PERSONAL

11/2/85

I think it important that you should glance over this memorandum which came to me last Friday from Chips Keswick. I think he has some valid points which are being obscured by possibly fallacious opposition. I think it would be a good idea for him to see the Governor of the Bank of England or some top official there so that they can argue the matter through.

Chips Keswick is very intelligant and a great fan of yours.

W.W.

Enc.

10 DOWNING STREET

From the Private Secretary

11 February 1985

Dear Tony.

ACTION TO DISCOURAGE SPECULATION

No. 10 has received three approaches, each through different channels, from Mr. Keswick, urging a policy of high interest rates for overnight money as a way of discouraging speculation. A first approach gave rise to the request for the Treasury/Bank paper of 25 January on a "bear squeeze". The conclusions of that paper were fed back to Mr. Keswick who replied with his notes of 4 and 8 February.

We agreed that as these notes raise questions about the Bank's conducting of money market operations you would see Mr. Keswick in an effort to explain the position of the authorities.

Yours sincerely
Andrew Turnbull

ANDREW TURNBULL

A. L. Coleby, Esq.

Speculation against Sterling

The Nation's banking system as currently operated by the Bank of England does not appear to have a defence against speculators bearing sterling except with resort to the U.K. reserves or bringing back exchange control.

In recent times the per diem cost of borrowing money has not been sufficient to erode the profit margins of selling sterling short and borrowing to cover the position. To quote LEX on Tuesday 29.1.85 "For short-term traders, the penalty is ludicrously small, since the daily impact of the extra two points of interests costs is of the order of one two-hundredth of a cent, negligible in relation to the currency movement."

The conclusion therefore is that instead of base rates at 14% per annum a rate of 350% or 1000% per annum overnight to give a flat cost of 1% or 3% is required to discourage the speculator. Speculators only desist if they actually lose money or feel that there is a system in place to cause them to lose money. The solution which is needed is the short sharp corrective violence of 300/1000% interest rates without the ripple effect into everyones daily lives as well as the longer term damage to the economy.

At the present time the Bank of England controls the Nation's liquidity and with it short term interest rates (under one year) through the medium of the discount market.

As keeper of the Nation's books the Bank alone knows the daily shortages or surpluses on the Nation's account. First thing in the morning they publish their guess at the shortage or surplus for the day. If there is a shortage in excess of £500m the Bank purchases Treasury Bills, Bank Bills and Local Authority Bills from the discount market thereby releasing liquidity into the system. This operation is repeated at noon and again if necessary between 2-2.30 p.m. If the shortage is not completely taken out by the Bank the natural result is for short term interest rates to rise. There are other means of alleviating a shortage of liquidity:-

a) Repurchase agreement of assets from discount houses.

b) The sale and repurchase between the commercial banks and the Bank of England of percentages of the commercial bank's eligible liabilities.

c) Last resort lending facilities to the discount houses.

This entire operation puts no fear into the speculator for two reasons. Firstly he can see what is happening in advance, and secondly he is in the spot market and not the cash market. In other words he is always borrowing money two days in advance to meet his liability under a bear position. Therefore even if there is a sharp rise in the cost of money for one day he need not be caught if he is nimble due to the two day settlement period on the foreign exchange market.

For the reasons above the discount market as currently operated is too slow and too obvious to catch the speculator and it takes too long for the hidden shortage to reach the commercial lender to enable him to raise his interest rate to catch the covering speculative borrower.

cont'd..

Furthermore the combined capital and reserves of the discount market of £200m are inadequate to stand the necessary substantial losses in their books which violent upswings in interest rates would produce on their carried assets. In other words the whole market is badly financed which makes it an unlikely medium for corrective violence.

The other leg for controlling sterling interest rates are the eligible banks, lead by the clearing banks who are obliged to keep credit balances of say £200m with the Bank of England.

The daily clearing has to produce a balanced book so that the clearing banks are not overdrawn at the Bank of England and in practice they should not reduce their agreed balances much below the £200m agreed level. Under the current system the clearing banks put up their base rates on a lead from the interest rates as operated through the daily assistance provided by the Bank of England to the discount market through the four date bands of bill purchases. These rates as explained above are based on the Bank of England's view of the shortages/surpluses through their accounts. The weakness therefore is inherently the same as with the discount market in other words the speculator can always see the Bank of England and the Clearing Banks coming.

Within the present system therefore it is very difficult for the Bank of England to disguise the position, unless it puts out a false shortage on any particular day and subsequently refuses to give help, which undoubtedly would cause a sharp rise in short term interest rates, but due to the speculator dealing two days in advance might well not catch him, and everybody ends up paying except for the miscreant. The Bank therefore has to be prepared to run a shortage for a number of days in succession. Clearly the longer the period of shortage and the higher the daily rates, the greater is the danger of effecting the three month rates with its attendant influence on the economy. Here however the objective must not be lost sight of which is to regain the initiative against active and/or defensive speculation and the restoration of confidence. Introducing lack of confidence in the speculator is a key component.

