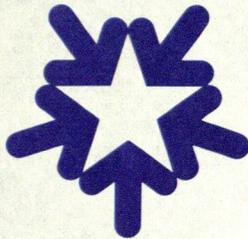


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CENTER FOR RESEARCH IN
GOVERNMENT POLICY & BUSINESS

Prime Minister (2)

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LEW

September 22, 1982

The Right Honorable Mrs. Thatcher
Prime Minister
10 Downing Street
London
England

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Dear Prime Minister:

A series of events delayed my summary of the points discussed on August 19 on Lake Zug. It still seemed possibly useful for your purposes to receive my summary. The delay offered an opportunity to acquire more information about the internal state at the Bank of England. Kurt Schiltnknecht, at the Swiss National Bank, had an opportunity at the occasion of a recent meeting between four Central Banks to talk with some representatives from the Bank of England. My assessment is based on my discussion with Schiltnknecht and the summary he conveyed to me.

Sincerely,

Karl Brunner

Karl Brunner

Fred H. Gowen Professor of Economics

KB:jwm

Enclosure

Memo Concerning the Issues Discussed on August 19, 1982 at the
Freudenberg on Lake Zug

I. Monetary Policy

1. Current state and immediate requirement

The Bank of England did pursue in the average over the past years an anti-inflationary course. This course effectively lowered the rate of inflation by a substantial margin. This policy also produced in the context of an inflationary heritage the recession experienced. The recession has unfortunately been prolonged by the recent course followed by the Bank of England. The signs of economic recovery appearing earlier this year were overwhelmed by a new deflationary thrust initiated last fall. The Bank of England actually lowered the crucial monetary aggregates during last winter and spring.

The anti-inflationary program proposed by the Prime Minister does not require such harsh measures. There is no good reason to let the money stock and monetary base fall for any prolonged time. The benchmark level of non-inflationary growth for these monetary measures remains positive.

At this stage the Bank of England needs, quite immediately, to raise the growth rate of the monetary base for the balance of the year. This "reflation" should not exceed 5%-6% at an annual rate. It is important to avoid an excessive "reflation".

2. Adjustments beyond the immediate future.

The "reflation level" of 5%-6% p.a. should not be maintained for an indefinite future. A successful anti-inflationary policy will retard for a time the movement of monetary velocity. This pattern has been

observed in all countries which successfully lowered the rate of inflation. Once this phase is over, further reductions in monetary growth to a long-run non-inflationary level need be made. I would expect that some first adjustments of the kind indicated will be necessary during next year.

3. Strategic conception and tactical procedure of the Bank of England

The Bank's behavior during last winter and spring reveals both the progress made and the problems remaining in policymaking. All the indications available suggest that the Bank of England is strongly committed to pursue an anti-inflationary policy. This commitment apparently makes the Bank very sensitive to possible (short-run) bubbles in price indices. This sensitivity directs moreover the Bank's attention to possible devaluations of the Pound Sterling. The anti-inflationary commitment seems to have fostered some concern about the effects of "imported inflation" attributable to higher import prices. The Bank of England settled under the circumstances on a course designed to lower the probability of a new surge in the price-level. But this course also involved a serious risk of an "overreacting deflation" with the consequences emerging this summer.

The apparently determined commitment to an anti-inflationary policy marks in my opinion a substantial progress in the Bank's views. There seem to be other indications of movements in the Bank's thinking and policy conception. For a long time the Bank essentially neglected to develop the data required as a basis for adequate policymaking. This situation

has been substantially improved over the past two years. More reliable data on the relevant money stock measures (M-1 and M-2) are now available. The Bank appears moreover to lower the attention traditionally directed to an essentially unsuitable measure (M-3). Beyond recognizing more relevant measures of the money stock some of its officials even speak about the monetary base.

All these indications do not mean that the accustomed conceptions and practices have been definitely abandoned. But it suggests to me that the monolithic tradition has cracked sufficiently to permit possibly some new ideas to enter. I suspect that some rethinking may proceed within the Bank. Most particularly I suspect that some of the new directors are interested and willing to reexamine the proper choice of monetary strategy and its tactical execution. Recent behavior reveals however that this reexamination has not proceeded very far. The Bank of England seems at this stage in a phase of suspension or transition. Uncertainty and anxiety unavoidably characterize this phase. If my interpretation of the Bank's situation is correct then some friendly prodding and encouragement would seem useful. It is very important at this stage that the Bank reexamine how to develop a credible and effective long-run anti-inflationary policy without raising the social cost any further.

The Bank may be concerned at the moment with the repercussions of a "reflation" on the bond market. Some of its staff and officials seem to understand that the credibility of the Bank's anti-inflationary policy is an important issue. Some may feel that a reflation lowers the credibility level of their policy. This concern is probably justified. But this justification offers no case against reflation. The patterns produced by

past policies do indeed create a credibility problem. The resolution of this problem should not proceed however along the lines initiated last fall. Reflation will probably induce some uncertainty on financial markets. The Bank of England would best serve its long-run commitment and most effectively contribute to a credible posture by committing itself to a monetary strategy and tactical execution suggested at the occasion of the discussions in early October 1980.

II. The Budget and Fiscal Policy

Some clear progress has been achieved in budgetary policies. The major problems confronting the government at the moment are demands from the private sector for substantial budget expansions and the demands by public employee unions. These demands should be resisted in order to protect the progress made so far.

