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MORGAN GRENFELL'S JUNE REVIEW: EXCHANGE RATE POLICY IN THE EIGHTIES

The latest edition of Morgan Grenfell's Economic Review (June 1980) contains a further article by John Forsyth on the ways in which the Government can and should influence the real exchange rate. Many of the themes are familiar from earlier articles, but the issues he raises are important ones which are the subject of continuing work here as well.

Summary

2. Forsyth is disturbed by the dramatic rise in the real exchange rate over the last two years. He argues that the effects on the balance of payments and domestic activity are already clear. In his view, deteriorating competitiveness was responsible for the failure of manufacturing output to respond to the rapid growth in personal consumption in 1978/79, and has been reflected in the sharp erosion in the surplus on trade in manufactures, which in turn has largely offset the improvement in the oil account since end 1976. The authorities have failed to respond, in the mistaken view that an active exchange rate policy would endanger monetary targets. Forsyth argues that even if the rate of monetary growth is given, Governments can and do influence the real exchange rate by the way in which they meet their monetary targets. In recent years, a combination of lax fiscal and tight monetary policies has meant high interest rates, and against the background of rising oil production, this has ensured a sharply rising real exchange rate.

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3. He proposes three remedies:-

i. the Government should move to a tighter fiscal stance within the framework of the medium term financial strategy.

ii. it should be prepared to take "a more pragmatic view" of the monetary target in the near future. Forsyth cites Germany and Switzerland as examples of countries which have overshot their monetary targets in order to avoid what they regarded as an excessive appreciation in their currencies.

iii. Greater use should be made of tax-exempt debt instruments in funding the PSBR, to discourage foreign inflows.

Comment

a. Recent developments

4. The size of the deterioration in competitiveness over the last two years has been unprecedented among major industrial countries, certainly since the War. It is extremely hard to gauge what the consequences will be, if it is not reversed. But we would not accept Forsyth's assertion that the effects are already clear. The change is too recent to have had much effect on trade volumes and output. Indeed the current account may have been somewhat better as a result of the high exchange rate, thanks to the associated improvement in the terms of trade. It is true that a series of industrial disputes have made interpretation of the trade figures rather difficult. Even so, our view is that the failure of domestic manufacturing industry to respond to the sharp upswing in domestic demand, and the resulting deterioration in the manufacturing trade balance, was part of a familiar pattern. It can be explained reasonably well by past relationships which suggest that changes in competitiveness take several years to have their full effect.

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5. High interest rates and North Sea oil do seem to have been important influences on the exchange rate this year and last. But it is worth recalling that the recent strength of sterling took commentators by surprise. As Alan Budd pointed out in his article in the Times on 25 June ("Has international monetarism failed?")relationships established over a longer period between relative money supplies and the exchange rate seem to have broken down - or at least to have been heavily overlaid by other developments, notably the rise in oil prices. Against this background, it is extremely difficult to predict the exchange rate effects of different policies with any reasonable degree of accuracy.

b. A more restrictive fiscal stance

6. We would agree that, all things being equal, lower interest rates would help to reduce the exchange rate. But cutting the PSBR to make room for lower interest rates would itself have an effect on the exchange rate; a more restrictive fiscal policy can be expected to push up the exchange rate. This effect will be especially strong if a low PSBR reinforces the credibility of the Government's Financial Strategy. Whether or not the exchange rate is higher or lower on balance will depend in part of how the PSBR is reduced. Reductions in the PSBR which lead to a large direct improvement in the current account are less likely to reduce the exchange rate than those which have a relatively small impact on the external account, even though in both cases interest rates are likely to be lower. According to this reasoning, the chances of a lower exchange rate are greater if a lower PSBR reflects less Government procurement or direct employment (which have a relatively small effect on trade) than if it reflects lower Government transfers overseas (which will be matched, one for one, by an improvement in the current account). In practice, of course, the choice over the next few years is likely to be between different uses of the revenue from North Sea taxes - but the principle is the same.

