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cc: Governor of B/Eng.
CO
CPRS
J. Hoskyns

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From the Private Secretary

18 September 1980

Dear John,

As you know, the Prime Minister held a meeting this morning to discuss the possibility of imposing inflow controls with a view to getting the exchange rate down. The following were present: the Chancellor of the Exchequer, the Financial Secretary, the Governor and the Deputy Governor of the Bank of England, Sir Ken Couzens, Terry Burns, Roger Lavelle, Robin Ibbs and Sir Robert Armstrong. They had before them the Chancellor's minute of 17 September and the note by officials which he had sent over with it.

The Chancellor said that, like the Prime Minister, he was concerned about the adverse effects on industry of the high exchange rate. There was therefore every reason to consider seriously the possible options for getting it down a little. But he had come to the conclusion, after a very careful review, that imposing inflow controls would not be an effective or appropriate response. On philosophical grounds he disliked the idea of mounting an elaborate set of controls; it would immediately give the impression that the Government had embarked upon an exchange rate policy, which would inevitably involve the subordination of its monetary strategy; it was by no means certain that the imposition of controls would have the desired effect - indeed, it could conceivably push the exchange rate up; and having created the apparatus of controls, the Government would be under continued pressure to maintain them. Because of North Sea oil the exchange rate was likely to be uncomfortably high from industry's point of view for a long time to come. Once controls had been introduced, therefore, there would be pressure from industry to continue with them. His own view was that the only secure way of getting the exchange rate down, while sticking to the monetary strategy, was to obtain a fall in interest rates. But this would only happen when the monetary aggregates were seen to be under control, and in particular the Public Sector Borrowing Requirement.

The Prime Minister said that, in contrast to the Treasury paper which suggested zero or negative interest rates on non-resident sterling deposits, she had envisaged merely a differential interest rate. If that approach were adopted, she wondered whether the panoply of controls outlined by the Treasury would be

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necessary. She still felt that the Swiss experience showed that action to restrain inflows could be effective. More generally she found it somewhat ironic that the monetary aggregates were running well above target and yet the exchange rate remained very strong. The failure to control the money supply rather undermined the Treasury's argument that intervention would put the monetary strategy at risk. Nonetheless she was not disposed to any further undermining of the strategy, and was therefore opposed to large scale intervention to get the rate down. If inflow controls would not work, she wanted to know what other measures would.

In discussion, it was argued that whether the authorities were to go for merely a differential interest rate or a zero interest rate on non-resident deposits, the same control instruments would be necessary. As for the Swiss experience, they had moved their exchange rate down mainly through intervention rather than through the effect of the controls which they had imposed. By intervening on the scale they did, they had quite explicitly decided to forget about their monetary targets. On the other hand, it was argued that the high interest rates in the UK compared with other countries did contribute to the high level of the exchange rate; and therefore the imposition of controls might be worth doing - even though the effect would probably be small. Although there were all kinds of difficulties inherent in introducing controls, any advantage to industry from a lower exchange rate should not be lost sight of.

There was then some discussion of the reasons for the high rate of monetary growth so far this year. The Prime Minister said that she was very disturbed by the large month-to-month fluctuations in the borrowing requirement and by the large size of the requirement during the first five months of the financial year, neither of which the Treasury seemed to have foreseen. The monthly fluctuations must make monetary management that much more difficult, and she was concerned that the borrowing requirement for the year might well turn out to be above the budget forecast - particularly given the expectation of a high figure in November.

In conclusion, the Prime Minister said that she was clear that the present exchange rate was too high and that a rate of between $2.20 and $2.30 would be desirable; anything below $2.20 would jeopardise the fight against inflation. She would very much like to see a $2.20 - $2.30 rate achieved, though this should not be at the expense of the monetary strategy. She was still not entirely convinced that inflow controls and differential interest rates could not achieve this objective. She would like to consider this option again with the Chancellor and the Governor in early October, and any other ways which might be available of getting the rate down together with their advantages and disadvantages.

As for the money supply, she would be taking a meeting on monetary policy and controls on 13 October. She would like to have in time for that meeting some further analysis of the borrowing requirement. In particular, she would like to see the monthly profile of borrowing for 1980/81 as forecast at the time of the budget, an analysis of the reasons for any differences between the actual figures so far this year and the forecast,

and the Treasury's latest forecast of the profile for the rest of the year and the Treasury's reasons for thinking this forecast will not be overrun. She would also like to have a note in advance of the meeting on the possibility of withdrawing the Government guarantee from certain borrowing by the nationalised industries and the local authorities with a view to excluding such borrowing from the PSBR: she had in mind in particular borrowing to finance profitable investment.

I am sending a copy of this letter to the Governor of the Bank of England and to Sir Robert Armstrong, and also to Robin Ibbs.

Yours ever,

Tim Lankester.

A. J. Wiggins, Esq.,
H.M. Treasury.