Treasury Chambers, Parliament Street, SWIP 3AG
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PRIME MINISTER

INFLOW CONTROLS

At our meeting on 12 September I referred to the further review I had asked to be undertaken of the case for imposing inflow controls in present circumstances. I now attach a paper setting out the results of this additional analysis as background to our discussion tomorrow. I have had some discussion of it with the Governor of the Bank of England earlier this week.

2. The paper seeks primarily to assess such controls in their own right rather than consider them in a wider context. But I would like to add some more general comments.

3. I start with the Swiss experience, of which the paper gives an account. The central message which I learn from this is that whatever the priorities with which they may have begun, the Swiss became locked into an exchange rate policy: an extensive array of controls, accompanied by heavy intervention. In the end they decided to give the exchange rate priority, and abandon monetary control altogether. I do not think we want to follow them along that road.

4. This lead directly to my second point. We have been struggling since July with the problems caused by a set of controls of our own - the corset. The analogy may not be complete. But the general lesson seems to me quite striking. A control measure was adopted which led to distortions in the market. As so often with controls, the

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direction and extent of the distortions proved impossible to foresee. It was awkward to get rid of it and the problems of interpreting the underlying position are still very much with us.

5. We cannot be altogether certain whether the announcement of inflow controls would put the exchange rate down or up. If the market interpreted the announcement as meaning that the Government now had an exchange rate objective and that we could be expected to take other steps if necessary to enforce it, then the rate might well fall. But we would be regarded as having changed policy, as the Swiss did in 1978. If on the other hand we convinced the market that there was no change in underlying policy and that inflow controls were a temporary bridge to a period when interest rates would come down, then the market might conclude that the fall in interest rates was likely to be deferred for some while. That would tend to put the gilts market down and the exchange rate up.

6. I understand very well the concern which the CPRS expressed at our last meeting about the pressure on industry from the exchange rate. But I do not see inflow controls as offering a secure or an apt way forward. Some of the reasons are reflected in the paper. But in the last analysis - and this is my last point - this sort of device is not simply one that I find philosophically unattractive; it can offer no substitute for the far-reaching changes we need in the economy, notably in the balance between the public and private sector, and in the structure of UK industry (which will inevitably have to come to terms with a higher real exchange rate than in the past because of the fact of our North Sea oil). It is only, in my view, if we can get the public/private sector balance right that the other elements in the situation, including interest rates and the exchange rate, will fall into place.

/7. I am

7. I am sending a copy of this minute and its enclosure to the Governor of the Bank of England and also to Robin Ibbs.

R.I. Tolkien (Private Secretary)
on behalf of

(G.H.)
17 September 1980