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 expectations, 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

ff P E MIDDLETON
16 February 1981

Encs