13

cc Mr Hoskyns
Mr Duguid.

SECRET

Prime Minister

A further plea that we should somehow get the exchange rate down. Grist for the 13 October meeting.

Qa 05145

Has this gone to 1) the Chancellor 2) Terry Burns. MAP

To: PRIME MINISTER

From: J R IBBS

Sterling Exchange Rate

1. In my minute to you on industrial support dated 10 September I suggested that in considering ways in which industry can be helped high priority should be given to finding methods of reducing the exchange rate. I suggested in particular that some system of inflow controls might provide the necessary relief, at least for the period until more permanent improvements could be achieved by a reduction in interest rates.

2. Since then I have attended a meeting in the Treasury on inflow controls and also your meeting on this subject on 18 September. It emerged from these meetings that there was little belief that any system of inflow controls could be relied on to be effective because there would quickly be 'leakage' and there was also anxiety that the effect on the exchange rate might in practice be perverse. I have also made enquiries about the possibility of 'talking' or 'nudging' down the rate but find there is great fear after the experiences in 1976 that if such steps were successful it might be impossible to prevent the rate falling much too far.

3. The process of squeezing inflation out of the economy is bound to be painful for industry and inevitably there will be some casualties. Strong nerves are needed if the policy is to have a fair chance to succeed. However, it is important to prevent excessive damage. Recent contacts I have had with industry have increased my concern that the exchange rate is now doing serious harm to businesses which are basically sound and which the country cannot afford to lose. It is businesses whose prices in export or home markets are set by international competition that are being excessively strained. The loss of competitiveness from the high exchange rate added to the many other pressures that affect industry generally is more than they can reasonably be expected to adjust to. In some of the worst hit sectors businesses are likely to be abandoned entirely. Even where companies persist and trade at a loss the cash flow will be

insufficient to permit investment and proper development of the business. The beneficiaries will be competitors in other countries who are better able to develop and invest and so improve their relative long term competitiveness. I am not referring to marginal businesses that might be regarded as bound to dwindle in due course and therefore as expendable but to ones that but for the strength of the exchange rate would be looked on as efficient and viable by international standards. At present these companies are often holding on to overseas business at little or no profit in the hope of a downturn in the exchange rate. That hope needs to be sustained by significant progress in the desired direction if we are to avoid decisions to pull out of the overseas business and even the abandonment of sectors of industry which are important for the country's long term well-being and whose early demise would create severe social problems in the shorter term.

4. My considered opinion is that some easing of the exchange rate is now not only desirable but essential if excessive damage is to be avoided. You have already asked the Chancellor and the Governor for a further meeting at which control of inward flows or any option for bringing the rate down can be considered. I believe that any further assessment of the options needs to be against the background that by one means or another the rate must be brought down - in my judgement by about 10 per cent.

5. In my previous minute my view was that the time was not ripe for major liquidity easements for industry that would undermine basic economic policy. Provided that some easing of the exchange rate can be achieved this is still my view even though the situation now appears more serious and needs to be monitored very sensitively. There is evidence that stringency is leading to improved attitudes in industry and I would be sorry to see this trend broken.

6. The objection made against proposals for two-tier interest rates is that they cannot be made even partly effective as a means of bringing the exchange rate down without a system of inflow controls or perhaps without a readiness on the part of the monetary authorities to sell sterling (and thus increase the money supply) if necessary in order to hold the rate

down. If they have for these reasons to be regarded as impracticable or unacceptable, it would appear that it is only by means of a significant reduction in the level of interest rates that the exchange rate can be brought down. How large such a reduction would need to be in order to bring about, say, a 10 per cent drop in the exchange rate is hard to say: it would depend on levels of interest rates internationally, and on the psychological effect in the exchange markets of the Government being seen to have decided to take action to reduce the exchange rate. The problem would be to achieve the reduction of interest rates without impairing the monetary strategy or losing the beneficial effects of monetary stringency.

7. Apart from the effects of dismantling the corset, the main factor keeping the increase in money supply at its recent high rate - thus preventing the possibility of a reduction in the level of interest rates - has been the public sector's (and in particular the central Government's) borrowing requirement. It may be that the Treasury's analysis of the figures for the next six months will forecast a reduction of the PSBR which would be consistent with getting back at or near the money supply targets by the end of the financial year. In that case the problem would be primarily a technical one of market management. But even if that were the case, it might not be enough to bring about the change in expectations necessary to bring the exchange rate down.

8. If further action is required to reduce the borrowing requirement, so as to make possible a reduction of interest rates within the monetary strategy, the first choice should clearly be to reduce expenditure. But we face increasing demands for nationalised industry financing, and increasing expenditure on unemployment benefit: it seems unlikely that a significant reduction of public expenditure could be achieved in the necessary timescale. The second choice would be to raise additional revenue by increasing taxation, either direct or indirect. The likely outcome of such moves, both on the exchange rate and in other respects, would obviously need further examination to explore, for example, the effect on the retail price index or possible further depressing of the economy. But this may be the price of achieving a significant reduction of interest rates, and thus a fall in the exchange rate, without compromising the basic strategy.

9. Another possibility that should be examined is whether some additional relief of the pressure on interest rates could be achieved by the temporary introduction of direct controls on bank credit to non-industrial borrowers (mainly the personal sector). I believe this could not be more than a temporary measure since its tendency would be to drive disappointed would-be borrowers away from the banking system to more expensive secondary sources and perhaps directly or indirectly to borrowing overseas. It could also add to the problems of small businesses. Nonetheless, it could provide a measure of temporary relief of the pressure upon interest rates at the centre of the financial system.

10. Once the exchange rate had by some suitable means been brought down sufficiently a decision to enter the European Monetary System might help to assure industry that it was the intention to try to keep the rate at that level - and indeed might actually make it easier to do so. But a move to enter the EMS before the exchange rate had reached an appropriate level would be more likely to be unhelpful than helpful.

11. I realise that if no other way of easing the exchange rate can be found, my belief that the situation in industry will force moves to be made that are in conflict with present strategies is not one that will be welcomed. However, I believe I must draw attention to the situation so that as much time as possible is available for considering ways of overcoming the problem.

12. In brief, the points I am making are:

(a) That the high exchange rate is doing serious damage to sections of industry which the country cannot afford to lose or gravely weaken and which but for the strength of sterling should have considerable ability to survive the general liquidity squeeze which industry is undergoing. This damage should not be allowed to continue for long.

(b) That it is therefore essential (rather than merely desirable) to find a way of bringing the rate down - I suggest by about 10 per cent.

(c) That it is desirable to find a way of doing this that does not undermine basic economic strategy. Possibilities such as inward controls, 'talking' or 'nudging' down need therefore to be looked at against the background that if one of them cannot be made to work then it will be necessary to face more unattractive alternatives.

(d) That if the only way of bringing down the rate is by a significant reduction in interest rates (and if the course of events does not permit this to occur as a normal move within present policies) then again it is desirable to look for a way of achieving this which does minimum damage to the basic strategy. In this context, if significant reduction in public expenditure is not possible within the necessary timescale, additional taxation may be the least damaging course to follow.

(e) That in the extreme the need to avoid massive damage to important otherwise viable businesses may mean that some adjustment of basic policy becomes unavoidable.

13. I am sending a copy of this minute to Sir Robert Armstrong.

2 October 1980