

Mr Dawkins

MR DAWKINS

Mr Hancock
Mr Britton
Mr Hodges
Mrs Lomax
Mr Riley
Mr Allan
Miss O'Mara
Mr M L Williams
Mr Perfect

At her meeting on 15 September with X - Mr D A Dawkins B/E
The Prime Minister said she would like to see (3 copies)

23.9.80

INFLOW CONTROLS, ETC

I am circulating with this note the draft paper to be discussed at your meeting tomorrow afternoon. You will see there are several loose ends. For example we need a paragraph - possibly a telling one - on the administrative implications of a simple ban on overseas purchases of gilts.

2. More generally, of course, we have yet to benefit from the Banks's views about the merits and likely effectiveness of various kinds of "talking" and minor changes in intervention tactics.

3. I am sending three copies to Mr Dawkins. Could he please pass these on as necessary to others from the Bank who will be attending?

D L C

D L C PERETZ

23 September 1980

MR LAWRENCE

Mr George

Mr Hancock
Mr Britton
Mr Hodges
Mrs Lomax
Mr Riley
Mr Allan
Miss O'Mara
Mr M L Williams
Mr Perfect

Mr Dawkins

Thank you. I imagine this greatly underestimates the steps necessary to effect a ban on gilts. There is also need for some consideration of the monetary effect in the gilt market but from the monetary outflow acts. Perhaps I could be kept in touch please.

Mr D A Dawkins B/E
(3 copies)

I am circulating with this note the draft paper to be discussed at your meeting tomorrow afternoon. You will see there are several loose ends. For example we need a paragraph - possibly a telling one - on the administrative implications of a simple ban on overseas purchases of gilts.

2. More generally, of course, we have yet to benefit from the Banks's views about the merits and likely effectiveness of various kinds of "talking" and minor changes in intervention tactics.

3. I am sending three copies to Mr Dawkins. Could he please pass these on as necessary to others from the Bank who will be attending?

D L C

D L C PERETZ
23 September 1980

EASG 25/9 48

24D 29/9 6

INFLOW CONTROLS AND OTHER OPTIONS FOR REDUCING THE EXCHANGE RATE

Note by the Treasury

Introduction

At her meeting on 18 September with the Chancellor and Governor the Prime Minister said she would like to consider again the possibility of a system of inflow controls and differential interest rates, together with any other ways which might be available of getting the exchange rate down. This note discusses the advantages and disadvantages of two further variants of inflow controls, and then goes on to consider other possible options.

2. The Treasury paper of 17 September set out a possible package of controls, and identified various difficulties likely to arise were such control introduced as a counter to temporary interest rate-induced inflows: the uncertain effect on the exchange rate; the danger of being trapped into further measures; the administrative complications; and the adverse impact on the money supply.

3. More generally, any measure that lowers the exchange will also raise the demand for money and thus put off the time when interest rates can be safely lowered without undermining the monetary strategy. A lower exchange rate implies a higher demand for money because both the general price level and the level of output are likely to be higher. In the short run bank

lending may be reduced because of the favourable impact on profitability in the traded goods sector, but this is likely to be a transient effect which would in practice be accompanied by a reduced incentive to keep wage settlements down. And to offset it a worsening of sentiment in the foreign exchange market may spill over into the gilts market, thus directly adding to the money supply. This is true both of the further variants of inflow controls discussed below, and also of the other options - although some measures would seem likely to have a larger and more direct impact on £M3 than others.

But
 needs
 more
 supply
 later

4. Many of the disadvantages of the complete package of inflow controls would, of course, seem less important were the controls being introduced as a temporary response to some major disruption in the international currency markets. A blunt instrument of this kind might well be an appropriate response, for example, to the effect on sterling of a full scale Middle East war.

7/10 Elizabeth Line
 9/10 C.G.B.A.
 16/10 H/S. & Home
 27/10 Home bank.
 2/10
 13/10
 17/10
 Cabinet Govt.
 Part's Govt.
 P.M. resumed meetings.

PART I: FURTHER OPTIONS FOR INFLOW CONTROLS

Differential Interest Rates for Non-Resident Deposits

5. Our earlier note suggested a simple ban on the payment of interest on additional non-resident bank deposits. The alternative of a differentially lower interest rate for non-resident sterling deposits would discourage interest-induced inflows to a degree depending on the differential chosen but to a lesser extent than an interest ban. It would still need to be supported by the same controls as for an interest ban over the variety of other routes into sterling provided by the London market, even though the pressure to use these would presumably be less than if interest on additional deposits was being wholly prohibited. Unless the banks were to be allowed to profit from the differential, there would also have to be a negotiated scheme for them to make special deposits at the lower rate with the Bank of England. Thus, very much the same difficulties would arise as for an interest ban while the effectiveness in reducing inflows into deposits would presumably be less.

