File

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Dear Andrew,

ACTION TO DISCOURAGE SPECULATION

I had a long session yesterday afternoon with Mr Keswick, seeking to elucidate what exactly were the propositions he wished to advance, and what thinking lay behind them. Clarity was by no means easy to achieve, but I set out below the position that I believe we reached.

The first and most important conclusion is that he does not argue that it is possible to inflict a severe penalty on speculators bearing sterling, without substantial ripple effects on domestic interest rates. He claims that he has never held that position, which would be very half-baked. The ground on which he now stands is that it is desirable to inflict severe penalty on the speculators despite the effects on domestic interest rates, and the damage to domestic institutions, that might be expected to follow.

We were not able to reach agreement on what exactly those effects might be. He did however agree that if overnight rates of 3% per diem were to be brought about, and to persist for the three business days necessary to ensure that they were brought to bear on speculators, it would be inconsistent for the rate for one month money to be below 36% per annum. Arguably it would be a good deal higher. He accepted that this sharp departure from the established experience on which existing institutional behaviour is based would cause widespread disturbance among domestic practitioners. His memorandum had singled out the discount houses, whose essential business is to provide liquidity to other banks by borrowing very short and investing somewhat longer. But he agreed that the effects could go much wider. All banks with committed borrowing facilities for customers would be in grave difficulties, which they could escape only by sharply raising base rates (in the case of base rate-related facilities) or bidding up the relevant inter-bank rates (in the case of inter-bank related facilities). That would in turn threaten the viability of customers having outstanding drawings under similar facilities. Mr Keswick's position was that the duration of the squeeze would be sufficiently short-lived for these wider repercussions to be ignored.

The upshot is, I think, that we do now see a little more clearly what policy prescription he offers, and it does not contain any new insights making our current problems easier to solve.

Our discussion on the content of his second memorandum dated 8 February was even more inconclusive. I took him through the mechanics of the existing arrangements for managing money as we understand them, starting with the virtually autonomous behaviour of banks in putting on sterling assets and finishing with the money market operations which put to use the positive cash flow which central government has at its disposal once it has achieved the funding necessary to manage M3. Whether he was unable to understand or simply unwilling to accept that version of the system I was uncertain, but he persisted in seeing our money market operations as the initiating source of a chain of transactions leading to inflated bank lending and a desperate attempt to fiddle the monetary figures through gilt sales. He was entirely explicit in believing that the behaviour of bank lending was a more valid indicator of monetary conditions than that of M3 or other monetary aggregates. His evident belief that higher interest rates would correct the overshoot of bank lending was not based on any analysis or evidence not already well known to us, but was implicitly resting to some extent on there being an accompanying supply of funds discipline on the behaviour of banks.

My conclusion from that part of the discussion was a depressing one. First, because it revealed how little understanding of the objectives and techniques of current policy there was even in quarters where one might reasonably expect it to be total: secondly, because of the readiness it revealed in those quarters to reject current policy on grounds as superficial as those of the least well-informed commentators: and thirdly because of the absence of any new insights in offering alternatives, or even of a coherent expression of the case that can be made for alternative approaches. There is no doubt that we are suffering quite a lot from the unflattering perception of policy exemplified by Mr Keswick, and should spare no efforts to counter it at every possible opportunity.

Yours sincerely,

Tony Coleby