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MRS THATCHER

The Chancellor's Package

You may find the following quick reactions to the package of some interest.

Reasons for sterling's decline

In the supplementaries after the Chancellor's statement yesterday he made some interesting remarks about the move of funds out of sterling in recent months. In Cols. 922-923 he argues that leads and lags on commercial transactions and invisibles were, by implication, responsible for getting on for half of the exchange loss, and movements out of non-resident sterling accounts for another quarter. When the contribution to the current account deficit is added this leaves only a small proportion of the total outflow to be explained in terms of withdrawals of reserves by overseas governments. I have today heard from a good source that the Bank of England's under-the-table guidance is very much on these lines too, as one would expect. It was emphasised that official movements of sterling are small and only amounting to perhaps a few hundred million pounds.

This does not, of course, mean that there will be no further moves out of sterling by anxious foreign governments in the months to come. As some newspapers have pointed out, the fact that the price of sterling has effectively been guaranteed for a while at (probably) a rather higher rate than has prevailed recently means that substantial withdrawals can take place in the confident expectation that the rate will be maintained rather than pushed down as would normally happen in the thin markets that have prevailed recently.

Leads and lags on visible and invisible trade are normally assumed to unwind themselves fairly swiftly. The hidden premise is that one is starting from a position of normality to which a return is inevitable in due course. Gordon Pepper is arguing that this premise is incorrect. His reasoning is as follows.

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During the liquidity crisis of 1974 and 1975 companies were desperately short of cash for their British operations and all those that could do so repatriated profits, delayed paying for imports and insisted on early payment for exports in order to improve their cash flow. With the recent improvement in their cash flow and the lull before the financing of economic recovery makes substantial financial demands, liquid assets are accumulating. Companies are naturally reversing the leads and lags which were wound up in the last two years and sending back to their overseas operations the money which they temporarily hauled in. It is not obvious that they will wish to change their current disposition of liquidity even though the sterling rate may now be stabilised for a while.

Has sterling been undervalued?

Pepper is inclined to see this process in fairly general terms. The improvement in companies' financial position is the counterpart in Flows of Funds terms of the Government's budget deficit. Liquidity is being supplied domestically for which there is no great demand and normal market pressures are inducing its investment overseas.

It follows that there is nothing irrational or inexplicable about the fall in sterling in recent months to levels below those which the trade account would dictate any more than there was anything foolish about the over-valuation of sterling during 1974 when inflation was roaring ahead.

Pepper's argument is in a sense a special case of the general proposition that supply and demand for sterling internationally is determined by several quite separate economic processes. Quite apart from the normal transactions on the current account - exports and imports of goods and services - people are buying and selling pounds and financial assets and the criteria for their doing so will include far more complex and fundamental issues than whether or not the current account is moving at a surplus or deficit.

Adam Ridley

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