in a period of fixed exchange rates the normal effect was, of course, a balance of payments surplus. We seem to have got those in Britain. Again, however, to avoid misunderstanding, may I say that no-one should use evidence of a marked appreciation of the exchange rate as evidence of a monetary squeeze. One should use it merely as evidence which corroborates a theoretical proposition. One should look for one's monetary squeeze in the monetary aggregates.

Similarly, I do not disagree with your basic proposition about real interest rates. They can be very difficult to measure and quite misleading. But under conditions where the money supply is being distorted by Government regulations of one sort or another, even the most hazy notions about real interest rates may be useful. I think also you miss an important point that the inflation rates which enter into the real interest rate calculation should be for storable goods and assets such as houses, work in progress, stocks etc. and should exclude services, electricity supply and rides on the tube and trains. I think if you do this analysis you will find interest rates in real terms in the latter part of 1980 were enormously high, and as far as I can recollect ^{higher} than any other period in monetary history. But I have not done any detailed analysis of these phenomena. I think the important point is that you need the expected rate of inflation. In principle you need some theory of expectations to calculate real interest rates and, of course, there you are on much more treacherous ground. I suppose most of us implicitly take the actual rate as an indicator of the expected rate, at least when we are analysing historical series. And perhaps that is about the best we can do. But it does indicate, I think, very high real interest rates certainly in the latter part of 1980.

On your Statistical Discussion of M_3 and M_1 , I am rather surprised that both M_1 and M_3 perform as well as they do. Is there any statistical difference between the two \bar{R}^2 ? I suspect that they are roughly the same. But also, since you are concerned with early warning systems and the average lag for M_1 is a long, long seventeen quarters compared with ten for the sterling M_3 equation, would not this lead you to prefer to use M_1 as an early warning system rather than M_3 ? It is also worth noting that the M_1 figure has been distorted by the operation of competition and credit control in 1971. And you did not adjust for that. I suppose you could do it by putting in dummy variables or something of the sort.

Finally, something of a quibble but on page 11 you remark that the nominal money supply is not affected either by changing real factors or changes in the expected rate of inflation. If you take nominal money supply as being determined by the authorities as an instrument variable, then of course it's a tautology. But that is certainly not true in the real world determination of M_3 or M_1 . The expected rate of inflation and changing real factors will determine asset preferences which will have an effect on M_3 .

Although I find some of your conclusions acceptable, there are one or two I cannot follow. Of course I agree that it takes some years for changes in money growth to make a significant impact on the rate of inflation. But on your statistics which show that the half life of the M_3 effect is ten years, would imply that the reduction in the growth rate of M_3 in 1978-79 from 18% to 14% would have an effect of roughly 2% reduction in the rate of inflation by 1981. But I think the reduction in the inflation rate has been much more rapid than your equation forecast. I would ask you to also contemplate a considerable reduction in the rate of growth of M_3 in 1981. If this occurs, say the growth rate drops to 7-8%, would you expect that the deflation to appear in 1982, 83, 84?

Another difficulty I have with your conclusions, is the argument that the high real exchange rate depressed export demand. As far as I can see export demand remained high and on a level during 1980 and into 1981. Surely the point is that as you remark in the next sentence on page 28, exports rose. And this was surely because the fall in the supply schedules, denominated in sterling prices, in export markets. This fall was due to the monetary squeeze.

Similarly, I am not convinced of your argument that the real problem in 1980 was the excess stocks which had been built up in 1978 and 79 when money growth was high and producers thought they were facing a growing real demand for their goods. I was, as you know, in America at the time but everyone was fearing the most enormous slump from about 1976 onwards. And if America would have gone into a slump then it would have dragged Britain and Europe along with her. If you accept the argument that real interest rates reached an all time high in 1980/81 then of course it is easy to explain the de-stocking of that period and the depth of the slump is also more tractably explained. But I must confess I am in very grave doubts about all these explanations since there are lots of loose ends to be tied up yet awhile.

Now to the general programme of monetary control. I think that the best aggregate to have as a target is the monetary base. I would not wish to have any of the other broader aggregates as the target, except that of course I would keep a close monitoring watch of them over the medium term. That after all is supposed to be the main rationale of the medium term strategy. Even for monetary base, however, one must recognise that it should be controlled, for the purpose of restraining inflation, only over quite long periods. One might easily have short run variations in the monetary base to accommodate incipient liquidity crises; but these would be of short duration, certainly less than a year and preferably they should be over in two or three months. I must say that ultimately I would prefer to have constant monetary base so that the technological changes in the financial markets would probably induce the growth of M_1 and perhaps also M_3 at some two or three percentage points. This would be enough to accommodate real growth with a non-inflationary price level. I suppose that target is a long way away, but I think it is one we should keep in mind. It is a policy that has eminently respectable supporters. You will recall that Denis Robertson recommended such a policy in those halcyon days of the mid-1950s. And it seemed Eisenhower was pursuing a very similar policy in the United States.

Professor Brian Griffiths

*Your ever
A.C.*