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NIEHANS THE APPECIATION
OF STERLING EFFECTS
AND POLICIES

1981

DD's 25yrs N.A3y
24/4/97

THIS FOLDER HAS BEEN
REGISTERED ON THE
REGISTRY SYSTEM

18.3.81

16.2.81

Chancellor of the Exchequer

cc Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr Ryrie
Sir Kenneth Couzens

without attachment:

Mr Burns
Mr Britton
Mrs Lomax

NIEHANS

1. You and others might like to have a copy of the paper prepared by Jürg Niehans, a Swiss economist who was commissioned to do a study on sterling appreciation by the Centre for Policy Studies. The report is due to be published shortly by the Centre.

2. Dr Niehans was recommended for the study by Alan Walters. His views are very similar to those of Mr Walters. The report is a long one, so I also attach a short digest of key passages prepared by Mr Burns. He and I attended a seminar to discuss the study with Niehans who I have also seen on a number of earlier occasions.

3. The study is strong on views but not so strong on analysis and evidence. It also, not surprisingly for a piece of work done over a 5 week period by someone unfamiliar with our institutions, tends to treat the UK as though it was Switzerland. With one exception there is nothing very new in it. But it is a very good read for anyone with the time. Perhaps I could pick out a few points.

4. Niehans' basic proposition that the exchange rate has overshot in both normal and real terms is one with which most people would agree. The causes of the overshoot are however hotly contested. Kay and Forsyth you will remember attribute a major role in this to North Sea oil. Niehans and Walters are right at the other end of the spectrum in assigning a very small weight indeed to the North Sea. They attribute the overshooting overwhelmingly to the tightness of domestic monetary policy.

5. The argument is one with which you will be familiar from the papers put into the Select Committee by some of their own advisers and outsiders such as Professor Dornbush. It suggests that the

exchange rate adjusts quickly to tighter monetary conditions. But prices and wages adjust only slowly. So interest rates have to remain high in the short term, and the exchange rate rises by more than is justified by the relative growth of the money supply in the UK and overseas.

6. You obviously cannot construct an argument based on £M3 growth because it is much too high. The argument is usually put in terms of expectations engendered by the medium term strategy or in terms of real interest rates. It has to be based on expectations in some form or other. The question is what determines the expectations.

7. Niehans (and Walters) have come up with a new angle in relating overshooting to the tightness of domestic policy as seen by observing movements in the monetary base.

This diagnosis affects the policy prescription to relax monetary policy:

a. to the extent necessary to rectify excessive past tightness; and if this does not succeed in bringing down the exchange rate

b. by specifically overriding the monetary target in favour of an exchange rate objective. Niehans picks a rate of $2.15 as the point at which the "Imperial Guard" is rolled out to expand the money supply temporarily until the exchange rate falls - by intervention and a progressive lowering of interest rates.

8. There are a number of difficulties with this:

a. the numbers for the monetary base cannot carry too great a burden of explanation. And they cannot have influenced expectations in a direct sense because practically no-one knows what they are. The base has been provided on demand under a system where discount window lending was available without penalty at a market rate. So the numbers cannot tell us too much about the banks' true demand for cash, or the tightness of policy.

b. Niehans uses some strange numbers - for good reasons, because we do not publish a series - for the base. He suggests that the base is about 10% below trend. Our figures suggest it is about half that.

c. The objective of monetary policy has of course been to reduce monetary growth in order to get inflation down. So there is no reason why we should expect monetary growth to be on the trend of the 70s. And there is some curious logic involved in suggesting that we should compensate for tightness in this sense.

Look at it this way. The monetary base school suggests keeping the growth of the wide base steady in order to bring long term stability to prices. It is not a fine tuning approach. A growth rate of 5-6% a year in M_0 is usually suggested as being consistent with the MTFS figures and also with a reasonable inflation objective for the time being. This is about the rate at which the base is currently growing. Most would want to get it down to 2% eventually. So it is very odd to recommend that the base should be allowed to expand back to 13-15% or perhaps a lot further if the exchange rate stays sticky, to counteract the effects of what is seen as excessive tightness over the past 3 years in order to get it back over perhaps a shorter period to where it is now.

d. There was considerable consternation at the seminar - particularly from Patrick Minford and Sam Brittan - that even if the argument for a temporary relaxation on the grounds of excessive tightness in the past was valid, it would be very difficult to present convincingly. People would assume that the domestic monetary policy was being relaxed permanently. Moreover, given the stickiness of the exchange rate, in relation to changes in interest rates and intervention - and indeed our past lack of success with exchange rate policy - they would probably be right. In this context, Niehans is however undoubtedly right in suggesting that intervention which does not affect the money supply is unlikely to have much effect on the exchange rate.