6. A differential rate could be either fixed at a certain level or expressed as a fixed discount on currency market rates. The former would be far simpler for the banks to operate on their customer's accounts and for any scheme of special deposits with the Bank of England. On the other hand it would not allow the banks to discriminate in their interest rates between deposits of different maturity. *Float off.*

7. Compared with an interest ban, there would also be extra problems about the level at which to pitch the differential rate. Whatever figure was chosen would have to be capable of being explained and defended. It could perhaps be set at about the level to which the Government hoped interest rates could be brought down - although it would be presentationally difficult with the danger of appearing to adopt both an interest rate and exchange rate policy. to be at all explicit in that respect. / Alternatively it might be possible to justify some rate higher than zero on the basis of the difference between UK and overseas inflation rates.

A Simple Ban on Non-resident Purchases of Gilts

8. A ban on non-resident purchases of gilts would (on its own) be a fairly modest measure to fend off non-resident demand for sterling and hence hold down the exchange rate. Non resident flows into gilts are, for example, much less than their flows into the banking system (£1.9 billion compared with £3.3 billion respectively over the last year - Annex 1 shows the month by month figures). But such a ban could be presented as a particularly appropriate measure when there was a prospect of a continued fall in UK interest rates, and gilts were likely to be correspondingly attractive because of the prospects of capital gain. If non-residents are free to buy gilts then the effect on the exchange rate of falling interest rates might be somewhat delayed as non-resident purchases of gilts offset to some extent non-resident sales of sterling bank deposits. A ban might help the effect on the exchange rate to feed through quicker, and would prevent non-residents making capital gains at the

expense of the Government or of other UK residents.

9. We would not expect the effects on the exchange rate to be at all large - indeed the effects would be likely to be swamped by small changes in general market sentiment. But the measure might be considered small and self contained enough to reduce (but certainly not to eliminate) the danger of the Government being trapped into reinforcing it with further measures. It could be presented as a very specific measure designed to prevent a surge in inflows into gilts in search of capital gains as interest rates start to come down. Its success could not therefore be measured in a lower exchange rate; the thesis would be that without it the rate would have risen. And since it would be directed at capital gains-induced inflows rather than interest-rate-induced inflows, its success could not be measured by the differential between domestic and eurosterling interest rates either. No such differential would be expected. Although in principle the flows concerned could be diverted into the company debenture market, we think this would be too thin to absorb flows on anything like the scale involved.

10. Despite its very small impact on the exchange rate, this limited measure might thus be thought to have sufficient advantages as a gesture reflecting the Government's concern about the exchange rate. These / ^{would have to be weighed against} the considerable administrative and other difficulties involved even with such a straightforward control, in this case to be borne for a very limited effect.

But what about Local Authorities, Private Sector, Banks, and Money Supply

11. [Paragraph on the administrative arrangements.]

12. [A ban on non-resident purchases of gilts would need a derogation from our obligations under the Treaty of Rome; the 1972 directive on inflow controls does not cover purchases of long-term securities such as gilts. This is potentially a little awkward, but we think we could use our right to take action to prevent disturbances to capital markets to justify imposing a ban on non-resident purchases without prior consultation with the Commission, and could then argue our case for an authorisation on balance of payments grounds. Other Member States would not be likely to raise too many objections.]

Effect on money supply?

① Swain of inflow controls

② Bank Lending to non-residents

③ Tamour of non-resident funds leading to fall in gilt price in other assets.

15. But in the right circumstances a suitable Government consent could cause conditions to be satisfied in a particular way which would otherwise have gone, to give a relatively modest adjustment in the desired direction. There are various possible approaches of this kind that could be used, ranging from the lightest of touches to something more substantial.

PART II - OTHER OPTIONS

13. As mentioned in paragraph 3 above, any measure that succeeds in reducing the exchange rate carries with it dangers for the Government's monetary strategy. But two options seem likely to have a small and less direct impact in this respect than would, for example, major and sustained intervention.

- (a) Statements designed to influence sentiment ("talking" the rate down); and
- (b) a modest change in the Bank dealers' tactics in "smoothing" fluctuations in the exchange rate.

