From THE RT. HON. SIR KEITH JOSEPH, BT., M.P.

KJ/SMC

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
House of Commons,
Westminster,
S.W.1.

22nd April 1976

Dear Margaret,

I expect you saw the Peter Jay article in The Times last week suggesting that if and when the Sterling crisis comes, the opportunity should be taken to set up a Currency Commission - to lay down statutory guidelines for monetary policy so as to give complete assurance to overseas creditors.

I attach a copy.

I lunched yesterday with William Rees-Mogg who told me that the idea will be part of the policy of The Times and that he very much hopes that we will bear it in mind. He is not suggesting a campaign for it or on it since to do so would make it harder for Labour to adopt it if the need comes.

I am copying this to Geoffrey.

There is no need to reply.

Ever,

Keith.

C.c.Rt.Hon. Sir Geoffrey Howe, Q.C., M.P.

The creation of a Currency Commission could be a corrective to a further serious deterioration of sterling

A solution of the last resort

The pound is a little better. But what if before the summer is out it were once again to become very bad?

What would be called for would be measures which gave sterling holders grounds for confidence in the stability of the pound's value because there really were grounds, not merely pious incantations, for expecting it to be stable. The traditional package of deflationary measures, even i. it were supposed that the present Parliament would accept emergency public expenditure cuts, tax increases, credit restrictions, a pay freeze and the rest, would not powerfully or permanently boost the confidence of those who have seen the same thing already in September, 1957, July, 1961, July, 1965, July, 1966 and December, 1973.

There would naturally be strong pressures instead for siege remedies—import controls and a suspension of convertibility. This is not the place to go over yet again the arguments against believing that such measures could possibly contribute to a policy against inflation. The Chancellor himself made absolutely clear in the Budget speech that he has set his face against such economic isolationism and for strong reasons.

So, is there anything else? Yes, indeed, there is. Let the Government propose, in the circumstances here envisaged or before, the creation by law of a Currency Commission. Let it provide for the appointment by the Crown of, say, seven commissioners for periods of 10 years, terminable only on death, resignation or impeachment by Parliament itself. Let men and women of character, independence and reputation be duly appointed.

Let the commission be required by statute to regulate the growth of the money supply (suitably defined from time to time) so that in no 12-month period does it depart by more than 2 percentage points from the long-term growth in the productive potential of the economy as estimated from time to time either by the commissioners or by a suitably designated advisory body of competent economists appointed by the commission.

sure that monetary growth is matched to long-run real economic growth. Although individual prices will rise and fall against each other and there may even be cyclical periods when prices in general rise or fall, there can be no protracted inflation.

Indeed, there should in general be fewer fluctuations in national output and employment than hitherto, when monetary expansion has followed such an erratic course. Nevertheless, disturbances such as quadrupling of the price of oil will indeed cause periods of recession, as higher oil prices are matched by downward adjustment of other prices; and a large fall in commodity prices would cause a corresponding boom.

In these circumstances—and provided that the permanence of the Currency Commission was credible—there would be no further grounds for speculation against sterling in foreign exchange markets. Indeed, the pound would enjoy much greater confidence than any other currency whose supply was not equally insulated from political manipulation.

There might even be an embarrassingly strong demand for sterling. In that event the strain would be taken partly on the exchange rate and partly on a fall in real interest rates. This would imply an even bigger fall in nominal interest rates because the removal of inflationary expectations would have closed the gap between real and nominal rates. Thus nominal rates of 3 per cent or less might once again become normal.

Because of the cost to the Government of borrowing, even at low rates of interest, in order to supply the Exchange Equalisation Account with sterling to exchange for foreign exchange, there would be a limit on the degree to which the Treasury would wish to intervene to prevent the pound's external value from rising. It might well rise in these circumstances sufficiently to threaten some employment which depended on marginally competitive exports. But it is implicit in the hypothesis that the inflow of capital from abroad would be sufficient

incomes policy would remain as much of a theoretical as well as a practical impossibility as it is now, because of its inability to handle relative pay changes within the framework of a controlled average movement of pay. But at least the social costs and benefits of monopoly in the labour market could then be evaluated by Parliament on their merits without its being any longer falsely supposed that the cost, in terms of lost employment, can be magically removed by inflationary fiscal and monetary policies.

