Treasury Chambers, Parliament Street, SWIP 3AG
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17 February 1981

Dear Tim,

Interest rates

I attach a paper prepared in the Treasury for discussion at the Prime Minister's meeting tomorrow.

I am copying this letter, and the paper, to Tim Allen at the Bank of England.

Yours ever

John Wiggins

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INTEREST RATES

1. This note first sets out the new arrangements for determining short term interest rates after the Budget. It then examines the factors which might be taken into account, both before the Budget and in taking decisions under these arrangements.

The New Arrangements

2. Under the arrangements announced by the Chancellor in his statement on 24 November, the Bank will reduce its discount window (last resort) lending - indeed it has already done so. Instead it will rely on open market operations. Cash will be injected and withdrawn from the system by purchasing or selling bills. The objective, each month, will be to keep the interest rate on 7 day money within a 2% band, with a further outer band of 1% on either side to allow for fluctuations on individual days. These bands would be operating rules for the Bank; they would not be disclosed to the market.

3. There are a number of advantages in these arrangements:

a. shifts of the band would be smaller and more frequent than with MLR.

b. the market will have more of a role. It will influence short rates of maturities longer than 7 days.

c. the authorities will not fully control day to day swings in interest rates within the band. The terms on which cash is available to the banking system will be less predictable. The banks may be rather more cautious about their lending and about offering open-ended overdraft facilities than at present.

The institutions will thus have a controlled foretaste of the increased volatility of interest rates than might follow from a fully fledged monetary base regime.

4. Decisions on the centre point of the band each month, and whether interest rates will tend to the top or bottom of it within the month will still be taken by the authorities. The new

arrangements still leave the Government with the task of settling the criteria to be taken into account in making these decisions - though perhaps less of a problem in having to justify each move.

Criteria for Determining Interest Rates

5. The present position is that interest rate changes should be made in relation to changes in the monetary aggregates - particularly but not exclusively £M3. There have been difficulties with this:

a. the response of £M3 to changes in the level of short term interest rates is uncertain and difficult to predict. It may even be perverse in the very short run. The problem is that much of £M3 is interest bearing and thus responds to the structure rather than the level of interest rates, and the long run effect of interest rate changes can take time to build up. £M3 reacts more strongly to changes in fiscal and funding policy.

b. Experience suggests that £M3 on its own may not be an adequate measure of monetary conditions. £M3 has also been affected by the corset so it has not given a true reading, though it should be more accurate from now on.

6. There may be a case for looking at the narrower aggregates and other factors more closely than we have done in the past for purposes of short term interest rate management. The narrow aggregates respond more certainly to changes in the level of interest rates, though the effects also take a while to build up. M1 in particular changes to a much greater extent than £M3 for a given change in short rates. Moreover the narrow aggregates seem to have as good a relationship to the final objective of reducing inflation. £M3 could then assume a role as a medium term objective to be achieved over the whole MTFS period rather than in one specific year.

7. Since the autumn, it cannot be said that changes in £M3 have had much influence on interest rate decisions. We have however had a comfort that the narrower aggregates have grown slower. M1 has in particular been within the target range set

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for £M3. It is open to question whether this is reasonable; on past relationships M1 would be expected to be below £M3 for a given effect on inflation. The relationships between the aggregates observed last year are in any case unlikely to carry through in the same way next year, so it is also necessary to examine the implications of other factors - the inflation rate, the exchange rate and the real economy which might be taken into account in setting interest rates.

8. The following paragraphs consider what might be implied by the various indicators.

£M3

9. £M3 has grown at an annual rate of 21% since the present 7-11% target range was set in February 1980. Allowing for the effects of the corset, the increase was around 18%. It has grown slower in the last 3 months - an annual rate of 13% - but February and March could well see figures of over 1% and the rate of increase for the target period will be close to 18%.

10. Looking ahead, we face the task of persuading the markets that a PSBR of £11½ bn after the tax changes in the Budget is consistent with the MTFS figure of 6-10% growth in £M3 next year, given experience this year. The task is not so difficult as it might appear because, assuming we claw back none of last year's excess this year, the starting level for £M3 will have risen sufficiently to accommodate the rise in nominal incomes. Last year we began the target period with £M3 low relative to incomes. A target growth of £M3 of between 6-10% for the next financial year would be considerably nearer to the expected growth in nominal incomes, than when we set last year's target. But in practical terms we have to persuade people to hold a high proportion of the increase in financial assets which the PSBR and current balance implies, in a form other than bank deposits. Both in relation to its past performance and future prospects, it is impossible to make out a case for an early lowering of interest rates based solely on £M3. Indeed we should need all the favourable impact on expectations from lower inflation to avoid higher interest rates.

M1

11. The narrow aggregate about which we know most is M1. Over the target period it has risen by around 8% so far, but has grown rather more rapidly over the last 3 months. M1 is of course much more responsive to lower interest rates. At the interest rates required to give us a chance of keeping £M3 to the MTFS path, we think that M1 might grow by about 14% next year. A rise in interest rates would probably be needed to achieve a target rate of growth for M1 of 8%.

12. Looking to the future, with interest rates falling, M1 can be expected to grow relatively rapidly. If we experimented for example by bringing interest rates down to equal the inflation rate, M1 growth could rise to around 20%.

The Monetary Base

13. Though we are planning to publish the numbers in March there is, as yet no series for the monetary base. So it is difficult to mount a public argument now for changing interest rates by praying movements in the base. Moreover the interpretation of the numbers is open to doubt given past institutional arrangements.

14. Over the last 11 months the base has increased by around 4% as has the non-interest bearing component of M1, but the series is an erratic one and by April on our figuring the figure could be as high as 12%, when compared with the same month a year earlier. The base will move rather like M1 though not so certainly, in response to interest rate changes. But our knowledge of its behaviour is limited.