Influencing Market Sentiment

14. Experience in other countries as well as in the UK of attempts to influence the exchange rate by suitable official statements is not very encouraging. Their impact tends to be unpredictable: the market can over-react or ignore them. Much depends on whether a statement is combined with or thought to foreshadow some parallel policy announcement (eg a temporary ban on overseas purchases of gilts).

15. But in the right circumstances a suitable Government comment could cause sentiment to crystallise in a particular way ~~rather~~ than it would otherwise have done, to give a relatively modest adjustment in the desired direction. There are various possible approaches of this kind that could be tried, ranging from the lightest of touches to something more emphatic.

But we must first be sure of what will happen

(i) A temporary avoidance of Ministerial statements about the benefits of a high exchange rate. Although the Government's hands off approach to the exchange rate is generally well understood, there may still be some overseas investors who believe the Government would intervene to support sterling if the rate were to fall, and that there is therefore a floor to the currency risk they are taking. Statements about the benefits of a high exchange rate can be interpreted as support for this belief

(ii) Some Ministerial musing [the Chancellor's Mansion House speech?] about whether the market has given sufficient weight to the temporary nature of some of the factors underlying sterling's present strength. A properly working foreign exchange market should discount factors expected only to be temporary. North Sea oil and the Government's resolve to control inflation are not in question but high interest rates are not expected to remain indefinitely, and private sector capital outflows which have been building up steadily following the ending of exchange controls could well accelerate next year - particularly once sterling interest rates fall - as could overseas borrowing in the sterling market.

(iii) Some general statement that the Government thinks the £ is over valued.

(iv) A firmer statement, indicating perhaps that the Government would like to see a rate of £2.20-£2.30.

16. A statement as strong as (iv) or even perhaps (iii) risks not only over-reaction in the market, but also - were there little or no reaction - subsequent pressure to validate it by market intervention. The last would be interpreted as adopting an exchange rate target. But the first and perhaps also the second approaches above might be worth trying: Even if they had no impact, little would be lost.

Intervention

17. Any acquisition in the market of foreign currency for the reserves or for repaying official foreign currency debt risks adding to the money supply. Substantial intervention is clearly unacceptable. But there is no golden rule that so much intervention is required to achieve so much shift in the exchange rate, and it is certainly possible that some fairly minor change in market tactics by the Bank's dealers could have a noticeable effect.

18. As with talking the rate down it would be important, but not necessarily easy, to steer a course between action that would be widely interpreted as a change in policy - possibly leading to over-reaction in the market - and action not picked up at all by the market, and therefore having little impact on the rate either. Sterling's fall from £2.00 at the beginning of March 1976 to £1.91 by the end of the same month - the beginning of the slide to £1.56 - was sparked by a small amount of positive intervention on 4 March which the market interpreted as a signal that the Government wanted to see a depreciation.

19. In recent months we have been "smoothing" the upward pressure on sterling by taking into the reserves an average around \$200 million a month. Outside commentators have some difficulty in interpreting the monthly reserves figures, and if this "smoothing" were stepped up a bit it would be unlikely to be interpreted widely as a change in policy. But it might nevertheless be possible by a change of tactics to give a low key signal to the technicians in the market that had a modest but not over-large effect on the rate. There are several tactical changes that could be tried:

(a) Some asymmetry in day to day intervention, with less support for the £ on days when the rate comes down than positive intervention when the rate is rising.

(b) Greater use of off-market purchases of foreign currencies. In recent months the Bank have been channelling some requests from their customers (other central banks) to purchase sterling into the market, rather than taking the deals themselves, because of our concern that these transactions were adding to pressures on the money supply. We could temporarily reverse this policy.

(c) Greater use of forward purchases of foreign currency. This has less impact on the money supply than spot intervention, but less impact on the exchange rate too. Its main advantage

is that it can be used to disguise the total amount of intervention undertaken since the size of the Exchange Equalisation Account's forward book is not published.

[(d) A further option would be a more explicit statement that intervention was to be increased temporarily, and some small consequential addition to the money supply accepted, while interest rates remain high and before private sector outflows pick up further - with both the intervention and its effect on the money supply to be reversed once interest rates have come down.]

20. If the result of a shift in tactics on these lines were to add, say, a net \$100 million a month to the amount of "smoothing the Bank dealers undertake this would [on the usual rule of thumb/on recent experience] add under 0.05% a month to monetary growth. The effect on the exchange rate might be correspondingly small: the rate would still effectively be determined by the market. It is arguable whether such modest effects would be worth having, and [except in the case of (d)] the Government could take no credit for them if they did happen. However, it would quickly be clear whether or not the experiment had succeeded; if it had not the costs of failure to the money supply and to the Government's general economic stance would be limited.