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Copies to The Deputy Governor
Mr Fforde
Mr McMahon
Mr Dow
Mr Blunden
The Chief Cashier o/e
Mr George
Mr Walker

116

TELEPHONE
01-601 4444

BANK OF ENGLAND
LONDON EC2R 8AH

4th May, 1979.

My dear Chancellor,

I enclose a short paper giving some account of recent developments in the sterling exchange rate and some of the policy issues involved in managing it. You will see from this that we believe that the existence of North Sea oil is likely over the longer term to imply a rather deepseated problem of over-valuation of sterling in some sense, even if in the shorter term the present buoyancy of sterling in the markets is not maintained.

In general there are strict limits on our ability to move the exchange rate to any particular desired level. In the circumstances, however, there is a strong case for significant relaxation of exchange control. On this we have prepared a separate paper outlining a series of proposals which might be implemented at a relatively early date, perhaps at the time of the Budget. I should be glad to let you have this paper and discuss it with you whenever you are ready to receive it.

The enclosed note does not deal with the immediate situation. As I write in the wake of the Conservative victory, the rate is $2.0750, 67.3 effective. We have over the past month somewhat changed our tactics in the markets and have been intervening relatively little. This was partly to reduce the possibility of very heavy inflows, not least during the election campaign; but it also reflected a feeling that our previous tactics had become a little too predictable and that by resisting upward movements we were in danger perhaps of encouraging rather than reducing pressure.

Since the rate has already reached levels which are widely regarded as high, it may be that we shall not see much more buoyancy. In any case I think we should continue to stick to our present line as offering the best chance that any upward movement will blow itself out. If we encountered persistent upward pressure we might have to consider whether to increase our rate of intervention again.

We have considered whether in these circumstances it would be possible to implement immediately some form of exchange control liberalisation, perhaps on an explicitly temporary basis. We have concluded, however, that this would not be a wise course; it would risk looking clumsy or hasty, granted the general expectation that you will be announcing significant measures of relaxation fairly soon; and there is in fact very little scope for useful temporary action. Moreover, the necessity to consider detailed implications, draft and print Notices, etc., means that it is likely to be unwise to introduce significant exchange control relaxations without allowing several weeks before implementation.

There is also the opposite possibility that, either because the markets prove already fairly fully to have discounted a Conservative victory or because of unforeseen developments elsewhere, the rate may come under sharp downward pressure. Here too I would be inclined to let it move fairly freely for several cents; but, if a fall went on, would wish at some point to show some resistance to prevent the risk of a bandwagon effect developing.

I would welcome an early chance to discuss our broad exchange rate strategy. In the light of this I should be able to judge whether our present tactics need any modification to ensure that the strategy is successfully implemented.

Yours sincerely

Gordon Richardson

Ex control
conf section
18/8/79

The Chancellor of the Exchequer.

Exchange Rate Policy

1. Developments in recent years have led to a good deal of scepticism about the possibilities of actively managing an exchange rate, as many governments have tried and failed to resist the force of mobile currency flows. Total scepticism is not justified. The events of November and December last year affecting the dollar showed that at the right moment, and on the back of some more fundamental policy measures, very heavy and concerted intervention can change market expectations and validate, at least for a time, a particular pattern of exchange rates. (Total intervention in support of the dollar in November and December amounted to some $15 billion, virtually all of which has now been reversed.) But this is a long way from fine tuning an exchange rate, or from successfully pushing it up or down and then sustaining it at a desired level.

2. As exchange rates have become harder to control, they appear to have become weaker than was earlier believed in helping to bring about international adjustment, i.e. in affecting trade flows in a way that narrows payments imbalances. Cost and price effects appear to work through many economies relatively quickly - in both directions. As a result the polarisation of countries into strong and weak blocs has been continued. The currency of a fundamentally strong economy - with productivity high and rapidly growing, relatively little inflation and a tendency to external surplus - will tend to appreciate in nominal terms, but the consequences may turn out to be a further improvement in its domestic cost and price structure and so a smaller deterioration in its external competitiveness. A weak economy may on the other hand see a smaller effect from its depreciating currency on its trade, partly because of an exacerbation of its inflation. Thus, despite the considerable exchange rate movements of recent years, the imbalances in world trade are only now showing signs of diminishing.

