THE GOVERNOR

INFLOW CONTROLS: POSSIBLE LINE TO TAKE

1 Have for some time been concerned about the exchange rate and the damage it was doing industry. Therefore must look kindly on any scheme offering the possibility of easing it.

2 All the evidence suggests that interest rates are the main influence on sterling, at any rate around the present levels. When we can get interest rates down we can probably look for significant fall in the exchange rate.

3 No reason to be doctrinaire against inflow controls - we used them in 1971; many other countries including Germany and Switzerland used them; EEC blesses them; we have explicitly used the need to be prepared to impose them as a justification for attaining the Exchange Control Act.

4 Plan before us involves banning payment of interest on increases in non-resident deposits; banning the transfer of sterling securities to non-residents; controlling resident borrowing of sterling from non-residents and of foreign currency; and controlling the dealing position of banks.

We have powers to do these things and could put them into effect within a week or two.

5 However, cannot be denied that there are the following two major drawbacks:

(a) Commercial bills. Apparently it would need legislation to cover them which presumably means the scheme could not start until late October. Difficult to see how one could start with this loophole open. Non-resident purchases of bills from the discount market is already a common practice and there is a stock of nearly £6 bn bills in existence.

(b) It appears very likely that the operation of the inflow controls package would tend to increase £M3 perhaps by several percent.

There could be a further problem in negotiating with the banks to constitute special non-interest-bearing deposits with us to match those in their books. (A negative interest regime would raise much more serious problems but is probably irrelevant: the Swiss have only used it because their actual interest rates were so low.)

6 If statistical effect on money can be accepted and the legislation taken to cover bills, the scheme should have some rough and ready effect for a while. But it could, of course, only be temporary. Leads and lags of all kinds could quickly provide ways round the controls.

7 The question then has to be answered whether the effect on the rate would actually be positive or negative. If the aim were to offset higher interest rates arising from say a move to monetary base control, very doubtful if these controls would be strong enough to do the job. In any case, it would be utterly against the spirit of monetary base control.

If, on the other hand, the idea is to simply tide us over until it is possible to reduce interest rates there are considerations in both directions. On the one hand, the market could read the move as implying that interest rates would stay up and therefore is bullish. On the other hand the ~~effect~~ fact that the government had made a major policy shift in regarding the exchange rate as a policy variable and had indicated its desire to have it lower, might be bearish.

Very difficult to decide which way things would go [our Dealers think the reaction would be perverse; CWM guesses that it might be in the desired direction].

Tentative conclusion

Favourably disposed to trying something to ease the rate down and the proposed plan might be worth going for on a strictly temporary rough and ready basis. But very much against the spirit of present policies; would create bureaucratic nonsenses and complaints. There is the need for legislation and the effect on the money supply. A better route would be through interest rates. But, of course, interest rates can only come down when the money figures sharply improve or if some satisfactory action on the PSBR were taken.

What about the Germans and the Swiss? First, they appear to have statutory powers to cover all the main aspects of a simple control which we lack. Secondly, their financial systems are much less sophisticated and complex - much fewer banks and institutions, doubtless much less of a commercial bill problem, etc. Thirdly, the main use by the Germans was nearly 10 years ago before floating rates had been fully established and when the general degree of financial sophistication was much less. Fourthly, and very important, while the Swiss and the Germans have operated their inflow devices they have been prepared to intervene heavily at the same time to keep the rate down (between 1971-73, the main period of German controls, they bought $16 bn.) Presumably, because of money supply worries we would not be prepared to do this.

Cwm

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