As a result of thus focusing attention on the real causes of unemployment—excessive inflationary expectations by pay negotiators, collective bargaining itself and other structural imperfections in the labour

Peter Jay
Economics Editor

market—a real prospect of restoring high levels of employment within a moderate number of years would open up. It might then— and only then—be possible to reverse the long trend of rising average levels of unemployment from cycle to cycle during the last quarter of a century, although it should be remembered that there is nothing axiomatically wrong with a society deciding to accept rather higher unemployment levels as the price of making better social security provisions for those with low earning potential.

Such a proposition will naturally run into much predictable reflex hostility; and this means that it can be taken seriously by government only in conditions of more acute sterling difficulty and financial crisis than prevail this week. But on examination it is surprising how difficult most existing interests will find it to argue against the proposal.

Trade unionists have no interest in either inflation or unemployment, still less in the chronic interference with free collective bargaining which is

Bank now to be able credibly to take on the functions of the Currency Commission. The day may come again; but for the moment the Bank is neither politically nor in its economic orientation a suitable candidate.

"Old Cambridge" Keynesians will object on the grounds that such a regime would deny the very possibility of conventional postwar fine-tuning, indeed of any kind of active demand-management. They will indeed be right. But that is the price one pays for losing the argument about how the economy works and in particular for failing to provide a satisfactory account of the relationship between unemployment and inflation and so to offer a coherent policy for high employment and price stability in the longer run. Anyway, they have few votes and no sanctions.

The "new Cambridge" Keynesians, in so far as they follow Professor Lord Kaldor's views on monetarism, can hardly object. For he has always argued that it makes no difference what happens to the money supply, which is anyway in his opinion completely beyond the control of the authorities. They can say that the Currency Commission is wasting its time; but they cannot say that it is doing any harm. Indeed, given their enthusiasm for balanced budgets, they should welcome proper debt management; and they will still be as free as now to seek ways of cutting British labour costs and to argue for import controls.

Weaknesses of the NEDC

The *Tribune* group economists have no reason to object to the Currency Commission as such, although they will be entitled to continue to press for the positive policies of import controls and industrial planning in which they believe. It has never been any part of socialist economics that currency manipulation, still less debauchery, has a useful role to play (except in the Machiavellian sense of precipitating the economic

ings perhaps, in which the "representatives" of both sides of industry (the admirable Dr Michael Young of the National Consumers Council dissenting, if recent form is reliable) proclaim their solemn and binding hope that their respective constituencies will do better in future?

In the immortal phrase of my distinguished colleague, Mr Bernard Levin, "Pah!". Neddy's prospectuses are not gilt-edged because there is no mechanism to cause them to be fulfilled; and therefore they have no power to inspire confidence in anybody, however "useful" and well-intentioned the thing may be.

It may be objected to such a scheme that an important economic weapon is being removed from direct democratic control, that it is a disguised attempt to go back to the gold standard and that such automatism is quite unacceptable in this day and age. But it should be remembered that Parliament will create the commission, that it will be accountable—by annual report and testimony to Commons committees—to Parliament, that Parliament can abolish the commission and that under present arrangements Parliament enjoys neither any effective oversight over the Bank of England nor a sound currency.

In some ways the arrangement would be like that which governs the operation of the American Federal Reserve and its Federal Open Market Committee, which determines monetary policy. But in the British case Parliament would have specified in advance a much more stringent monetary rule to govern the commission's operations; and therefore the commission would enjoy less discretion and less freedom to follow different intellectual fashions than the Federal Reserve.

Finally, it should be remembered that the Government and Parliament would retain direct control over government spending and revenue, over the size of the budget deficit, over exchange rate policy and over the wider areas of incomes policy, industrial policy and social policy. All that Parli

resignation or impeachment by Parliament itself. Let men and women of character, independence and reputation be duly appointed.

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Government's cash needs

To accomplish this task let the commission be given absolute authority over the management of government debt, over the setting of required reserve asset ratios to be observed by banks, over calls for special deposits and over the central bank's minimum lending rate. The budget deficit (or surplus), the management of the Exchange Equalisation Account (whereby the pound's foreign exchange value is influenced) and all other economic and financial matters would remain the responsibilities of the Government.