3. Faced with these facts many countries have recently opted simply for aiming, through appropriate monetary policies and some intervention, at as much exchange rate stability as they could achieve, but with a very real awareness of the limitations of their power. In some cases the exchange rate has been left to move a fair way until it is judged that a point has been reached at which forceful official action can stabilise it: e.g. the US measures of 1st November. An alternative approach, exemplified in the emergence of EMS and the UK's own policies since the beginning of 1977 has been to lean against short run market trends (with both policy measures and intervention) but be prepared in the end to let the rate move if underlying pressures prove too strong.

4. Developments for sterling over the past couple of years illustrate this point. For the first ten months of 1977 fairly continuous upward pressure on sterling was resisted by the authorities with the twin aims of recreating a climate of stability after the violent moves in 1976 and of building up the reserves. These rose from $4 billion to over $20 billion, while sterling was held in the range $1.71-1.77¾, or 61½-62½ in effective terms. By the end of October, however, the pressures had with the dollar's weakness become virtually irresistible and the achievement of the authorities' domestic monetary objectives was being seriously threatened. The rate was therefore allowed to move freely, with intervention confined to minor smoothing operations, and the pound reached a peak of over $1.99 or 67.0 in January. In the spring, and especially after the Budget, there was substantial downward pressure from the markets: after appreciable official support, sterling ended April at around $1.83 or 61.4. For the rest of 1978 the pound moved relatively narrowly between 61 and 64, though as a result of first the marked weakness of the dollar and later its recovery, the dollar rate for sterling moved sharply. It reached a peak of just over $2.10 at the end of October, falling back as far as $1.92 as the US measures of 1st November and subsequent intervention reversed the fall in the dollar generally and ending the year at $2.04 or 64.1. Thus, over two years of great general turbulence in exchange markets, necessarily involving significant movements in the dollar rate for sterling, the rate was held in effective terms, except for relatively brief periods within the range of 61 to 64.

5. This year, however, there has been renewed upward pressure, especially since the revolution in Iran. After initial resistance the authorities decided on 5th April to let the rate move relatively freely again. There was an immediate rise to nearly \$2.11 and 68.0, the highest level for three years. But it soon fell back again; and after various fluctuations during the election campaign, it closed today at \$2.07½ and 67.3 - very much the same level as a month ago when we modified our intervention policy.

6. Even at these levels, however, the present and prospective position of sterling is in some ways unsatisfactory for perhaps two main reasons - one of which is likely to be temporary while the other is more deepseated. At present, exchange markets show a somewhat paradoxical picture with the fundamentally strong currencies - the DM, the Swiss franc and, especially, the yen - all exhibiting signs of weakness while the fundamentally weak currencies (or at least those belonging to countries with high inflation and low productivity) are relatively firm: examples are the dollar, the lira and the pound. The expectations of a period of broad exchange rate stability, which the November-December measures appear to have engendered, have allowed interest-rate differentials to affect capital flows in a way that they are powerless to do when prospects of immediate capital gain dominate exchange markets. Countries with higher inflation rates have tended to have higher interest rates and so attract inflows.

7. This has been especially true of sterling, where interest rates that have been neccessary in the interests of money supply control against a background of a high PSBR and relatively high and perhaps rising inflation, have looked very attractive in international terms. This has been one factor in the relative buoyancy of sterling over the past few months. For how long it will persist is very difficult to predict. The stronger economies are already beginning to raise their own interest rates and re-exert stronger control over their own money supplies. In the US, interest

rates may also rise further, though before too long the likely onset of recession there could limit and then reverse such a movement. In due course, if the recession is at all deep, its effect on the US deficit may substantially strengthen the dollar. The net effect of all these developments is hard to assess. But one may perhaps guess that at some point, if inflation in the UK continues significantly above the average of its competitors and the current account remains in bare balance or even deficit, some downward pressure on sterling will emerge.

8. There is, however, a quite different factor in determining the strength of sterling - more deepseated and likely to prove much more long lasting: the upward pressure from the existence of North Sea oil, a factor which has increased in importance since the Iranian revolution and the subsequent increases in oil prices. This upward pressure is likely to persist and may increase as the value of output from the North Sea rises.