The Narrower Aggregates: the Past

15. The monetary squeeze looks different when looked at over past periods in terms of different aggregates. If we examine changes in the real money supply for this purpose, it can be seen that whereas £M3 is about back to its historic trend, both M1 and the monetary base are still some way below. But they are both recovering. And the prospects of more rapid growth in these aggregates in future, together with our expectation that they will grow substantially quicker than £M3 next year, means that it is difficult to take full credit for the past low growth rate in setting our objectives for next year.

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16. To sum up then, it is not easy to construct a case based on the observed movement of the monetary aggregates for a sustained fall in interest rates. The past behaviour of narrow aggregates might be used to support a case for a limited further fall. There might also be a case for a limited fall based on the possibility of more favourable developments in £M3 later in the financial year. But this would imply a commitment to raise interest rates again if the narrow aggregates do move ahead rapidly as we should expect, and if £M3 fails to fall. The analysis and numbers above could of course turn out to be wrong - the picture might turn out to be a good deal better than we think. But as of now the numbers do not show it.

The Exchange Rate

17. A case for lower interest rates would have to be supported by reference to other factors. The most obvious of these is the exchange rate. This is higher than anyone thought, partly for reasons connected with North Sea oil and seems likely to stay so. The exchange rate does part of the job which tight domestic monetary conditions are supposed to do in bringing down inflation. It is part of the total monetary picture. In an open economy it is one of the main ways in which monetary restraint affects inflation. But it also affects activity and output. If the exchange rate has overshot, a case could be made out for lower interest rates and a greater expansion of the domestic money supply for as long as at least some of the overshootin lasts. If the exchange rate overshoots temporarily the inflation rate reduction is brought forward at the cost of an acceleration in inflation when the exchange rate falls back later on. But any benefit to inflation is important in the battle against inflationary psychology.

Inflation and Real Interest Rates

18. The inflation rate has fallen while nominal interest rates have remained high. Real interest rates have now risen - though it is an impossible task to measure them accurately as they depend on expected inflation. They have risen sharply from the negative interest rates we experienced earlier in the year. But other OECD countries are also experiencing equally high real

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interest rates.

The Company Sector

19. The high exchange rate has a severe effect on the liquidity and profitability of industry. It had been hoped to offset some of this effect by fiscal means, but the high PSBR for next year rules out large scale help for companies. Lower interest rates would be an effective way of helping companies, particularly as low profitability means that many of them cannot get tax relief for the interest at present charges. This would be true whether or not the exchange rate falls in response to the lower interest rates.

The Real Economy

20. The Treasury forecast envisages a small improvement in output next year, but investment and exports are expected to weaken. It might be thought that these conditions are so tight that an easing of monetary policy, at least temporarily, is indicated.

Restating the Strategy

21. It is essential to restate the medium term monetary strategy in a way which restores credibility. £M3 will continue to be the centre piece of the strategy - perhaps with its medium term nature emphasised. The question then is whether movements of short term interest rates can be decoupled for medium term movements in £M3. Though it will be impossible and unwise to attempt to do this completely fiscal policy and funding policy - which is still under examination - would be seen as the main means of achieving medium term control. There are two broad possibilities for month by month decisions:

a. The Narrow Aggregates

Greater emphasis on the narrow aggregates would tend to suggest higher rather than lower rates consistent with the MTFS. Extra formal targets might simply multiply the problems of monetary control.

b. Inflation and real interest rates. Inflation is expected to remain around 10%. This would point to a further reduction in interest rates. The movement of the monetary aggregates could look very uncomfortable, but not completely unconstrained.

22. The position with the exchange rate and the real economy is different. One possibility would be to relax the stance of policy - both in the short and medium term - to take account of this. For example we could raise the upper and lower ends of the target range to 5-11% to accommodate more monetary growth. The high PSBR for 1981-82 reinforces the case for a move in this direction. But this has to be balanced against the need to maintain the expected thrust of the strategy.

23. This is however a very different proposition to adjusting monetary policy in order to achieve some particular objective for the exchange rate or the real economy.

24. The exchange rate responds uncertainly to small changes in relative interest rates, intervention and changes in the money supply unless there is a sharp change in confidence when it can respond all too quickly. Steering by the exchange rate could mean very wide divergence of the money supply from any target path. The response of the real economy to lower interest rates would of course be very slow, though companies would be helped over a difficult period.

25. The case for lower short term interest rates depends on the balance of factors outlined above. A downward move now would have to place a lot of emphasis on the movement of real interest rates and inflation. Given the prospects for monetary growth, a lot of weight would have to be placed on these arguments if we are not to raise expectations of higher interest rates later in the year or even sooner. It has to be recognised that it may be very difficult to reconcile these moves with the MTFS, unless we could argue convincingly that £M3 growth would slow down eventually or that monetary growth above the upper end of the target range would not imply higher inflation.

An Immediate Move

26. Against this background, the case for an immediate move in interest rates could be viewed in two ways:

a. It could be seen as getting a small change in interest rates in using the real interest rate argument, with very little immediate effect on £M3 before the Budget.

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b. It could be seen as heralding a sustained fall in interest rates for reasons which cannot be supported by the observed changes in the monetary aggregates. It would be a short step if this came to be believed to move into an exchange rate policy, as the most obvious alternative indicator - where we reduced interest rates until the exchange rate does move.

27. There is clearly some difficulty in mounting a complicated explanation of the sort required immediately before the Budget. The risk of a misleading signal would be very great, given the monetary background and what we know - but what the market does not know - about the PSBR.

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