MOORE, M.P.

10 DOWNING STREET

29th June, 1981

I showed Alan Walters your Memorandum about Interest Rates dated 16th June.

I enclose a copy of his comments dated 19th June.

Alan has said that he would be delighted to have a chat with you about this, if you would like to do so.

Alan's telephone number is 930-4433.

Ian Gow

John Moore, Esq., M.P.

cc: Professor Alan Walters.

NOTE ON JOHN MOORE'S PAPER

I think there is a misconception about the present role of government in credit markets. As he will observe in the recent Bank of England Quarterly, the role of the Bank has changed very considerably over the past 3 or 4 months. MLR has ceased to have any function. It is jokingly called the rate at which the Bank will not lend any money! And this is broadly true. The Bank has done very little business through its Discount Window. It no longer gives any guidance to the market about interest rates. It operates through open market operations. It does not quote prices at which it would buy and sell bills.

Thus during the rapid fall of the pound against the dollar which occurred some three weeks ago, there was an increase in interest rates on three-months and six-months money, and this occurred without any guidance from the Bank whatsoever. Had interest rates shot up very high, then the Bank would have provided assistance by buying bills. But even under these rather exigent circumstances, the market solved its own liquidity problems without any assistance, or at least unusual assistance, from the Bank.

These interim arrangements do provide for an unpublished interest rate band below which and above which the Bank will intervene. But if there is persistent pressure on the markets then the Bank will move that interest rate band either upwards or downwards. In particular they will be moved upwards if there is a tendency for the monetary aggregates to overrun their target values, and downwards if they are undershooting. This movement will not be done automatically and in a knee-jerk fashion. It is intended that the movement of the bands take account of the need to achieve the appropriate monetary targets in a relatively long run, round about a year.

Ultimately, it is anticipated that the bands will be widened until they are irrelevant and all the Bank's operations will be in the open market, primarily in the bill market, and the criteria will be simply the appropriate monetary aggregates.

/Now to turn

Now, to turn to the long end of the market, the intervention of Government here is primarily through their demand for credit in terms of sales of gilt-edged securities. It is primarily through the demand for Government finance that the authorities effect this market. Of course, some effects will be transmitted from the short end to the long end. But they are muted and uncertain.

The net result of all this is to argue that primarily interest rates are to be determined by the market. Government operations affect rates at both ends of the market. At the short end they are affected primarily by the Government's supply of cash and reserves to the banking system. In any medium-term period, such as, say, a year, the supply of cash and reserves will be determined by the Government's monetary targets; thus interest rates are determined by the achievement of the monetary targets, at least as far as Government activity is concerned. At the long end they are determined, as far as Government action is concerned, by the PSBR, and of course the impact of changes at the short end and the expectations generated thereby.

Now let me deal with Mr. Moore's particular points.

Government Funding and Lower Interest Rates

I think Mr. Moore is quite right here. He says "increased taxation is more honest than increased borrowing made possible only by rates of interest which impoverish the private sector". I think that the last budget was designed precisely with that in mind. And I believe it has been demonstrably successful. We have lower interest rates than many of our competitors, and lower real interest rates than most of the developed world. But at the long end we are still high, as high as America and indeed higher than Germany. This I am afraid reflects the fact that the market still does not believe that our policies will be successful. On the whole one cannot blame the market; they have been disappointed by every previous Government of the United Kingdom. But as confidence in the policy has grown, so the price of long-dated gilts has increased. It will take us a while yet to earn the confidence of the cynical managers of funds.

/The Exchange Rate

The Exchange Rate

Here again Mr. Moore is substantially correct. It is both existing interest rates and anticipations of the change in foreign exchange rates which determine the exchange rate. What matters is that the rate of return on financial assets should be equalised in terms of whatever currency one chooses. Thus, when we had very high interest rates in 1980 the pound appreciated very rapidly because everyone was anxious to acquire sterling assets and this meant that the pound having been driven to a considerable appreciation, was widely expected only to go one way, down, and it obliged in the first five months of 1981. I think it is important to get the causation right though. Under a system of free exchange rates, it is monetary policy relative to that of ones main trading partners, that determines exchange rates. It is not exchange rates that determine monetary policy, or monetary conditions.

