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Dear Gordon,

I've just read your "Monetary Control in the U.K." speech. I agree with almost everything in it. In particular I think you are right to single out the slowness of policymakers to adjust interest rates as the fatal flaw in current systems. Peter Howitt and I did a little work on this last summer and were able to show, for one rather special model, that provided interest rates adjusted quickly enough, a system that used them was viable. This is not a point of purely academic interest, because the Bank of Canada have been using interest rates to control the monetary growth rate, have been willing to change them quickly and quite radically, and have on the whole been able to stick to their targets in a way that should make the British and the Americans blush. The real problem is not a technical one, but rather stems from the fact that in Britain and the States the authorities have allowed their nostalgia for interest rate targets to interfere with their policymaking.

I quite agree with you that the British ought to go for base control. I also agree that the base ought to bear interest at competitive rates so as not to penalize banks. However I would suggest to you that fixing the reserve ratio close to "prudential" levels is probably not desirable. The reason for that is simply that what used to be a prudential reserve no longer is when it's a required reserve: remember the old fables about the last bucket at the well, and the last taxi at the railway station! Basically the higher the required reserve ratio, the less scope is there for prudential excess reserves to fluctuate and affect the base multiplier. Therefore on the whole I'd rather go for a high reserve ratio than a low one. If the reserve base is bearing interest at a competitive rate of course, and if that interest rate is adjusted rapidly and frequently, then you probably wouldn't get too much in the way of variations in excess reserves and my

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worries would not be so important.

Nevertheless it does seem to me that your otherwise very sensible proposals do not pay as much attention as they ought to the trade-off between the level of reserve requirements, and the closeness of the interest that required reserves bear to market rates, in ensuring that the money multiplier is a stable one. I hope you find these few comments of help. I found your speech both interesting and stimulating.

Yours sincerely,



David Laidler

DL/mm