Conclusion

To the outsider the Bank of England appeared in the January crisis to have an attitude of "benign neglect" so that speculators turned their attention to what others were doing and the herd instinct ran rampant.

Put another way, uncertainty makes people cover their foreign exchange positions. If every foreign receiver of sterling covers automatically you are bound to get a run on sterling due to the simple fact that there are more genuine receivers of sterling round the world than there are financial speculators. A genuine receiver of sterling may be defined as a defensive speculator, give him confidence and he will not automatically cover.

Finally there appears to be a misapprehension that there is a mysterious supply of sterling held abroad. This is irrelevant since sterling interest rates are controlled or should be controlled in London. Only a madman keeps a large number of coins in his pocket on which he is not receiving interest.

J.C.L. Keswick

4th February, 1985.

Speculation against Sterling

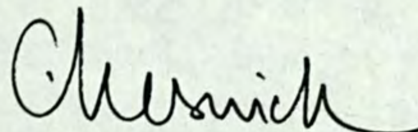
This is a sequel to my memorandum of 4/2/1985, a copy of which is attached.

A banking economist has apparently advised that very high rates of interest induced by the Bank of England through its money market mechanism for short periods, for say up to one week, would so effect the yield curve that the disruption to the economy would be too great. This begs a question, but does not give an answer. The unpalatable truth may be that money supply has been out of control. The attached graph B shows the private sector lending figures, and the point to concentrate on is the growth since the low of 1982. Graph C shows 3 months London interbank rates falling in 1983 and the first half of 1984 whereas private sector lending was rising. The conclusion to be drawn is that the Bank of England was supplying liquidity during this period to prevent interest rates from rising. How was this financed? The answer appears to be through the building up of a bill mountain which from a low start during the time of the Corset in 1980 has risen to £5b in 1981, £8b in 1982, and £10½-11b in 1984, and possibly to £13-15b today. In turn therefore how was the bill mountain financed by the Bank of England? The answer appears to be over-funding the PSBR by selling gilts. I suspect that this circle has distorted what appears to have been reasonable M3 figures in recent times. You even have to ask where has the money gone which has been lent by the banking system to the private sector, and the answer presumably is more into the stock market and overseas investment than into working capital for industry. Hence the weakness in sterling.

The conclusion that I draw is that if the bill mountain was not so high (and incidentally the discount market not so badly financed) then the short sharp shock of very high interest rates for short periods would be workable. However the whole system is so over geared when the crisis arrives that there is no leeway to take short term action.

Conclusion

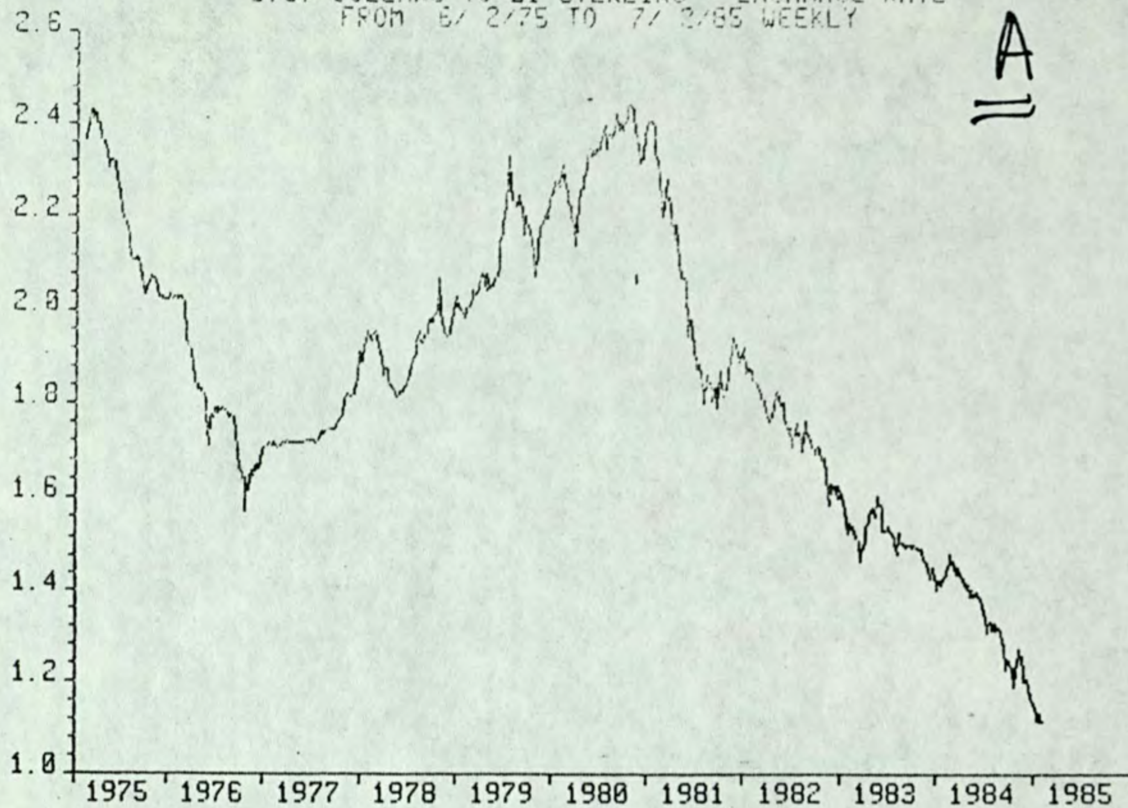
This is a complicated subject, but if banking practice were followed rather than economic theory I suspect that we would not be in the mess we now appear to be in. The key question remains why is the bill mountain so high and why is the Nation's liquidity based on a discount market which is so badly financed.