III. On the Law of the Seas

Within a few months the treaty prepared by the long series of conferences sponsored by the UN on the "law of the seas" will come up for signature. The provision of this treaty bearing on the exploitation of the deep sea minerals should be carefully weighed. These provisions would impose serious implication on western nations. They would undermine the property rights of western business firms, create a monstrous monopoly controlled by interests hostile to the West and assign implicit taxing powers over western democracies to an institution with no effective representation by the West. The whole endeavor is essentially a socialist

exercise at the cost of a market solution of the problem. There is an alternative approach to the exploitation of deep sea minerals based on competitive markets. This approach involves an application of the homestead principle used for the development of the "Wild West" in the USA. Some of my colleagues who worked on the problem also maintain that the State and Defense Departments in the USA substantially overrated the gains in the range of shipping and geopolitical-military interests and underrated the social costs of economic concessions. The treaty poses a particularly serious problem for nations with high technologies. An open competitive solution along the homestead principle would assure an expanding market for "high technology products".

IV. The UN's Assault on Patent Laws

The international state concerning patents, their rights and exploitation, are still governed by the Paris Treaty of 1883. Pressures exerted by Russia and Third World nations apparently induced the UNO to prepare the groundwork for a revision of this treaty. Preparations proceed in some UN offices in order to set up a commission or a series of conferences. Preliminary signs would indicate that the revisions addressed involve a serious attenuation of property rights in technological innovations. This change in the rules of the game would affect most seriously pharmaceutical firms in western nations.

V. On Insolvency and Illiquidity

The threat of insolvency and illiquidity confronts policymakers at this stage with a potentially serious problem. Emergence of insolvencies

or illiquidities requires careful attention by policymakers in order to avoid serious deflationary consequences in the near future or a further expansion of the government sector and the budget over the longer horizon.

The approach to insolvency and illiquidity should be guided by two conditions: first, there should be no socialization of losses (no bailout by the government), and second, there should be no deflation. The first condition prohibits the government's involvement as a supplier of funds and guarantees. Violation of this condition produces a pattern of "cold socialization" of business units. Once the government started on this road it will become increasingly difficult to terminate the arrangement. A "sheltered sector" beyond the narrower government sector develops which tends to raise the central budget. Socialization of losses encourages moreover private managers to misjudge risks and to rely on the government's power.

The second condition is important in order to protect the nation's money stock. The first condition makes sure in this context that this protection does not mean protection of management and creditors (with claims not constituting a portion of the money stock).

A proper policy addressed to the two problems may be summarized both for banks and non-banks as follows:

Non-Banks

Illiquidity:

The private parties involved should simply re-negotiate the maturity schedule of liabilities.

There is no need for the government to intrude.

Insolvency:

Once again, the private parties involved need to settle affairs on their own. Three aspects suggested by current experience in

some countries should be noted in this context. Attention to these aspects assures the rapid integration of the resources involved into a productive process.

First, assets and liabilities need be re-evaluated in order to have a balance-sheet reflecting the actual situation. This process simply acknowledges and distributes the losses incurred.

Second, on many occasions the new management need to renegotiate wage and salary settlements in order to assure future operations.

Third, the new management must be in a position to decide on relocations of plant and how to use the facilities without constraint by government in order to assure their most productive use.

The government may help in this process as a broker encouraging speedy negotiations and settlements of new arrangements. But the dangers confronting government are clearly visible in the Italian development over the past twenty years and also the current state in Germany with respect to the AEG.

Banks:

Illiquidity

Bagehot formulated the basic policy in his Lombard Street.

In case of a run on the banks Central Banks should simply supply the required currency. It appears that Central Bankers discussed this issue at recent meetings at the BIS in Basel. There seems to be a substantial awareness of the problem among Central Bank officials. They do understand that they will have to operate under the circumstances as a lender of last resort.

There occurs today however a new aspect which needs to be considered. The existence of "offshore banks" and the "Euro-market" extends the

function of a lender of last resort. A Central Bank is certainly responsible for the money stock within the national boundaries. It needs to offer therefore its services as a lender of last resort to all banks within the national territory irrespective of their ownership status. But the modern banking structure requires even more at this stage. Euro-banks supply liabilities in a variety of denominations. A run on a Euro-bank supplying dollars in Germany requires attention by the Federal Reserve Authorities. They are the only lender of last resort for dollars. Bagehot's principle need be revised to the extent that Central Banks function as lender of last resort with respect to all demand obligations issued by banks anywhere stated in their respective currency denomination. This extension of Bagehot's principle should be carefully examined by the Central Banks.

Insolvency

The discussions swirling around the case of the Ambrosiano Holding in Luxemburg exhibits some remarkable confusion between the illiquidity and the insolvency problem. In contrast to demands by some creditors of Ambrosiano Holding a lender of last resort should under no circumstances finance a bailout operation, i.e. absorb the losses for the benefit of management and creditors.

Insolvency of banks contains however a special dimension. It is important that such insolvencies be addressed at the least social cost in terms of disruptive economic conditions. Policymakers should in particular lower the risk of deflationary shocks. In case of insolvency adjustments in management and the value of non-monetary

liabilities should be encouraged via negotiations among the parties involved. If at all possible the bank should be maintained as an operating unit in the expectation that a future stream of earnings can be produced under a new management. The first order of such earnings would be the write-off of the losses incurred and the development of the firm's net worth. An insolvent bank may thus be granted a period of grace of up to 5 to 8 years, designed to adjust its affairs along the lines suggested. It is important that this period be not too long as in the case of Austria (50 years). Such a long period rewards incompetent and irresponsible management. The period of grace should be short enough to put all the costs and risks on owners and managers and to make them aware that Big Brother will not "solve their own problems".