

Mr. Britton,

Awaiting the further
response of

Sir Douglas Wass

M. Middleton

Many thanks. 9

with mine X

AW

2/12

Mr Middleton
Can be second time
for forward (C) - Mark 1
done there is too
much to say
cc Mr Bridgeman
Mr Cassell
Mr Shepherd
Mr Odling-Smee
Mr Riley

27/12

see 1.2.80

following vol.

INTEREST RATE SENSITIVITY

X 1. May I reply briefly to the question in your minute of 17 December about the efficacy of high nominal interest rates. I have agreed with Charles Goodhart that we will prepare a joint note on interest rate sensitivity and I should prefer to wait until this is done before replying at length.

2. The main point however is this. We have spent a lot of time this year thinking about new schemes for monetary control. But the main feature which all these schemes have is that they sharpen the response of short term interest rates to changes in the supply of money. However, there is precious little evidence that changes in nominal interest rates in the range we have so far witnessed have much effect in reducing monetary growth. Possible reasons for this are:

a. bank lending responds very sluggishly to interest rate changes. The lags may be so long that for monetary control purposes in relation to an annual target there is no response at all.

b. Gilt tactics are for the most not designed to reinforce changes at the short end of the market. So short rates have to play a disproportionate part in bringing about changes in the general level of interest rates.

c. The one area where interest rate sensitivity seems to have improved is in external flows following the abolition of exchange control. But this is an unhelpful change as far as controlling the money supply is concerned because it produces a smaller outflow from the private sector and a larger inflow from the rest of the world.

3. In my view the Prime Minister was probably asking the right questions at the seminar when she queried the sensitivity of the system to interest rate changes. Our paper will explore this further.

BE

P E MIDDLETON
20 December 1979

39-21-12

101/1