Inflation

I find some difficulty with this part of Mr. Moore's thesis. Supposing that we reduced short-term interest rates by increasing cash and reserves of the banking system. This would inevitably lead to an expansion of the money supply, probably initially the narrow aggregates. Now Mr. Moore is quite right that historically there has been virtually always some expansion of production as a consequence of an increase in the rate of growth in the money supply. But that increase in production has taken place only for a few months then production falls back even to below its previous trend value. We are left then with merely the effects of an increased growth in the money supply with, if anything, a lower level of production, and so we go through the dreary cycle of inflation and stagnation. Over the past historical record we have seen that the stimulus to production has become smaller and smaller. I suspect that with present expectations the effects on real output would be small, and the effect on inflation large. You can see these effects working in the last two expansionary periods in the United Kingdom, in 1971-73 and in 1977-78. In both cases there was some increase in output and in employment. But again both of them saw a sharp fall in output, an increase in unemployment and yet another twist in the inflationary spiral.

/Furthermore,

Furthermore, as the inflation gets under way, or strictly as expectations of inflation become ingrained in people's consciousness, then interest rates will rise even higher than they were before the monetary expansion took place. This again is the sad story which has been repeated over and over again since the 1950s.

I do not share Mr. Moore's belief that most businessmen do not take a sophisticated view of real interest rates. My experience in a large number of economies is that businessmen and indeed ordinary small investors are much influenced by the real interest rate and are not fooled by any money illusion. In some economies I have seen interest rates in more than 100% and with almost as high rates of inflation. However, Mr. Moore is perfectly correct in saying that businessmen will not take out credit for which they have no use. What will deter the demand for credit is the lack of an outlet for profitable use of those funds - which is reflected nowadays in the very low rate of return on real assets. The explanations for this low rate of return are, of course, many; trade union practices, planning restrictions, government regulations, local authority rates, etc.

Property Boom

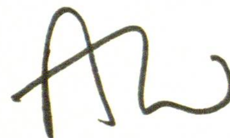
Again I think that Mr. Moore is right that to a large degree the property boom was stimulated by the laxity of the monetary authorities. But I would also argue that it was generated by the profligacy of the Heath government in first expanding the rate of the growth of the money supply which was less than 9% before September 1971 and after that never less than 20%, sometimes over 30% until 1973. This was also to some extent a consequence of the dirigiste policy of the Heath government in keeping down artificially the rates of interest. And that should be a lesson to us all.

I do not share Mr. Moore's enthusiasm for limiting the mortgage relief only to the standard rate. This is a very complicated matter since it links up with all the chaotic absurdities of the housing market, with its regulations and rigidities. Perhaps this subject is best left to a later discussion.

/Conclusion

Conclusion

I believe that our objective should be to get the money supply right and government borrowing right, and then leave interest rates to be determined by the market. If we are on course with our money supply and our government borrowing, then interest rates can be left to look after themselves. Furthermore, that enormously important factor expectations and confidence will be working with us rather than against us.



19 June 1981

ALAN WALTERS

MOORE, M.P.

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

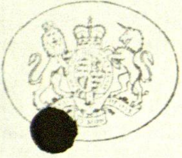
There is general agreement that reducing interest rates would stimulate economic growth by encouraging productive investment. Yet the Government hesitates to reduce them because of a mistaken belief that the action would:
1) be inflationary 2) hurt the exchange rate
3) make it more difficult to fund 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 <u>80 per cent</u> 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:

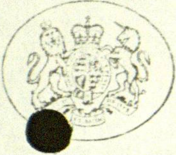
Effect on funding Government debt The first question that arises, then, about a proposal to cut interest rates is whether the Government would then be able to go on funding its debt. Undeniably, lower interest rates will make gilts less attractive, but what is the elasticity of demand? At what point 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 bouyancy which we often seem to neglect.

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 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.

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 facae 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.

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.

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 5½ million tax-payers 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.

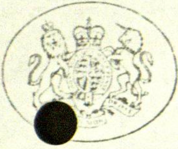
A man in the same position earning £40,000 (therefore receiving relief on his interest at the top rate of 60 per cent) would gain by £400 from a 4% reduction in interest rates. But if at the same time relief at the higher rates were abolished, he would end up £275 a year <u>worse</u> off.

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 bouyancy 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

16/6/1981