9. I must say that I think the issue is not all that complicated. If the exchange rate was not so high, no-one would be drudging the domestic monetary statistics looking for an aggregate that appeared to produce a degree of tightness which appeared to furnish a

complete explanation for it. There would be satisfaction rather than consternation at having got the growth of the base to its present rate. If it is accepted - which it usually is - that there is no very clear explanation for the exchange rate in terms of conventional indicators, but that the high exchange rate does exert a strong downward influence in inflation, then so long as the exchange rate remains high there is a case for relaxing domestic monetary policy - something has done the job for you and you do not need to do it twice. But exchange rates go down as well as up and we are left with judging whether it is worth the risk of an adjustment to the monetary stance, taking account of what that implies for expedations, for what might be a temporary phenomenum but one which we cannot see the end of. That is exactly the issue which we have been discussing with you over the past few days. It is much the same issue that Harold Rose is raising when he says that the demand for money must have changed in the last year; the question is whether the change is permanent or temporary.

E. A. Clarke

pp P E MIDDLETON
16 February 1981

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CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

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CHANCELLOR

CC Chief Secretary
Sir D Wass
Mr Ryrie
Sir K Couzens
Mr Burns
Mr Middleton
Mr Britton
Mrs Lomax

NIEHANS

I have seen Mr Middleton's critique of the Niehans report - and of its serious shortcomings - circulated on 16 February.

Mr Middleton's analysis is, in my judgement, wholly valid. We would be crazy to go this route - at least unless and until we have succeeded in turning the UK into Switzerland in more substantial ways.

SAJL

PP NIGEL LAWSON
17 February 1981

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Direct Dialling 01-233 5627

cc Mr Barratt
Mr Burns
Mr Lavelle
Mr Monck
Mr Peretz
Mr Riley
Mr Turnbull
Mrs Lomax
Miss Barratt
Mr Spencer
Mr Fisher

P E Middleton
Deputy Secretary

2 March 1981

A Walters Esq
10 Downing Street

Dear Alan,

We showed the Bank a copy of Niehans paper because Graham Hacche and John Townend had prepared a paper examining whether relative rates of monetary growth could be shown econometrically to have affected the exchange rate. In their original work they concentrated on the relative rates of growth of broad monetary aggregates and found no significant effect for relative monetary growth. In view of Niehans work, Graham Hacche has re-run his equations to see whether there was a more significant effect to be found for the relative rates of growth of M1 and M_o on effective exchange rates. Again he has found no such significant effects. I am sure you would like to have a copy of this work.

If you think it would be useful for the Bank to send a copy to Niehans to see what he thinks of it, the Bank would be very happy to do so. Indeed if Niehans would like to specify an econometric test of his claim about the effects of monetary growth on the exchange rate, the Bank would be very happy to run an empirical test for him.

I am copying this letter to Charles Goodhart.

Yours ever,

Peter

P E MIDDLETON

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Mr Boulton
Mrs Lomax
18/3

10 DOWNING STREET

2 March 1981

Dear Peter,

Thank you for your letter of 2 March about the Graham Hacche and John Townend paper examining econometrically the effects of M1 and M_0 on the effect of the exchange rates. I think the Bank should certainly send Niehans a copy of their paper.

For my own part I would have thought that the "noise" in monthly differences in the monetary base* were so enormously large that one would never expect any relationship between such differences and the change in the exchange rate. And I understand they even tried weekly figures! However I can quite see their point that they have not enough years, and so insufficient degrees of freedom, for their formal modelling. But I doubt very much whether Niehans would agree that they have tested his hypothesis; nor, I think, would he regard any of the hypotheses they tested as even remotely plausible for the time periods under review. I won't speak for him. Let us send the test to him and see what he says.

I am copying this letter to Mr. Goodhart, Bank of England.