[illegible] mate continuously how much of the Government's net cash needs (for the budget deficit plus refinancing of maturing debt, plus or minus the net sterling transactions of the EEA) should be met from expansion of the money supply within the statutory rule. It would arrange that all cash needs beyond that amount were met by direct borrowing from the public by sale of government bonds at whatever price (and therefore implied rate of interest) the market would bear. Despite the Bank of England's conviction to the contrary there is always such a price, as every barrow boy knows.

The interest on these bonds would remain as now a charge on the taxpayer and would therefore have to be taken fully into account by governments; and the automatic effect of large budget deficits on interest rates and so on investment expenditure by the private sector would normally make deficit financing unattractive.

In these circumstances the Currency Commission can en- again become normal.

Because of the cost to the Government of borrowing, even at low rates of interest, in order to supply the Exchange Equalisation Account with sterling to exchange for foreign exchange, there would be a limit on the degree to which the Treasury would wish to intervene to prevent the pound's external value from rising. It might well rise in these circumstances sufficiently to threaten some employment which depended on marginally competitive exports. But it is implicit in the hypothesis that the inflow of capital from abroad would be sufficient to compensate the losers by way of adjustment assistance, and still leave a net gain in living standards to be enjoyed by the rest of the community.

Much the more important gains from such an arrangement would be domestic, although the immediate and permanent removal of the "sterling" shadow across economic strategy would be no inconsiderable short-term gain. The whole debate about incomes policy would then be put in its proper light.

With the money supply set, as it were, on the auto-pilot to expand at its appropriate non-inflationary long-term rate, it would be quite clear that the only effects of collective bargaining or indeed of any other monopolistic price-setting would be to cause unemployment of men and resources. This is, of [illegible] sent arrangements; but the fact has hitherto been concealed by the illusion that monopolistic pricing and "full employment" sales can be reconciled by sufficient expansion of monetary demand in the manner associated with "Keynesian" demand-management.

It would thus be manifest that pay restraint has to do with preventing unemployment. The fallacy that in some way trade unionists are doing the Government a favour by pay restraint in order to contribute to a government interest in restraining inflation would be exposed. Governments could then ask for pay restraint on a basis of trade unionists' direct self-interest without the necessity for other bribes, constitutional or otherwise, which tend to distort other aspects of economic policy.

There would still remain the basic conflict between collective bargaining and high employment, under non-inflationary conditions; and a permanent [illegible] with low earning potential.

Such a proposition will naturally run into much predictable reflex hostility; and this means that it can be taken seriously by government only in conditions of more acute sterling difficulty and financial crisis than prevail this week. But on examination it is surprising how difficult most existing interests will find it to argue against the proposal.

Trade unionists have no interest in either inflation or unemployment, still less in the chronic interference with free collective bargaining which is maximized under a "Keynesian" regime of steadily mounting (from cycle to cycle) inflation and unemployment. The future of collective bargaining, in the light of its impact on employment, real wages and living standards, would not in any way be prejudged by the creation of the Currency Commission.

The Bank of England will, of course, object to the loss of prerogatives which used to belong to it. But unfortunately too much water has flowed over the dam in the last 25 years for the

the NEDC

The *Tribune* group economists have no reason to object to the Currency Commission as such, although they will be entitled to continue to press for the positive policies of import controls and industrial planning in which they believe. It has never been any part of socialist economics that currency manipulation, still less debauchery, has a useful role to play (except in the Machiavellian sense of precipitating the economic chaos out of which revolution may be more quickly born; and that is not *Tribune* policy).

The proposition can hardly offend the economic liberals among Conservative ranks, not anyway if they have any intellectual integrity, which most of them do. This leaves the Tory Fabians and corporatists and their dwindling band of fellow-thinkers on Labour's right.

But what have they to offer instead in the critical conditions envisaged? The NEDC meeting to end all NEDC meet- [illegible] more stringent monetary rule to govern the commission's operations; and therefore the commission would enjoy less discretion and less freedom to follow different intellectual fashions than the Federal Reserve.

Finally, it should be remembered that the Government and Parliament would retain direct control over government spending and revenue, over the size of the budget deficit, over exchange rate policy and over the wider areas of incomes policy, industrial policy and social policy. All that Parliament would have done would have been to institutionalize a particular monetary policy in the most visible possible way. This is, moreover, a policy which more and more people recognize as, at the very least, a necessary part of any successful policy for containing inflation and restoring prosperity and which would insulate government economic policies from foreign exchange crises in a way that no other acceptable policy could.

It is worth thinking about.