7. Forsyth totally neglects the direct effects of fiscal policy on the external account and therefore fails to recognise that the effect on the exchange rate of a tighter fiscal stance within a given money supply is ambiguous. This oversimplification would only be justifiable on the extreme assumption that international capital flows are very highly sensitive to changes in interest rates - and possibly not even then, if the PSBR is an important influence on market expectations. The recent abolition of exchange controls makes it difficult to be categorical on this point. What evidence there is for the 60's and 70's suggests that capital flows were surprisingly insensitive to interest rate changes. But this was never a very reliable finding, and the ending of exchange controls will have increased this sensitivity anyhow. In our view, however, it is unlikely that exchange rates are now dominated by interest rates to the extent needed to validate Forsyth's assumption that a cut in the PSBR would reduce the real exchange rate, regardless of how it was achieved.

c. <u>A more pragmatic approach to the target</u>

8. This suggestion ignores an important theme of current policy, as expressed in the Medium Term Financial Strategy, the hope that monetary targets will influence expectations, thereby reducing the cost of bringing down the rate of inflation. It is clear from the German, and still more the Swiss experience, that what is involved is a willingness to abandon monetary targets in the interests of exchange rate stability - and to accept the risk of higher rate of inflation as a consequence. The reply of the Swiss National Bank to the Select Committee questionnaire is clear on this point:-

> "The Swiss experience indicates that the exchange rate cannot be controlled without losing control over the appropriate monetary target. For this reason, we do not believe that it is feasible to combine in some way monetary and exchange rate targets. The practice of the Swiss National Bank has been to handle monetary targets in a flexible manner. If the foreign exchange market is seriously disrupted - as was the case in the summer of 1978 - we are prepared to abandon temporarily the money stock target and replace it by an exchange rate target."

In the German case, the attempt to hold down the exchange rate in 1978/79 was largely responsible for a rapid rate of monetary growth, well in excess of the target, which has contributed both to strong growth, and to an increase in inflationary pressures over the last 18 months. In any event, this year the Germans have been notably cooler about the advantages of a low real exchange rate.

9. The idea that the money supply could be expanded to accommodate capital inflows without severe inflationary consequences is not intrinsically absurd, but at a time when the Government is trying to squeeze out inflation by restrictive monetary policy it would be a highly dangerous option. The problem is that the authorities have no reliable means of knowing what kind of flows they are accommodating: while the consequences of creaming off purely speculative inflows from non-residents might not be too damaging - always providing steps were also taken to prevent a fall in domestic interest rates, and to mop up excessive bank liquidity - supplying sterling to UK residents in response to domestic cash shortages would sabotage the attempt to reduce inflation.

d. Greater use of tax exempt gilts

10. Forsyth may be exaggerating the effects of inflows into gilts (and non-resident deposits) on the exchange rate, so his suggestion about tax exempt issues, even if practical, may be less important than he thinks. He fails to recognise that, with a floating exchange rate, financing the PSBR by selling gilts to foreigners helps to reduce the money supply. (Increased holdings of gilts by themselves cannot add to the money supply; and in order to pay for them, non-residents must bid sterling away from existing holders if the official reserves are fixed. Since existing holders include UK residents, the result is likely to be some fall in UK bank deposits and hence £M3. This is explained in some detail in an article in the forthcoming Economic Progress Report "Monetary effects of external flows"). If selling gilts to foreigners reduces the money supply, this means that interest rates can be lower for a given monetary target. This in turn will help to limit the extent to which the exchange rate appreciates.

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11. Making gilts deliberately unattractive to foreigners might help to hold down the exchange rate a little: but it might also mean higher domestic interest rates. What Forsyth is proposing would therefore amount to a shift in the emphasis of monetary policy - in effect, he wants to trade off a lower real exchange rate for higher real interest rates. It is not clear how far he recognises this implication.

12. Finally, it is not axiomatic that discouraging foreign inflows into gilts would lead to a corresponding reduction in the demand for sterling. To some extent, foreign interest in gilts may be stimulated by the prospect of capital gains, but it may also reflect a general desire to hold sterling. If gilts become relatively less attractive, non-residents might compensate by investing more heavily in other sterling assets - with correspondingly less effect on the exchange rate.

Conclusion

13. There probably is something in Forsyth's general proposition - even within a fixed monetary target the Government can have some effect on the real exchange rate by the combination of fiscal and monetary policies it selects. But the extent of this influence may be neither very great, nor very certain in direction. The major influences on the exchange rate are likely to remain the monetary target itself, and the credibility of the supporting policies, and, of course, oil and the state of the oil market. Given the strategy outlined in the Financial Statement, the Government's scope for exerting any significant influence on the real exchange rate is likely to be really quite limited.

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RACHEL LOMAX
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