



10 DOWNING STREET

R.

MR. GOW

Attached are my notes on
John Moore's paper, as requested.

19 June 1981

ALAN WALTERS

cc Mr. Wolfson
Mr. Hoskyns
Mr. Lankester ✓

NOTE ON JOHN MOORE'S PAPER

I think there is a misconception about the present role of government in credit markets. As he will observe in the recent Bank of England Quarterly, the role of the Bank has changed very considerably over the past 3 or 4 months. MLR has ceased to have any function. It is jokingly called the rate at which the Bank will not lend any money! And this is broadly true. The Bank has done very little business through its Discount Window. It no longer gives any guidance to the market about interest rates. It operates ^{through} open market operations. It does not quote prices at which it would buy and sell bills.

Thus during the rapid fall of the pound against the dollar which occurred some three weeks ago, there was an increase in interest rates on three-months and six-months money, and this occurred without any guidance from the Bank whatsoever. Had interest rates shot up very high, then the Bank would have provided assistance by buying bills. But even under these rather exigent circumstances, the market solved its own liquidity problems without any assistance, or at least unusual assistance, from the Bank.

These interim arrangements do provide for an unpublished interest rate band below which and above which the Bank will intervene. But if there is persistent pressure on the markets then the Bank will move that interest rate band either upwards or downwards. In particular they will be moved upwards if there is a tendency for the monetary aggregates to overrun their target values, and downwards if they are undershooting. This movement will not be done automatically and in a knee-jerk fashion. It is intended that the movement of the bands take account of the need to achieve the appropriate monetary targets in a relatively long run, round about a year.

Ultimately, it is anticipated that the bands will be widened until they are irrelevant and all the Bank's operations will be in the open market, primarily in the bill market, and the criteria will be simply the appropriate monetary aggregates.

Now, to turn to the long end of the market, the intervention of Government here is primarily through their demand for credit in terms of sales of gilt-edged securities. It is primarily through the demand for Government finance that the authorities effect this market. Of course, some effects will be transmitted from the short end to the long end. But they are muted and uncertain.

The net result of all this is to argue that primarily interest rates are to be determined by the market. Government operations affect rates at both ends of the market. At the short end they are affected primarily by the Government's supply of cash and reserves to the banking system. In any medium-term period, such as, say, a year, the supply of cash and reserves will be determined by the Government's monetary targets; thus interest rates are determined by the achievement of the monetary targets, at least as far as Government activity is concerned. At the long end they are determined, as far as Government action is concerned, by the PSBR, and of course the impact of changes at the short end and the expectations generated thereby.

Now let me deal with Mr. Moore's particular points.

Government Funding and Lower Interest Rates

I think Mr. Moore is quite right here. He says "increased taxation is more honest than increased borrowing made possible only by rates of interest which impoverish the private sector". I think that the last budget was designed precisely with that in mind. And I believe it has been demonstrably successful. We have lower interest rates than many of our competitors, and lower real interest rates than most of the developed world. But at the long end we are still high, as high as America and indeed higher than Germany. This I am afraid reflects the fact that the market still does not believe that our policies will be successful. On the whole one cannot blame the market; they have been disappointed by every previous Government of the United Kingdom. But as confidence in the policy has grown, so the price of long-dated gilts has increased. It will take us a while yet to earn the confidence of the cynical managers of funds.

/The Exchange Rate

The Exchange Rate

Here again Mr. Moore is substantially correct. It is both existing interest rates and anticipations of the change in foreign exchange rates which determine the exchange rate. What matters is that the rate of return on financial assets should be equalised in terms of whatever currency one chooses. Thus, when we had very high interest rates in 1980 the pound appreciated very rapidly because everyone was anxious to acquire sterling assets and this meant that the pound having been driven to a considerable appreciation, was widely expected only to go one way, down, and it obliged in the first five months of 1981. I think it is important to get the causation right though. Under a system of free exchange rates, it is monetary policy relative to that of ones main trading partners, that determines exchange rates. It is not exchange rates that determine monetary policy, or monetary conditions.

Inflation

I find some difficulty with this part of Mr. Moore's thesis. Supposing that we reduced short-term interest rates by increasing cash and reserves of the banking system. This would inevitably lead to an expansion of the money supply, probably initially the narrow aggregates. Now Mr. Moore is quite right that historically there has been virtually always some expansion of production as a consequence of an increase in the rate of growth in the money supply. But that increase in production has taken place only for a few months then production falls back even to below its previous trend value. We are left then with merely the effects of an increased growth in the money supply with, if anything, a lower level of production, and so we go through the dreary cycle of inflation and stagnation. Over the past historical record we have seen that the stimulus to production has become smaller and smaller. I suspect that with present expectations the effects on real output would be small, and the effect on inflation large. You can see these effects working in the last two expansionary periods in the United Kingdom, in 1971-73 and in 1977-78. In both cases there was some increase in output and in employment. But again both of them saw a sharp fall in output, an increase in unemployment and yet another twist in the inflationary spiral.

/Furthermore,

Furthermore, as the inflation gets under way, or strictly as expectations of inflation become ingrained in people's consciousness, then interest rates will rise even higher than they were before the monetary expansion took place. This again is the sad story which has been repeated over and over again since the 1950s.

I do not share Mr. Moore's belief that most businessmen do not take a sophisticated view of real interest rates. My experience in a large number of economies is that businessmen and indeed ordinary small investors are much influenced by the real interest rate and are not fooled by any money illusion. In some economies I have seen interest rates in more than 100% and with almost as high rates of inflation. However, Mr. Moore is perfectly correct in saying that businessmen will not take out credit for which they have no use. What will deter the demand for credit is the lack of an outlet for profitable use of those funds - which is reflected nowadays in the very low rate of return on real assets. The explanations for this low rate of return are, of course, many; trade union practices, planning restrictions, government regulations, local authority rates, etc.

Property Boom

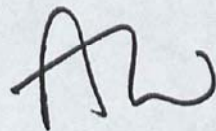
Again I think that Mr. Moore is right that to a large degree the property boom was stimulated by the laxity of the monetary authorities. But I would also argue that it was generated by the profligacy of the Heath government in first expanding the rate of the growth of the money supply which was less than 9% before September 1971 and after that never less than 20%, sometimes over 30% until 1973. This was also to some extent a consequence of the dirigiste policy of the Heath government in keeping down artificially the rates of interest. And that should be a lesson to us all.

I do not share Mr. Moore's enthusiasm for limiting the mortgage relief only to the standard rate. This is a very complicated matter since it links up with all the chaotic absurdities of the housing market, with its regulations and rigidities. Perhaps this subject is best left to a later discussion.

/Conclusion

Conclusion

I believe that our objective should be to get the money supply right and government borrowing right, and then leave interest rates to be determined by the market. If we are on course with our money supply and our government borrowing, then interest rates can be left to look after themselves. Furthermore, that enormously important factor expectations and confidence will be working with us rather than against us.

A handwritten signature in black ink, consisting of the letters 'A' and 'W' in a stylized, cursive font.

19 June 1981

ALAN WALTERS