E. R.

5 February 1981

Policy Unit

Chron
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Niehans

PRIME MINISTER

You will not have time to do more than glance at the massive Niehans report* before you see him (hopefully on Friday, 13 February - he is staying over the weekend in London).

I attach, therefore, the summaries of each of the three parts of his paper, retyped for easier reading.

*A full copy of Niehans report will go into the week-end box.

JOHN HOSKYNS

Summary of Part I

The conclusions of part I about the causes of sterling appreciation can be briefly summarized as follows:

(1) North Sea oil was probably not a major factor. To the extent it contributed to the appreciation of sterling, this was not so much through its effect on trade and capital flows than through its effect on the demand for money.

(2) The principal cause of recent sterling appreciation was the abrupt halt in monetary expansion in the spring of 1979.

(3) The effect of monetary contraction on the sterling rate was magnified by exchange-rate overshooting, which must be regarded as a normal concomitant of shifts in monetary policy.

Summary of Part II

Overall, part II led to the following conclusions about the effects of sterling appreciation:

(1) The price effects of overshooting, being only temporary, are rather an undesirable disturbance than a valuable contribution to long-run anti-inflationary policy.

(2) Overshooting, taken by itself, may have a serious, though temporary, effect on output and employment while its effects on trade are generally less clear. If overshooting is the concomitant of domestic monetary restraint, it may be conjectured that it magnifies the real effects of monetary policy.

(3) To the extent this is possible in a simple single-equation approach, empirical estimates for the United Kingdom tend to confirm a considerable influence of real exchange rates on output and also on trade.

Summary of Part III

The appreciation of sterling during the last two years is largely a monetary phenomenon. While monetary aspects of North Sea oil may have contributed, its main cause was progressive monetary restraint, culminating in a complete stop in the growth of the base money supply in the late summer of 1979. A pronounced overvaluation of the currency is a normal concomitant of such a policy.

Monetary restraint is absolutely necessary for the elimination of inflation. Some temporary recession in output and employment is the unavoidable price that has to be paid. However, if the restraint is applied abruptly and the rigidity of wages and prices is high, the recession may be intolerably severe. It is further aggravated by the overshooting of exchange rates. The empirical evidence suggests that this additional effect can be very strong.

In the present situation of the UK economy, monetary policy faces the task of effecting a transition from abrupt restraint to a sustainable path of gradual disinflation combined with a resumption of growth. The strategy proposed in this study can be briefly summarized in the following points:

(1) Money supply targets should be expressed in terms of the monetary base instead of £M_3; as the main policy instrument, the minimum lending rate should be replaced by the supply of base money.

(2) During the first half of 1981, the monetary base should be raised to the level it would have had if it had been permitted to grow at an annual rate of 5-6 per cent since the middle of 1979; from then on, the target range should be slowly lowered to a non-inflationary trend.

(3) If the normalization of the base money supply is not enough to restore competitiveness, the overshooting of the sterling

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rate should be reduced to tolerable proportions (though not necessarily eliminated) by a temporary exchange-rate target to be implemented by foreign-exchange purchases, even at the cost of temporary deviations of the monetary base from its target.

The principles of British monetary policy during the last two years were sound. The resolution with which they were applied is admirable. The people understand that the price of noninflationary growth is a temporary recession and they are willing to pay the price. The early decline in inflation has justified and even exceeded their expectation.

The implementation of those principles, however, is in urgent need of improvement. If the present rigidity of monetary policy is maintained, there is a serious danger that the principles themselves may be irreparably compromised. The consequence would be a tragic relapse into inflation. The sacrifices would have been in vain.

Such improvements are proposed in this study. They grew out of the experience of central bankers and the progress of economics during a period of rapid evolution in the field of monetary policy. The proposed measures do not guarantee success; decision-making is inherently risky and there will be doubts, warnings and controversies. I believe, however, that in the present situation the risk of doing nothing would be much greater. I am also confident that the proposed measures could put the British economy on a sustainable path of declining domestic inflation and expanding output within three months. I am convinced finally that these measures, if properly explained, will command wide support.