9. The fact that an underlying upward pressure from North Sea oil on the exchange rate is likely to persist does not of course mean that sterling is bound to remain high in absolute terms. Downward pressures from the factors mentioned earlier may outweigh the oil effect. What it means is rather that sterling may become - indeed may already be - "too high". To say this is not to deny the counter-inflationary benefits of a high exchange rate; nor is it to imply that a firm and unambiguous view can be taken of the "right" exchange rate and the "right" degree of competitiveness for British industry. The point is rather that the boost to sterling from favourable market sentiment linked, in particular, to North Sea oil, has produced a rate level that is unlikely to be compatible - save over a fairly short period - with maintenance of even the present viability of parts of non-oil manufacturing. Specifically, a rate higher than would be produced by productivity, cost and price developments in the economy as a whole* is likely in due course to reduce or squeeze out areas of activity that could remain competitive but for the artificial boost to the rate.

*Oil production in the North Sea is of course not entirely separate from the UK economy: it generates some UK employment and activity and has various spillover effects. But economic links with the economy as a whole are very small relative to its balance of payments and public revenue effects.

10. A high exchange rate, whatever its causes, will provide assistance in counter-inflation, both directly through lower import costs and indirectly through the disciplinary effect on wage settlements. But the effect on industry's investment, innovation, export capacity and indeed survival will be different according to whether the high rate comes "organically", at least partly as a consequence of the initial strengths of industry itself, or artificially, when it may be imposed on industries which are inherently weak.

11. It is likely therefore that the UK would be better off with a somewhat lower exchange rate than is likely to emerge if no action is taken to influence it. On the other hand, it is, as was stressed at the outset, extremely difficult to move exchange rates a particular distance in any direction. Stability is a benefit in itself, whatever level is being maintained, and any attempt to move the sterling rate in a world of floating exchange rates could involve unacceptable risks of losing stability. It would, moreover, be a reversal of the appropriate priorities to attempt to modify money supply policies in the interests of the exchange rate in a way different from that demanded by domestic priorities.

12. There is thus in practice likely to be relatively little freedom of manoeuvre. We should emphatically not recommend a course, sometimes suggested, that the exchange rate could be reduced below what it would otherwise be by a more aggressive intervention policy: i.e. actively selling sterling at a time when there was no natural market demand for it. It is something we have never done, because of the dangers of destabilising the exchange rate which such a policy would involve. With a widely used and widely held currency the utmost care must always be exercised in official sales of it - a lesson which the Americans learned the hard way during 1978.

13. However, there are certain possibilities. It is paradoxical in the UK's present circumstances to be maintaining the artificial boost of exchange control, designed for the opposite circumstances in which, by virtue of prolonged weakness in both the current account and the external liquidity position, sterling was judged to be chronically weak. There are many arguments for a more liberal exchange control regime than that operated at present.

In particular, given the difficulties of rapidly stimulating domestic investment, it would seem appropriate to enable at least part of the value of the wasting asset of North Sea oil to be converted into external assets which will yield the UK a return when the oil has run out. But apart from all the broader considerations there is a strong case for relaxation, simply as a potential means of moderating upward pressure on the rate. A separate brief is available with a proposed package of relaxations which could produce, in certain circumstances, a significant outflow of exchange or downward pressure on sterling. It must be emphasised, however, that the effects of exchange control liberalisation on the exchange rate are bound to be uncertain; and, unfortunately, are likely to be less effective when confidence is strongest and more effective when it weakens.

14. A rather different approach to the problem might be sought in due course in joining the intervention mechanism of EMS. It is conceivable that this might make it easier for the authorities to hold the exchange rate at a level judged appropriate, withstanding better both upward and downward pressures. Again, however, this must be very uncertain. If there are strong market pressures in either direction, membership of the EMS regime may greatly complicate domestic monetary management. Thus this step would need very careful consideration and is in any case not recommended for early decision.

15. The conclusion must be that apart from acting structurally on exchange control or a move into a fixed rate regime, which would have other disadvantages, there is little scope for positive action on the exchange rate. The future development of sterling is very difficult to forecast. Whether it strengthens further, or eases from its present position of strength, it could and should be an object of policy to moderate fluctuations, but there are strict limits as to how far one can go in resisting fundamental trends.

