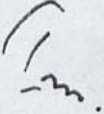


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PROFESSOR ALAN WALTERS

1. Herewith Memorandum dated 16th June from John Moore M.P., who is Under-Secretary of State at the Department of Energy, and who is a strong supporter of the Prime Minister.
2. I think that his Memorandum does contain a number of fallacies.
3. Would you be kind enough, please, to let me have your comments on his Memorandum? Thereafter, perhaps it would be helpful for you and him to have a chat.
4. I repeat that John Moore is a good man.

18th June 1981


IAN GOW



WHY THE ARGUMENTS AGAINST REDUCING INTEREST RATES ARE NOT VALID

There is general agreement that reducing interest rates would stimulate economic growth by encouraging productive investment. Yet the Government hesitates to reduce them because of a mistaken belief that the action would:

- 1) be inflationary
- 2) hurt the exchange rate
- 3) make it more difficult to fund Government debt
- 4) lead to an unproductive property boom as in the early 1970s.

None of these assumptions is necessarily true, and most of them stem from misunderstanding of the nature of financial markets and in particular the US market.

There is much talk currently of the high US "prime rate" being the reason for the stronger dollar, talk which automatically assumes the prime rate plays the same role as MLR. That is not so, the US prime rate tells you nothing about the rates at which government,



the municipalities and most of business are actually borrowing. Municipal bonds, with very low interest rates attract high taxpayers because they are tax free and so are quite special instruments. Both business and government borrow on the bond market at rates of interest well below prime. Well-rated businesses are right now probably paying half prime or less.

In Britain, by contrast, MLR really is the rate at which most businessmen have to borrow, and some have to borrow at overdraft rates ABOVE MLR. In such a situation a high MLR has a much more stifling effect on business growth than a high prime.

The contrast between the British and US situation is further heightened by the dominant role the Government play in the British market. The stock market here is now 80 per cent geared to funding government and local authority debt. In the US, Government is a minority interest in the money markets compared to private



enterprise. In Britain, the Government can set a rate of interest that reflects its own need for funds. The private sector, the minority interests in Britain, then is forced to compete with the Government for funds. What should be a Government tail is wagging the business dog.

Given this background, and thus an acceptance that the US situation is substantially different from the British, we can address the particular British arguments against lowering interest rates:

Effect on funding Government debt The first question that arises, then, about a proposal to cut interest rates is whether the Government would then be able to go on funding its debt. Undeniably, lower interest rates will make gilts less attractive, but what is the elasticity of demand? At what point do we think that the Government would not be able to raise all that it required? And how large would that shortfall be - £1 billion, £2 billion?



If we reached the point of such a shortfall, so what? We would be forcing the Government at a given rate of interest to convert part of its debt into something else - either reduced spending or increased taxation. We ought to regard pressure towards either one of those as healthy. Increased taxation is more honest than increased borrowing, made possible only by rates of interest which impoverish the private sector.

There will be offsetting factors. As interest rates fall, and Government debt becomes harder to raise, so new debt and some existing debt will be cheaper to finance. Furthermore, as lower interest rates stimulate activity, so higher tax flows will accrue, particularly from VAT. The switch to a 15% rate of VAT and the switch that we have made towards higher real excise duties gives us a much greater revenue buoyancy which we often seem to neglect.



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The exchange rate The conventional wisdom is that a wide differential between interest rates here and American rates or average foreign rates will weaken the pound. But interest rates are only the determining factor when foreign investors already have doubts about the economic viability of the country. Anticipation of the future is what determines investor actions. Hence Switzerland is able to maintain low interest rates ^{because she has} ~~but~~ a sound currency. The pound's recent decline against the dollar is more to do with increased confidence in the Reagan Administration, and some reduction in confidence in Britain as real oil prices ease, than with differential interest rates.

monetary

Inflation The policies of the Government are rightly based on the assumption that it is the creation of new money without increased productivity that is inflationary. Cutting interest rates will boost credit, but it will also boost gross domestic product. There is therefore no prima facie reason for a cut to be inflationary. High interest rates have not been effective in reducing inflation. They have made it easier for Government to



borrow, and in the recession hard-pressed businesses have been forced to continue borrowing even at the highest rates. It is not clear, therefore that high interest rates have acted to hold down the money supply.

If a reduction in the rate of interest brings an increase in the amount of credit, there will be some offset to that from the greater difficulty of government borrowing, and the further reduction of that borrowing as VAT and excise duty receipts pick up with increased economic activity. Furthermore I do not believe that most businessmen take a sophisticated view of real interest rates at any time. To them rates of interest above, say, 10 per cent seem very high whatever the rate of inflation, and so act as a major psychological impediment to investment. I do not think that in general businessmen will take out credit for which they have no use just because the rate of interest is near the rate of inflation.

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Property boom There is a danger that some of the upturn in activity might be vitiated in a property boom. On past experience the danger is more likely to arise in the commercial property sector rather than the domestic, and we might have to look at measures to deal with that. In fact the 1970s boom was closely associated with the emergency of secondary banks. Since then new banking legislation has given us much more effective controls against them.

X On the domestic side we should not be afraid to abolish tax relief above the standard rate of tax and so cover the most likely area of difficulty. Of $5\frac{1}{2}$ million taxpayers currently claiming mortgage interest relief, only about 0.7 million claim it on rates other than standard. The other 4.8 million would therefore be unaffected by such a change. However, they would stand to gain substantially from cuts in the mortgage interest rate. For example, a 4% cut would reduce the effective payment of interest on a £15,000 mortgage by £420 per year.



For the 0.7 million who do claim relief above the standard rate of tax the effect of abolishing the higher levels of relief will vary according to income. The married man earning £20,000 with no special tax allowances and the maximum amount of mortgage qualifying for relief (25,000) would be better off by about £698 a year if interest rates fell 4 per cent. But if at the same time as falling 4 per cent the higher reliefs were abolished he would end up only £305 a year better off.

A man in the same position earning £40,000 (therefore receiving relief on his interest at the top rate of 60 per cent) would gain by £400 from a 4% reduction in interest rates. But if at the same time relief at the higher rates were abolished, he would end up £275 a year worse off.

This limitation of tax reliefs is, let us not forget, the natural counterpart of having reduced the top rates of tax in our first budget. And indeed we should now be considering a further reduction in the top rate.



Conclusion

This note has sketched the case for a reduction in interest rates, and addressed some of the most readily perceived objections to such a course. What is missing from it are several numbers and estimates.

What, for example, is our best estimate of the elasticity of demand for gilts as interest rates fall? The answer to that is likely to depend on the state of confidence in the Government, and naturally this would be presented as a coherent policy capable of retaining that confidence. Another complex factor is the exchange rate, in which once more confidence plays a crucial role. What impact would a reduction in interest rates have on the cost of Government borrowing? And what effects might follow from our now greater revenue buoyancy as economic activity picked up?



We can of course turn to the Treasury for guidance on these matters. But this outline need not, I think, be delayed awaiting that work.

John Moore.

JOHN MOORE

16/6/1951