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THE GOVERNOR

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31/5

POLICY

Policy is obviously coming under great strain. Some of the criticism comes from those who are sceptical and/or hostile to the whole approach from the start and who want something so radically different (basically protectionism probably) that there is no way of meeting them. Some of the criticism reflects a faint-heartedness of original supporters to a policy who deluded themselves into thinking that inflation could be brought down painlessly and quickly. Obviously it is right to be robust towards such critics. Having been embarked on, the policy must in broad terms be given a reasonable chance to show some success, which we may interpret as continuation until the end of next year.

But there is a strand of criticism which accepts the general thrust of policy as necessary but urges either that it needs supplementing by other measures or that it has become for some reasons "too severe". These criticisms need to be taken seriously both on grounds of substance and because we may be faced with such a ground-swell of protest that modifications of policy occur in any case whether well justified or not.

As regards supplementary measures, it is hard to think of what anyone could mean beyond some form of more explicit or more severe action on incomes. For example, it is beginning to be urged that we need a freeze. It seems to me that it may come to this and that it would be worth doing some work on what might be involved - when it would be imposed; how it would be organised and policed; what other ancillary measures might be appropriate with it; what would be likely to be its effects on exchange rate, interest rates etc; and most important of all, how long it would have to last and how one could conceive with coming out of it. But this is perhaps not

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an immediate question although a freeze should presumably ideally be imposed at the beginning of a wage round, there is still some time before it is likely that this becomes an urgent policy option.

Short of a freeze there is the question of tackling public pay. Here some of the questions are: should there be a norm for pay or should cash limits continue to be relied on? What should in either case the figure be? When should it be announced? What differential complications arise for local authorities and nationalised industries compared with central government? It may be that it is worth trying to get together some views on these questions. It may be that this is relatively urgent and that one might want to announce something by ?July.

There is further the possibility of somehow backing up the monetary policy for the private sector by more governmental explanation and exhortation. It is not clear what can be said on this other than to urge that ministers talk more firmly to employers (and perhaps the trade unions?). But there is perhaps a question as to whether some degree of quantification should be introduced - despite the government's great reluctance to be seen to be sliding towards a norm. Perhaps general statements about the need for some reduction in real wages?

Outside the field of incomes any other measures are probably best considered not as supplementary to the present strategy but as ameliorations of its arguably excess severity.

There is now a strong chorus against the level of interest rates and the exchange rate. Can or should we do anything about either of these?

The calls for lower interest rates may be muted when the May money figures are known, especially since it seems likely that not only will the total increase be large but that it will be characterised by large government borrowing and relatively modest bank lending. This may help to focus commentators on something they have rather overlooked: ie that in terms of any reasonable expectations Government borrowing has been abnormally low for some months and is now bound to move to a much higher level. The trends in bank lending may be seen more clearly as a counterpart of this.

It could still be urged that some limited reduction in interest rates is quite likely compatible with continued adherence to the monetary target and that in any case it would be a risk worth taking to secure a relief on the exchange rate. It would seem to me a dangerous line both because the risks are in fact much greater than commentators suggest (because of the extraordinary difficulty we would have in raising interest rates again later this year if it were necessary) and because there is no guarantee that say a 2% fall in MLR would do much to bring the exchange rate down. Indeed there is plenty of evidence from the past to suggest it might simply whet appetites for more. More fundamentally, there remains the point that interest rates are almost certainly negative in real terms which would suggest that it would be unwise to reduce them on monetary control grounds.

With the exchange rate, however, it is I think not possible to say that it has to be as high as it is as a necessary part of the overall monetary policy. There are the purely exogenous factors - US interest rates and the effects of oil price rises for example - which must surely have meant a higher sterling exchange rate than could legitimately be expected to follow from the nominal interest rates which the domestic monetary policy required. In addition, there is the structural factor of North Sea which, though not new, nevertheless does mean an exchange rate higher for manufacturing industry than policy might otherwise require.

It seems to me that there is a major element of arbitrariness in the level of sterling - as indeed in any exchange rate at any particular time. But at present all factors seem to be conspiring on the upside. It would seem, therefore, quite compatible with full adherence to the general policy stance to wish that the exchange rate were lower. The question then is how to translate the wish into a fact. One method would be lower interest rates - already dismissed above. The other obvious approach would be to abandon our hands-off policy and intervene heavily in an attempt at least to prevent further increases in the rate. The immediate objection of course is that the intervention would tend to swell the money supply. But it can be argued (see CAEG's note on a mixed monetary target/exchange rate objective strategy) that the potential damage to the money supply objectives would be less

certain and less severe from this route than from moving interest rates.

Moreover, it seems to me that though it would represent a major departure from our previous practice, we could take a leaf out of the books of the Swiss and others who have experienced excessively high exchange rates. We could make a public announcement that the exchange rate was too high and that we were going to intervene sufficiently to prevent further rises and (perhaps) to try to bring about some reduction. Such a move might I think produce quite a significant fall in the rate even with unchanged interest rates and without the need for a great deal of intervention. It would need much careful thought. Would there for instance be a risk of beginning another 1976? How would we explain why we were not moving interest rates at the same time? Would we get led into further statements later indicating what we <u>did</u> think was an appropriate exchange rate? But I suggest it is worth thinking about rather seriously, because the problem is so serious.

A possible consequence of perhaps incidental advantage might be that this could be a half-way stage towards entry to EMS which I think may turn out to be a useful option for us in the not-too-distant future.

A final area of "alleviation" is action to help the company sector. I do not go into it here because much has been written about it already and DAW has under consideration everything that would seem likely to help.

Dictated but not seen by
the Deputy Governor

30 May 1980