4th May 1979.

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TELEPHONE
01-601 4444

BANK OF ENGLAND
LONDON EC2R 8AH

Copies to The Deputy Governor
Mr Fforde 4/7
Mr McMahon
Mr Dow
Mr Blunden
The Chief Cashier o/r
Mr George
Mr Walker
Mr Goodhart.

4th May 1979.

My dear Chancellor

Domestic Monetary Policy

I felt that you would wish to have, even at this very early stage, an indication of the Bank's views on some of the broader questions that have arisen in the past few years concerning the formulation and execution of monetary policy. Accordingly, I enclose a short paper which I should be glad to discuss with you in due course.

That paper does not deal with the immediate situation on which I should now like to comment.

Although no firm figures are yet to hand for the latest month, to mid-April - we expect to have a clearer picture in the course of next week - the present indications are that in the six months since mid-October, the beginning of the present target period, £M3 has grown at an annual rate of 12¾%, that is to say somewhat above the top of our target range. M1, which appears to have risen particularly strongly in the banking month of April, may have risen over the same period at an annual rate of over 15%. And the existing short-term forecasts, which are due to be revised by Bank and Treasury officials early next week, suggest that, without further gilt-edged sales beyond those already secured for May and June through the recent issues of partly-paid stocks, the growth of £M3 may remain above the top of the target range over the next three months.

Among the factors lying behind the recent growth of £M3, there has been the large borrowing requirement of the public sector. But the effect of this has been substantially offset by very heavy sales of government debt outside the banking system, most notably gilt-edged but including heavy sales of Certificates of Tax Deposit in March. So the main counterpart of the expansion in money has been an upsurge in bank lending, which in the three months to mid-March has been running at double the rate of the preceding three months. While some of this acceleration can be explained by the severe winter and by the disputes in industry, and subsequently in the Civil Service, and while there appears to have been some moderation in the growth of bank lending in April, there is evidence from some of the main banks that it also reflects stronger underlying demand for credit.

I draw two conclusions from these developments.

First, we will need to maintain the momentum of gilt-edged sales by bringing a further new issue at the earliest opportunity. As things stand, the calls from the earlier partly-paid issues, net of our purchases of stocks maturing in the autumn, will bring in some £600 million in the current statistical month which ends on 16th May, and perhaps £400 million in June. But on present estimates we need to raise upwards of £500 million more than this if we are to finance a sufficient proportion of the borrowing requirement outside the banking system and bring £M3 growth back within the target range. The market itself, after a sharp and sustained improvement during February and March, has retained a generally firm undertone through the period of the Election campaign; and we would wish to take advantage of this in the period immediately following the Election, particularly if the undertone gets firmer. The Bank's portfolio is effectively devoid of saleable stock. I shall therefore be suggesting to you in the next few days that the Treasury announce at an early date a new issue of partly-paid stock.

My second conclusion is that we should seek to maintain short-term interest rates at about their present level for the time being, and perhaps until the situation can be reassessed in the light of the Budget and of the developing monetary situation, including in particular the course of bank lending. It follows from this conclusion that through our market operations we should lean against any developing downward pressure.

This position may be complicated if upward pressure on the exchange rate becomes stronger. However, in the circumstances in which this may happen it is not clear that such pressure would be moderated to any significant extent by a reduction in domestic interest rates, which would at a later stage encourage the expansion of domestic credit and cast doubt on the new Government's commitment to maintaining monetary control.

I am writing to you separately on the question of exchange rate management.

Yours sincerely

Gordon Richardson

SECRET

PROBLEMS OF MONETARY CONTROL

Consistency

1. Over the past few years the struggle to maintain counter-inflationary monetary control has been a continual one, necessitating frequent changes in interest rates, periodic resort to direct controls over the banking system, and an adaptive policy regarding the aggressive marketing of government debt. The problems encountered have been well illustrated by the various episodes of the past year. In part they reflect the difficult climate in which the monetary authorities have been acting. Inflation, and expectations thereof, often associated with the course of pay settlements, have been high and variable. The government's borrowing requirement has been large, and difficult to contain. Productivity and profitability have been low, with little dynamism in the economy. External disturbances have been frequent. It is to be hoped that this background, including particularly the weight of government borrowing, will lighten as time goes by, and that monetary policy will in turn become easier to conduct. Nonetheless, proper control of the money supply is unlikely to become a simple matter. In part this is because of the definitional ambiguities and behavioural uncertainties of the money supply itself. But it is also due to the conflicts that can and do arise between the monetary goal and other goals.