Yours
Alan

* or M_1 or M_3

P.E. Middleton, Esq.,
HM Treasury.

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cc Chief Secretary
Financial Secretary
Mr Ridley
Mr Cropper
3/3

1. MR MIDDLETON

2. CHANCELLOR

cc Mr Burns
Sir K Couzens
Mr Barratt
Mr Britton
Mr Lavelle
Mr Monck
Mr Peretz
Mr Turnbull

NIEHANS : SUMMARY

As requested, I attach a very brief summary of the Niehans Study. The Chancellor will recall seeing your note of 16 February recording the seminar you and Mr Burns attended to discuss the study; that note also included a fairly detailed summary of the paper made by Mr Burns.

RL.

RACHEL LOMAX
2 March 1981

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NIEHANS: THE APPRECIATION OF STERLING : CAUSES EFFECTS AND POLICIES: A Summary.

A. Analysis

1. The real appreciation of the rate due to North Sea Oil has been small and largely avoidable. The main effect of oil has been to intensify the monetary squeeze by increasing the demand for money; this could have been offset by allowing the money supply to rise. Rather, the strength of £ to is due to a severe domestic monetary contraction which has caused the exchange rate to rise, temporarily, far above its long run value.

2. Exchange rate overshooting is a wholly undesirable disruption. The benefit to inflation is illusory. As the rate falls back to more normal levels, inflation will accelerate. There will be serious transitory effects on output, employment and, may be, trade.

3. Monetary policy has been very tight, despite £M3. Real interest rates show this. £M3 is a misleading indicator; M1 is better; but the monetary base is better still. Measured by the growth of base money, the shift to a restrictive stance in mid 1979 was more abrupt than advocated by the most ardent monetarists.

B. Policy Prescription

4. The long run trend of monetary policy should be set to prevent inflation or deflation. But the authorities should deviate from this trend to dampen excessive fluctuations in the real exchange rate.

5. Intermediate Monetary Targets £M3 should be discarded because (i) it bears no reliable relationship to prices, output or the exchange rate. A rise in £M3 may foreshadow inflationary or deflationary pressure on the economy depending on how it is brought about. The 1980 overshoot probably reflected the economic

contraction.

(ii) it cannot be controlled by monetary policy instruments (ie short term interest rates); M1 would be an improvement, because it approximates better to money as a means of payment. But no monetary aggregate is very suitable for rigid targeting. There are inevitably structural shifts in the financial system. And inflexible targetry runs the risk that important information eg. about output, the exchange rate, will be neglected.

6. Monetary Control Whatever target is chosen, control of base money is a better technique than discretionary setting of interest rates.

7. Exchange rate ceiling The authorities should temporarily abandon the medium term monetary target and adopt an exchange rate ceiling of say $2.15. This should be achieved by intervention, which should be allowed to expand the monetary base. Reducing interest rates will be a less effective way of capping the exchange rate. The expansion in base money will probably be short lived.

8. There should be no permanent shift to an exchange rate target, nor should the UK join the EMS.

D.2

CHANCELLOR

cc Mr Burns
Mr Middleton

NIEHANS: PLANS FOR PUBLICATION

It strikes me that it would be important to establish before long whether it is the intention of the CPS to publish the Niehans study; to make it available informally; or simply to sit on it. Publication could be distinctly unhelpful, as could fairly widespread informal circulation, particularly if it took place in the near future and in time for the Select Committee to draw on the Niehans analysis in cross-questioning this Department. You or the other recipients of this note may have some idea what is intended. But if you do not I imagine it would be sensible to find out what is currently planned. If so I am willing to undertake the necessary investigations.

AR

ADAM RIDLEY
4 March 1981

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Mr Ridley

cc Principal Private Secretary
PS/Financial Secretary
Sir Kenneth Couzens
Mr Burns
Mr Britton
Mrs Lomax
Mr Walters) No 10
Mr Wolfson)

NIEHANS

You were asking when the Niehans study was likely to be published. I have had a word with Alfred Sherman. He said that he now had a more or less satisfactory text, but there were still some points to be resolved. He expected to be distributing the study sometime in the next 3-4 weeks, but he could not be more precise than that. He will let us have a copy of the final version, but in substance it is said to be very little different from the earlier draft.

PEM

P E MIDDLETON
18 March 1981

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