Dupes.

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EXCHANGE RATE

In the light of the Prime Minister's explicit wish for a lower exchange rate - albeit qualified by a wish that none of the rest of the policy stance be affected - we need to consider all possible options for achieving this. What follows might serve as a sort of annotated agenda for a discussion to which as many of the addressees of this note are invited as would like to attend. Partly because of the possible new factor of war in the Middle East, partly because almost anything one might do on the exchange rate could have some effects on the general policy stance, and partly to close off as few options as possible at this stage, I am for the moment ignoring the Prime Minister's qualification.

1 Lower interest rates

The point presumably is lower interest rates relative to those abroad. We need to assess:

(a) what will happen to overseas rates in the near future;

(b) the effects of different speeds of reduction (ie how far will a sequence of small falls simply encourage inflows in the short-run?);

(c) what differential needs to be reached to turn the exchange rate round;

(d) how much difference does it make if the exchange rate falls are "appropriate" (ie part of a credible monetary policy) or "inappropriate" (seen as incompatible to a credible monetary policy). What is the danger in either case that an outflow, once started, might be hard to control significantly above, say, $2.00.

2 Intervention

If Middle East factors push the rate sharply up, how effective could intervention be in holding it? What is the possibility that the public adoption of such a stand could in due course lead to a weakening of the rate if the initial emergency passed?

As a sub-variant of intervention, what about forcing the public sector to buy their dollars in the market (I know this has been looked at many times but the situation is now very serious).

Any increase in intervention risks inflating money supply. How serious could this be? How likely that we could argue (or believe) that the inflow would be largely in non-resident deposits?

3 Inflow controls

Should we change our view about the current "package" if there is a threatened surge in sterling on Iran/Iraq factors? Even in the absence of these, would there be any case for the package as part of a wider package of measures on the money supply? (Quite apart from all the leaks etc how seriously would we regard the increase in the M3 numbers which the inflow package is thought likely to produce?)

What do we think about two sub-variants of inflow controls.

(a) Prevention of purchases of gilts by foreigners.

(b) The Prime Minister's "two-tier" interest rates.

Are these variants likely to share most of the disadvantages of the bigger package with the prospect of less benefit?

4 Taxing bank deposit interest

Is there anything in this idea?

5 Talking the rate down

Is it possible to produce any effect between zero and an avalanche from ministerial statements and comments?

6 EMS

Is it conceivable that we could "jump down into EMS"? Ie either with or without interest rate reduction or other measures could one simply announce that we are going into EMS on 6% margins around, say, $2.20? Could one conceivably convince the partners? How vulnerable would we be to massive upward pressure immediately? How damaging would it be to Government stance etc? .

As a variant of the above, could we envisage jumping into EMS if a fall in the rate, once started, threatened to go too far? Would it be impossible to make such a move in a crisis? Or could we help ourselves out of the crisis by beginning to talk of EMS membership and gradually negotiate ourselves in?

7 In the light of the manifest disadvantages of all the above options, and at the same time the manifest disadvantages of continuing with the exchange rate where it is or higher, what should we recommend.

Cwm

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