2. At times, with a combination of correct judgment and good fortune, the authorities are able to steer a course that allows the money supply to grow within its permitted range without this being accompanied by unforeseen, unwelcome, or unacceptable behaviour of either the rate of exchange or the rate of interest. In a less disturbed world, indeed, these three could more usually progress in a mutually consistent fashion. But it is the experience both of the UK and of other countries that this desirable consistency is on occasions upset. For example, developments in other countries may provoke large currency flows across the exchanges which may put undesired pressure on sterling, up or down. If there is heavy official intervention in the exchange market, this may in turn upset the desired course of the domestic money supply, either directly or through otherwise uncovenanted movements in domestic interest rates. This particular conflict may well recur in the period ahead.

3. Likewise the pursuit of a quantitative target for the money supply requires that interest rates be adjusted promptly and sufficiently to that end. But the perceived need for such adjustments may be due to unexpected movements in the money supply attributable to sudden changes in volatile expectations, or to causes difficult to assess accurately in short order, which at the time may well seem unconvincing reasons for prompt action. Yet the adjustments, if nevertheless made, may have direct and unwelcome implications for other areas of policy: for example, industrial investment (and confidence) or housing construction.

4. A familiar response to conflicts of this kind is to seek some direct control over the relevant flows of money and credit, with the aim of achieving the prescribed statistical result for the money supply without so severe a change in interest rates as would otherwise appear to be required. The arguments in favour of imposing direct controls can then seem persuasive and powerful; and in the short run their use may seem successful. But this apparent success, in a monetary system of sophistication and of innovatory skill, is likely to be largely cosmetic in nature. Meanwhile longer term problems of distortion and avoidance accumulate and the further conflict, between the requirements of credit policy on the one hand and of fostering the efficiency of the banking system on the other, grows with time.

5. Reliance on the Supplementary Special Deposits scheme (the 'corset') has already become a habit without, in our judgment, achieving much more than postponement of the need for higher interest rates. But its removal would be difficult so long as the underlying demand for bank loans has not manifestly fallen back and so long as we would have to expect that a burst of monetary growth would follow as the distortions were unwound and as banks sought to forestall, by balance sheet padding, a future reimposition.

6. Experience of the past few years tells us two things. First, these conflicts should not be resolved by a weakening of monetary control. Second, it makes matters more difficult if avoidable imperfections in the system of monetary control remain untreated, or if the significance of movements in the target aggregate is misjudged.

Targeting, Monitoring and Interpreting

7. It is generally accepted that we need first to limit monetary growth and then bring it steadily downwards, as part of a long-term

counter-inflationary strategy. But the statistical definition of 'monetary growth' is not straightforward. There is a range of aggregates and, at least in the short run, their rates of growth frequently diverge, giving different signals for policy purposes. They also diverge in the timing and nature of their response to policy measures, in the stability of their relationships with other economic magnitudes (and hence in their predictability), and in the way they can be associated or linked with such nearby activities as the management of the gilt-edged and foreign exchange markets.

8. Each aggregate has advantages and disadvantages. Our present target aggregate, £M3, certainly has its full share. Thus the conceptual basis for including all domestic bank deposits in 'money', but excluding deposits of similar maturity and ease of use held with non-bank intermediaries, is dubious. It could become even more strained with the establishment of licensed deposit-takers and the continued growth of building societies. Next, the year on year relationship between £M3 and nominal incomes, its velocity, has moved in quite sharply unpredictable ways in the 1970s, so much so that we have not been able to use a demand for money function for £M3, for example, as a guide to target setting. Moreover the course of £M3 from month to month is often erratic and prone to distortion by, for example, large short-term fluctuations in the level of public sector borrowing (often unpredicted), by the often random fluctuations in bank lending to the private sector, by sudden ebbs and flows of foreign exchange, and sometimes by the forestalling or avoidance of the 'corset'. So we have found £M3 difficult, perhaps particularly difficult, to control in the short run. We also find it at times difficult to interpret even when the evidence is clear. What, for example, is the domestic monetary significance of a rise in £M3 due to a speculative shift of multinational funds out of other currencies into sterling? Does it herald, or reflect, changes in the domestic economy or does it merely record a temporary change of residence on the part of funds held for purposes that are quite unaltered?