J.C.L. Keswick

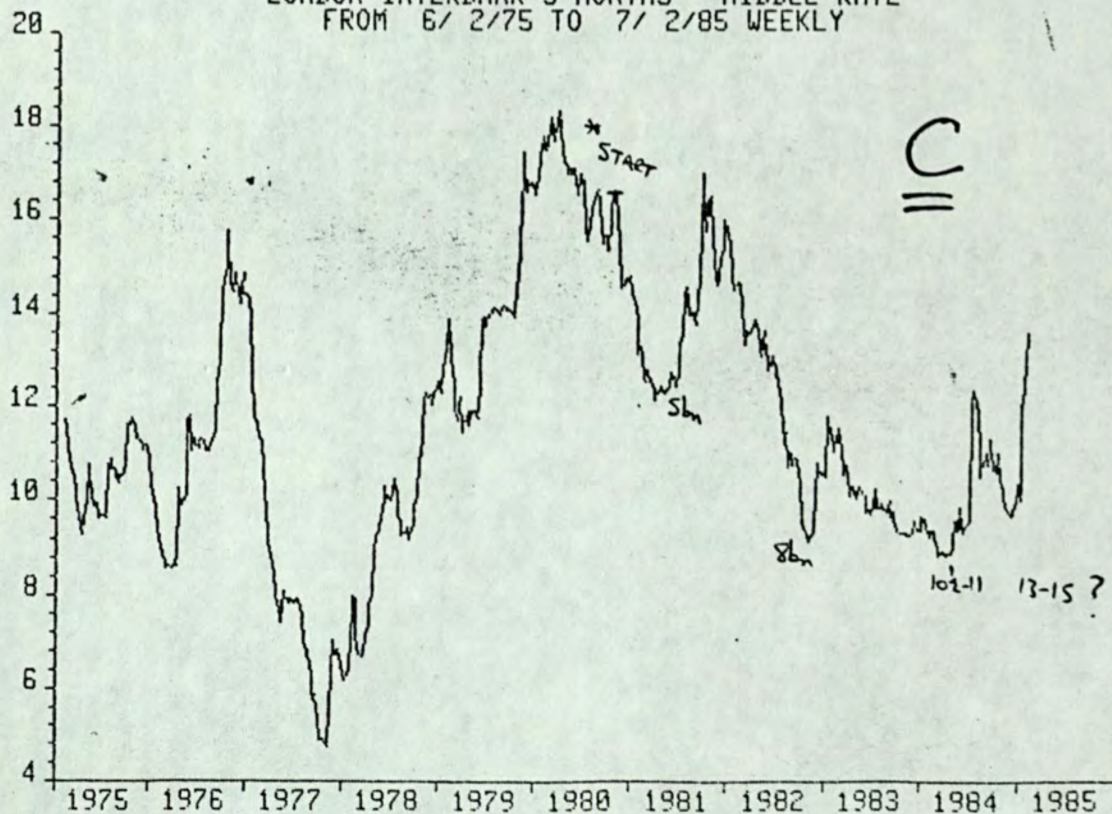
8th February, 1985.

U.S. DOLLARS TO £1 STERLING - EXCHANGE RATE
FROM 6/ 2/75 TO 7/ 2/85 WEEKLY



HIGH 2.4425 23/10/80 LOW 1.1165 7/ 2/85 LAST 1.1165

LONDON-INTERBANK 3 MONTHS - MIDDLE RATE
FROM 6/ 2/75 TO 7/ 2/85 WEEKLY



HIGH 18.375 3/ 4/80 LOW 4.781 10/11/77 LAST 13.563

* BILL MOUNTAIN

B