Monetary Policy file

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c Mr Turnbull

RESISTING A RISE IN INTEREST RATES

You might be interested in the attached Treasury paper assessing our power to control interest rates in the light of July's events. It is good exposition of standard Treasury doctrine, which Andrew Turnbull and I remember from our days in HF.

The key argument is that if you really pull out all the stops and take on the markets to resist a rise in interest rates, then although you might succeed at the very short end, you will be signalling clearly that you care less about overall domestic monetary conditions and bringing down inflation than you do about the level of interest rates. Even if you start by saying that existing interest rates are compatible with your financial objectives, the measures taken to defend interest rates will themselves tend to loosen financial conditions. The market's expectations of future inflation will change as a result of their new view of the Government's policy objectives. This in turn will lead to:

- A fall in the exchange rate so sharp that the Government's nerve may fail.

- An upward adjustment in all but the shortest interest rates, reflecting a more pessimistic view of inflation. Base rates might well be caught in this upward adjustment, given that we do not have total control over them.

There is one important point, however, which the paper does not emphasise enough. The 1981 arrangements were not only intended to depoliticise interest rate movements, but also - connected with this - to make interest rates more flexible. The Authorities, by becoming so obviously upset about the - admittedly unjustified - upward pressure on interest rates in July, may have contributed to the atmosphere of crisis, and so increased the political damage done by higher rates. It would be better to have accepted that interest rates will move up and down as a result of market pressure, and the Government doesn't want them to change only as a result of a major political decision. If the market drives up interest rates because of a temporary panic, then they are likely to come down again pretty soon. We should be looking for frequent modest changes in interest rates, with which we need not be associated. It is only the underlying trend we should care about.

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