9. Nevertheless, £M3 as the sum of domestic bank deposits, notes, and coin, appeals to common sense. This is very important for public acceptance of money supply control. The direct linkage between £M3, government borrowing, bank lending, and external flows, also helps in this respect. Moreover other possible target aggregates have their

own drawbacks, and insufficient advantages. Thus we do not advocate either abandoning the £M3 target or making targets out of every indicator.

10. In our view, there is in practice no alternative to making considered judgments on the course of monetary growth by drawing on all the available monetary evidence, month by month. The objective of policy cannot be exhaustively defined in terms of the single, fallible indicator used as the target aggregate. On the basis of other information the authorities might want for a time to override that single indicator. This would have been inadvisable in the early days of published targets, when confidence was low and the credibility of policy was weak. But we have satisfactorily demonstrated our resolve since that time and with careful presentation a degree of justified flexibility should now be manageable. Last autumn, indeed, restrictive policy action was taken even though the target aggregate itself, being distorted, suggested no such thing.

11. Maintaining a degree of justified flexibility will require a continual process of educative communication between the markets and the authorities and between the latter and the body of experts and critics. We are endeavouring to help meet this need through the Quarterly Bulletin, by participation in seminars or conferences, and by close attention to our relations with the Press. The more successful we can be in this, the more likely that attention can become concentrated on the underlying trend of monetary growth instead of overmuch on short-term divergences.

Imperfections of Technique

12. The instrument of control most readily to hand is our general influence over the level of market interest rates, in particular, short-term rates. Changes in these rates, however, have only a slow and uncertain, though after a time probably sizeable, effect on bank lending. They may also have on occasion a perverse effect on £M3 through their effect on external flows. This has meant that short-run control over £M3 has tended to concentrate on the way the government's borrowing requirement is financed and especially on official operations in the gilt-edged market, perhaps excessively so and much more than in other countries.

13. While the record of the monetary authorities in selling gilts outside the banking system, particularly against the unpropitious

background mentioned earlier, has been remarkably good in the 1970's, and while some outside criticism, for instance gibes about the Duke of York, have been superficial and misleading, the use of gilt market operations for short-term monetary control purposes cannot be pressed very far without inducing undesirable instability and tension. This remains the case despite the several innovations of technique that have been developed and despite the measures taken to relieve the burden on the gilt market by increasing the attractiveness of National Savings and of tax anticipation securities (Certificates of Tax Deposit).

14. Confronted with these problems of control, whether they be the stresses in the gilt market or the use of unsatisfactory restrictions on the banks, some commentators have argued that a radical change of method, to what is described as 'monetary base control', would cut us loose from our difficulties. Others concentrate on the problem of government funding and argue either for radical changes in marketing technique or for the indexation of gilt-edged securities.

15. In consultation with H.M.Treasury we have thought long and hard about these suggestions; and indeed we now keep the whole range of our control methods under active and more or less continuous review. A definitive paper on our management of the gilt-edged market has been completed and is due for early publication in the context of its circulation to the Wilson Committee. Likewise a thorough exposition and critique of monetary base control is in an advanced stage of preparation, with the aim of publication in the June issue of our Quarterly Bulletin.

16. These papers do not contain blueprints for successfully terminating all the problems of monetary control. Rather they expose the serious difficulties and disadvantages, as we see them, of several of the proposals that have been pressed and prepare the ground for some improvements to the present arrangements which we would like to suggest at a subsequent stage. Those improvements, together with the approach to the interpretation of the monetary aggregates outlined earlier and, we would hope, a more propitious background, seem to us to be the right way forward.

30th April 1979